Morgan Lewis

REPORT

CURRENT DEVELOPMENTS IN SEC ENFORCEMENT

FOR PRIVATE FUNDS AND A LOOK AHEAD

2024–2025

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CURRENT DEVELOPMENTS IN SEC ENFORCEMENT FOR PRIVATE FUNDS AND A LOOK AHEAD: 2024–2025

In 2024, private funds continued to be a major focus for the US Securities and Exchange Commission (SEC), with an active docket of enforcement cases and rulemaking efforts. Although we expect 2025 to include a continued emphasis on fraudulent practices by private fund managers, we anticipate that the Division of Enforcement staff will be less inclined to pursue technical violations by private fund managers or aggressively pursue novel cases that could appear to be "rulemaking by enforcement." This is because of significant court decisions in 2024 that curbed much of the SEC's private fund rulemaking agenda under Chairman Gary Gensler, and the change in presidential administration, bringing with it a shift in priorities and a change in enforcement approach. In terms of enforcement, the expectation is that the SEC staff under SEC Chair-nominee Paul Atkins will be less aggressive compared to the staff under his predecessor and instead focused on instances of more egregious misconduct, particularly those involving retail investor harm.

GENERAL ENFORCEMENT STATISTICS

During fiscal year 2024, the Division of Enforcement filed 583 total actions, which is a 26% decline in total enforcement actions compared to fiscal year 2023. Despite this decline, the SEC obtained orders for $8.2 billion in financial remedies, $6.1 billion of which accounted for disgorgement and prejudgment interest, which is the highest amount on record. Approximately $4.5 billion of the $8.2 billion of financial remedies recovered by the Division of Enforcement results from the SEC's jury trial against Terraform Labs and Do Kwon, who were charged with one of the largest securities frauds in US history when they misled cryptocurrency investors prior to the collapse of the stablecoin TerraUSD in 2022.[1]

PRIVATE FUND AREAS OF FOCUS AND A LOOK AHEAD

For the SEC's Division of Enforcement, 2024 included a continued focus on private funds, with enhanced scrutiny on disclosures and adherence by fund managers to their fiduciary obligations.

Looking ahead, we anticipate that the change in the US presidential administration and multiple departures at the SEC will result in a decrease in enforcement activity and more moderate sanctions than those under Chair Gensler. If the prior Trump administration serves as a blueprint, a Commission led by Paul Atkins will seek to expand access to private fund investments, foster innovation and growth while encouraging enhanced transparency and disclosures regarding fees, expenses and conflicts of interest, and focus enforcement resources on private fund managers who engage in deceptive or fraudulent practices against retail investors rather than technical violations.

2024 Regulatory Developments Relating to Private Funds

End of the Private Fund Adviser Rules

Most notably, successful court challenges to the SEC's private fund adviser rules last year mean that the SEC will have fewer tools in its arsenal when it comes to the regulation of private fund managers. However, the SEC, in adopting the rules, focused heavily on its authority to pursue much of the same activity covered by the rules pursuant to its authority under Section 206 of the Advisers Act. Although the end of the Private Fund Adviser Rules will impact how the Division of Enforcement approaches its investigations, the Division of Examinations made clear in its 2025 Examination Priorities[2] that it will continue to focus on issues the SEC attempted to address in that rulemaking, including (1) the adequacy of conflict of interest disclosures, (2) the fairness in calculating and allocating fees and expenses, and (3) compliance with new SEC rules and amendments.

- ***The Private Fund Adviser Rules.*** At the end of 2023, the SEC adopted sweeping changes to the regulation of private fund advisers by adopting the controversial "Private Fund Adviser Rules."[3] As adopted, the regulations significantly increased private fund disclosure requirements, including prohibiting advisers from charging certain fees and limiting preferential terms for certain investors unless explicitly disclosed, in addition to mandating annual private fund audits and prohibiting liability disclaimers in fund agreements. For more information, see our previously published LawFlash.
- ***The Fifth Circuit's Decision.*** Not surprisingly, the Private Fund Adviser Rules attracted an immediate challenge by the National Association of Private Fund Managers, and on June 5, 2024, the US Court of Appeals for the Fifth Circuit fully vacated the rules, including all five new rules and the amendments to Rules 206(4)-7 and 204-2 of the Investment Advisers Act of 1940, as amended (Advisers Act). The court found that the SEC exceeded its statutory authority in relying on Section 913 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and Sections 211(h) and 206(4) of the Advisers Act to promulgate regulations for private fund advisers.[4] This was a welcome result for many private fund managers who had been preparing for months to comply with the complex and burdensome set of requirements. For more information, see our previously published LawFlash.

The Fifth Circuit's decision will limit in some respect the SEC's toolkit in its approach in both the examination and enforcement of private fund managers, but private funds likely will remain a stated priority of the SEC's Division of Examinations for 2025, especially as it relates to two important issues the Private Fund Adviser Rules attempted to address:

- ***Fiduciary Duty Obligations.*** In the Adopting Release of the Private Fund Adviser Rules, the SEC made clear that private fund advisers must continue to adhere to existing fiduciary obligations, including acting in their clients' best interest, not subordinating their clients' interests to their own, and complying with their duties of loyalty and care. Although the explicit requirements imposed by the vacated rules relating to how a private fund adviser meets those obligations no longer apply,[5] the Division of Examinations has made clear that the SEC will continue to focus on private fund managers' fiduciary obligations. Among other things, the Division of Examinations intends to scrutinize whether a private fund managers' disclosures are consistent with actual practices, whether fiduciary obligations were met in times of market volatility, and the accuracy of fee calculations and allocations among investors. For this reason, the Private Fund Adviser Rules could have a lasting influence on market practices, serving as instructive guidelines as private fund managers navigate interpretive issues under the Advisers Act.
- ***Disclosure of Conflicts of Interest.*** Adequate disclosure of conflicts of interest was a main tenet of the Private Fund Adviser Rules as well as a priority of the Division of Enforcement in 2024. Despite the rule being vacated, the SEC will still monitor how private fund managers disclose conflicts of interests and risks, including whether managers maintain adequate policies and procedures regarding those disclosures and what action managers take to mitigate conflicts of interest, whether private fund managers provide preferential treatment and specialized terms to investors, the level of detail included in periodic statements to investors, how managers charge fees and allocate expenses, and whether private fund managers attempt to limit liability, for example through hedge clauses, as part of fund agreements. Although an Atkins-led SEC will likely invite more retail investor participation in the private fund market, there will likely also be an emphasis on the importance of investor protection and the prevention of investor fraud.

SEC's Dealer Rule Vacated

In 2024, the SEC's Dealer Rule was also vacated in a challenge brought by the National Association of Private Fund Managers. The Dealer Rule attempted to expand the definition of a "dealer" or "government securities dealer" to include any person that "engages in a regular pattern of buying and selling securities (or government securities) that has the effect of providing liquidity to other market participants."[6] The rule also did not provide any carveouts for private funds engaged in this activity, particularly those funds who engage in proprietary trading, market-making activities, or frequent buying and selling of securities. For more information, see our previously published LawFlash.

In vacating the rule, the US District Court for the Northern District of Texas found that the SEC exceeded its statutory authority by expanding the definition of "dealer" in a manner inconsistent with the text, history, and structure of the Securities Exchange Act of 1934, as amended (Exchange Act).[7] The District Court's decision was also a welcome result for private fund managers who would potentially be caught in the crosshairs of needing to register as a "dealer" solely because the fund's trading activity met the newly expanded definition. Further, the rule would have increased the cost and regulatory burden on private fund managers who would have needed to maintain higher capital, implement an additional compliance program, and potentially change their investment strategies if they wanted to avoid "dealer" status altogether.

On January 17, 2025, the SEC appealed both of its "Dealer Rule" losses in the Northern District of Texas.[8] While it remains to be seen whether the new SEC administration will withdraw these appeals, it may be a possibility once Chair-nominee Atkins is confirmed. Nonetheless, the SEC may continue to examine activities that may trigger "dealer" status, so private fund managers may want to consider whether their investment strategies and trading activities could be interpreted as dealer-like under existing regulations. This is particularly true as the SEC has pursued and prevailed in enforcement actions alleging that high-frequency traders were "dealers" under the plain meaning of Section 15.[9]

Amendments to Form PF

On February 8, 2024, the SEC and Commodity Futures Trading Commission (CFTC) voted to adopt amendments that will impact the required reporting for SEC-registered investment advisers that file on Form PF (Form PF Amendments). Among other requirements, the Form PF Amendments enhance reporting by private fund advisers regarding private funds' operations and strategies. This includes requiring private fund managers to look through certain types of fund structures and report information about the fund structures on a disaggregated basis. For example, advisers will be required to report information about master-feeder funds, parallel funds, trading vehicles, and relationships with counterparties and relevant parties involved in a fund's structure.[10] The main goals of the Form PF Amendments are to improve the SEC and CFTC's ability to monitor systemic risk, bolster the SEC's examination program and support investor protection efforts. The compliance date for these Form PF Amendments is June 12, 2025. For more information, see our previously published LawFlash.

Compliance with the Form PF Amendments was announced as one of the Division of Examination' priorities for FY 2025, and compliance with existing filing requirements by private fund advisers was also a priority for the Division of Enforcement staff in 2024. This is evidenced by administrative proceedings brought against seven private fund advisers on December 13, 2024 for failing to file annual reports on the current Form PF.[11] The SEC's orders found that the advisers violated the reporting requirements of the Advisers Act, and without admitting or denying the findings, the advisers agreed to cease-and-desist orders, censures, and civil monetary penalties totaling $790,000 in addition to remediating their failures by making the necessary filings. It remains to be seen whether an Atkins-led SEC will pursue similar violations through enforcement actions or take a more measured approach to ensuring compliance with filing requirements and resolve deficiencies through examinations and remediation without formal actions.

2024 Enforcement Actions Involving Private Funds

In addition to the matters noted above, the SEC's Enforcement program pursued a number of actions against private fund managers in 2024 involving disclosure violations, inadequate policies and procedures regarding insider trading, improper hedge clauses, redemption practices, and off-channel communications.

Misleading Statements and Inadequate Disclosures

A regular staple of the SEC's enforcement program are cases involving misleading disclosures or other deceptive practices by advisers to private funds, and 2024 was no exception. The only variation this year was that the SEC pursued most of its disclosure actions under the Marketing Rule, for which the SEC had set a November 2022 compliance date. Since then, the SEC has used the Marketing Rule in multiple sweeps against advisers.

For example, the SEC charged an investment adviser with violations of Section 206(4) of the Advisers Act and Rule 206(4)-1 thereunder (Marketing Rule) for presenting the performance returns of a single investor when advertising the performance of a private fund to its prospective investors.[12] The SEC determined that the advertised performance returns did not constitute fund performance and did not disclose that the single investor's performance at times differed substantially from the overall performance of the fund. The adviser's violations resulted in a penalty of $100,000. The SEC also recently filed a complaint in the Southern District of Florida against another investment adviser for alleged violations of the Marketing Rule, seeking injunctive relief and civil monetary penalties.[13]

In addition to failing to register as an investment adviser despite managing over $150 million in assets, the adviser allegedly violated the Marketing Rule by providing performance data to actual and potential investors on its website and in its marketing materials that included purportedly misleading performance figures. For example, according to the SEC, the investment adviser failed to provide support for or retain documentation reflecting how figures regarding enterprise value growth were calculated and did not disclose whether its enterprise value growth figure was a gross or net number or whether the figure related to all investments or only a specific subset of investments.

Outside of marketing rule violations, and continuing its years-long focus on disclosures regarding expense allocation practices, the SEC charged an investment adviser for failure to follow procedures established in a fund's limited partnership agreements (LPAs) regarding the disclosure of and consent to expenses allocated to private real estate investment funds managed by the adviser for services provided by affiliates of the company.[14] In violation of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder, the adviser was alleged to have caused certain funds to incur fees and expenses without providing the required disclosures to the funds' limited partners and obtaining the required approvals from the funds' limited partnership advisory committees (LPACs). As a result, the SEC imposed a $350,000 penalty.

Policies and Procedures Regarding Material Nonpublic Information and Insider Trading

The Division of Enforcement continued to investigate the potential abuse of material nonpublic information (MNPI) in FY 2024, bringing a number of cases charging private fund advisers with failing to maintain adequate MNPI policies and procedures.

In late December 2023, the SEC announced settled charges against a registered investment adviser for failing to maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI. The firm's policies prohibited disclosure of MNPI "except as may be necessary for legitimate business purposes." The SEC determined that, from 2019 through 2022, senior personnel repeatedly violated these policies when they sent emails to current and potential investors, as well as industry contacts, that unnecessarily disclosed M&A-related MNPI relating to US and foreign-listed public companies. The adviser agreed to pay a $4 million civil penalty.[15]

In August 2024, the SEC announced settled charges against a registered investment adviser for allegedly failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI through its trading of collateralized loan obligations (CLOs). After an incident in July 2019, the firm began conducting compliance reviews of the potential impact of MNPI in its CLOs, but according to the SEC did not establish any written policies or procedures aimed at preventing the misuse of MNPI until June 2024. As a result of such failures, the firm agreed to pay a $1.8 million civil penalty.[16]

In September 2024, the SEC announced settled charges against a registered investment adviser on the same grounds. According to the SEC's order, the firm invested in distressed corporate bonds and other similar debt, and due to the nature of this business, the adviser regularly attended ad hoc committee meetings of creditors for issuers in distress. Ad hoc committees are self-formed by the creditors of a company in financial distress, often to negotiate restructuring terms with the company. By its nature, ad hoc committees grant members access to the debtor's MNPI. Although the firm had written policies and procedures in place relating to MNPI, the SEC determined that these were insufficient to address the risks arising from participating in ad hoc creditors' committees. The advisor agreed to pay a $1.5 million civil penalty resulting from these insufficient MNPI policies and procedures.[17]

In late December 2024, the SEC charged an investment adviser with similar failings to establish policies and procedures around the use of MNPI.[18] According to the SEC's complaint, one of the investment adviser's core strategies was to invest in distressed companies. As part of this strategy, the SEC alleges, one of the adviser's consultants sat on an ad hoc creditors' committee in connection with the restructuring of Puerto Rico's defaulted municipal bonds. At the same time, the consultant allegedly received MNPI from a related confidential mediation. According to the complaint, the consultant had more than 500 calls with the adviser's public trading desk that did not involve the adviser's compliance department, creating a risk that the adviser may have misused information from the mediation in connection with its trading of Puerto Rico bonds. The case is proceeding in litigation.

Although it is possible that an Atkins-led SEC will cut back on these cases given the inevitable second-guessing of policies and procedures they involve, particularly where no insider trading is alleged to have occurred, where the deficient procedures result from bad faith or a disregard of regulatory requirements or known risks, we can expect to continue to see enforcement scrutiny and action.

Custody Rule and Preferential Redemption

In September 2024, the SEC announced settled charges against a former registered investment adviser to a private fund that primarily invested in cryptoassets.[19] The SEC determined that the firm violated the Custody Rule when it failed to ensure that a qualified custodian maintained certain cryptoasset securities. The SEC also found that the former adviser misled investors regarding the notice period required for cryptoasset redemptions. Specifically, the SEC alleged that certain investors were informed that redemptions required at least five business days' notice before month-end while other investors were able to redeem with shorter notice. Without admitting or denying the allegations, the firm agreed to pay a civil penalty of $225,000 to be distributed to the harmed investors of its fund.

That same month, the SEC also settled charges against an adviser to private funds in connection with the financial statement audits of private funds that the adviser advised.[20] In that case, the SEC charged the adviser with failing to distribute annual audited financial statements to investors in private funds in a timely manner. One year, a fund was liquidated, but no audit was performed, causing no financial statements to be prepared or delivered to investors. For other funds during the relevant period, financial statements were not delivered to investors until 333 to 1,064 days after the respective fund's fiscal year end. The adviser's violations resulted in a $65,000 penalty.

The Custody Rule remains an important component of the SEC's investor protection toolkit, and we expect that the new SEC administration will continue to ensure that advisers adhere to the rule's requirements,

although this issue may be addressed in an exam deficiency as opposed to an enforcement action under the new administration.

Off Channel Communications Sweep Cases

The SEC has continued to charge private fund managers, investment advisers, and other registrants for recordkeeping failures. For example, on September 24, 2024, the SEC announced charges against a dozen firms for failures to maintain and preserve off-channel communications on personal devices.[21] For one investment adviser firm in particular, the SEC determined that while it maintained policies and procedures designed to ensure the retention of off-channel messages, it failed to ensure that these policies were being followed. Examples of impermissible off channel communications included texts about the buying and selling of securities and discussions of the firm's investment strategy with respect to certain securities and trades. The adviser agreed to pay a civil penalty of $2 million.

In the last days of the Gensler administration, the SEC charged nine additional private fund advisers with failing to maintain and preserve text messages and other business communications on personal devices.[22] Under the settlements announced on January 13, 2025, these advisers paid penalties ranging from $600,000 to $12,000,000. These settlements were noteworthy in that they did not involve a requirement to maintain an independent compliance consultant as had been the practice in prior SEC settlements on this issue.

Looking forward, we expect that the SEC will ease its focus on these cases over the coming year, as they have come under intense criticism from the Republican members of the SEC.

Impermissible Limitation of Liability Clauses

Limitation of liability clauses in both investment management and limited partnership agreements continued to be a focus of both the Divisions of Examinations and Enforcement.

The SEC charged an investment adviser that worked with both retail clients and private funds for using liability disclaimer language that contained misleading statements regarding the scope of unwaivable fiduciary duties in violation of Section 206(2) of the Advisers Act.[23] According to the SEC, this hedge clause could have caused a client to incorrectly believe that they had waived a non-waivable cause of action against the adviser under state or federal law. This was the first hedge clause case involving a private fund and we believe the involvement of retail clients was likely a primary motivating factor in the SEC instituting the action. Such provisions often receive scrutiny from SEC examiners, and we expect that scrutiny to continue although it is an open question whether an Atkins-led SEC will bring enforcement actions in this area.

Whistleblower Protections

Although there were no Rule 21F-17[24] cases (whistleblower protection cases) against private fund advisers in FY 2024, this was an area of focus in FY 2024 and the SEC brought at least 11 enforcement actions alleging that entities had impeded the ability of their employees or others to report potential securities law violations to the SEC. The total number of 2024 cases were more than in any prior fiscal year and twice the amount that the agency brought in FY 2023, including one action that included an $18 million civil penalty, the record for a standalone violation of the whistleblower protection rule.[25]

Although we expect the new SEC administration to be more selective in bringing these cases, and will perhaps provide more leeway to advisers in protecting their confidential information without running afoul of Rule 21F-17, private fund managers should continue to ensure that their settlement agreements, employment agreements, customer agreements, and even employee handbooks, manuals, and internal policies do not contain any perceived impediment to reporting potential securities law violations directly to the SEC.

2025 Examination Priorities and Enforcement Predictions

2025 Examination Priorities

On October 21, 2024, the SEC Division of Examinations announced its 2025 Priorities. The 2025 Priorities are similar to the 2024 priorities in that they reaffirm the Division's continued focus on registered investment advisers' adherence to fiduciary standards and compliance obligations and on monitoring broker-dealers and their obligations under Regulation Best Interest. As discussed further below, the Division remains focused on monitoring the use of emerging technology and new assets.

As it relates to private funds specifically, the Division of Examinations will continue its focus on advisers to private funds through its review of (1) whether private fund disclosures are consistent with advisers' actual practices, that fiduciary obligations are met during periods of market volatility, and whether private funds are exposed to risks related to interest rate fluctuations; (2) the accuracy of fee and expense calculations and allocations and disclosures thereof; (3) disclosure of risks and conflicts of interest and adequacy of policies and procedures; and (4) compliance with SEC rules, such as the Marketing Rule and recently adopted amendments to Form PF. In its 2025 Priorities, and previously in the 2024 Priorities, the SEC noted that special focus may be given on examining advisers to private funds showing poor performance, significant withdrawals, higher leverage, or difficult-to-value assets.

2025 Enforcement Predictions

Given the new presidential administration and changes in SEC leadership, enforcement trends may shift away from cases that "regulate by enforcement," seeing less novel interpretations of securities law violations and a more measured approach to disgorgement and monetary penalties. If the prior Trump administration will be any indication, we can anticipate fewer enforcement actions against private fund advisers, an increased focus on cases involving retail investor harm and market fraud, and more reasonable monetary penalties than we have seen under the Biden administration and Gensler-led SEC.

This prediction is further enforced by the statements that Paul Atkins has made in the past. SEC Chair-nominee Atkins previously served as a commissioner at the SEC from 2002 to 2008. During his prior tenure, Atkins was an outspoken critic of imposing civil penalties on public companies, citing the fact that those penalties ultimately harm shareholders. He also has been vocal about how aggressive rulemaking only serves to increase costs for firms due to "disclosure overload," which was cited by former SEC Chair Mary Jo White as "a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant."[26] Since leaving the SEC, Chair-nominee Atkins continued as an influential figure in the financial sector and two current SEC commissioners worked for him during his time as a commissioner. With these like-minded commissioners, Atkins is expected to focus on whittling away at regulations and levying lower civil penalties for securities laws violations more broadly.

While it remains to be seen what SEC Chair-nominee Atkins will prioritize, it is expected that he will have a similar focus to the prior Trump-appointed SEC Chair Jay Clayton, who focused on retail investor protection, promoting access to public markets for small business, expanding opportunities for private fund investments and reducing regulatory burdens in order to encourage market participation and innovation, particularly in the AI and the cryptocurrency sectors. With respect to private funds, we anticipate less regulatory pressure with increased growth and accessibility while balancing investor protection and transparency in the market. A recent meeting of the SEC's investment advisory committee already signaled this trend shift, including an agenda item to discuss ways that retail investors can better access the private fund market. A side effect of this additional retailization of hedge and private equity funds could be a greater enforcement focus on private funds that are open to retail investors and whether advisers to such funds provide those investors with adequate disclosures or favor their institutional investors at the expense of individual investors.

Additionally, Atkins has been a forceful proponent of digital assets and is aligned with the Trump administration's embrace of cryptocurrency. Indeed, on January 21, the SEC acting chair's first press release announced the formation of a new crypto task force dedicated "to developing a comprehensive and clear regulatory framework for crypto assets" and aid the SEC to "draw clear regulatory lines, provide realistic paths to registration, craft sensible disclosure frameworks, and deploy enforcement resources judiciously."[27] The task force will be led by Commissioner Hester Peirce. This shift is likely to be reflected in friendlier approach to innovators in this space, whether that is through rulemaking or favorable resolutions to some of the crypto cases that are currently being litigated in the courts, while limiting enforcement actions to those involving outright fraud.

Areas that may remain a focus under an Atkins-led SEC are the use and disclosure of artificial intelligence (AI). The misuse of AI and "AI washing" claims have been a focus of the SEC under Chair Gensler. For example, in two recent enforcement actions, the SEC charged two investment advisers with making false and misleading statements to retail investors about their use of AI.[28] Earlier this year, an investment adviser was alleged to have made fraudulent claims to investors about its use of AI for a hedge fund that was ultimately never launched.[29] It remains to be seen, but, under Atkins, the SEC is likely to still pursue actions against fraudulent claims regarding the use of AI made to investors more generally, including hedge funds and private equity funds.

CONCLUSION

After four years under an aggressive enforcement and regulatory environment, it is unlikely that an Atkins-led SEC will focus its enforcement and rulemaking tools on private fund managers. In 2025 and the years ahead, advisers to private funds can expect continued scrutiny from SEC examiners, particularly with respect to more traditional issues such as conflicts and expense allocation, as well as developing technologies such as AI, with the most significant potential violations attracting enforcement attention.

CONTACTS

Authors

Frederick L. Block	+1.202.739.5125	fred.block@morganlewis.com
Ivan P. Harris	+1.202.739.5692	ivan.harris@morganlewis.com
L. Felipe Escobedo	+1.617.341.7891	felipe.escobedo@morganlewis.com
Sandra M. Formica	+1.305.415.3052	sandra.formica@morganlewis.com
Audrey Gibson	+1.202.739.5851	audrey.gibson@morganlewis.com
Julia L. Jacovides	+1.215.963.5368	julia.jacovides@morganlewis.com
Caitlin S. Onomastico	+1.412.560.7462	caitlin.onomastico@morganlewis.com

Securities Enforcement Contacts

Boston

Timothy P. Burke	+1.617.951.8620	timothy.burke@morganlewis.com
Thomas J. Hennessey	+1.617.951.8520	thomas.hennessey@morganlewis.com
Matthew C. McDonough	+1.617.951.8840	matthew.mcdonough@morganlewis.com
Jason S. Pinney	+1.617.951.8684	jason.pinney@morganlewis.com
T. Peter R. Pound	+1.617.951.8728	peter.pound@morganlewis.com
Emily E. Renshaw	+1.617.951.8517	emily.renshaw@morganlewis.com

Miami

Ivan P. Harris	+1.305.415.3398	ivan.harris@morganlewis.com

New York

Ariel Gursky	+1.212.309.6205	ariel.gursky@morganlewis.com
Kelly L. Gibson	+1.212.309.6287	kelly.gibson@morganlewis.com
Ben A. Indek	+1.212.309.6109	ben.indek@morganlewis.com
Emily E. Renshaw	+1.212.309.6716	emily.renshaw@morganlewis.com

Philadelphia

G. Jeffrey Boujoukos	+1.215.963.5117	jeff.boujoukos@morganlewis.com
Kelly L. Gibson	+1.215.963.5121	kelly.gibson@morganlewis.com

San Francisco

Joseph E. Floren	+1.415.442.1391	joseph.floren@morganlewis.com
Susan D. Resley	+1.415.442.1351	susan.resley@morganlewis.com
Alyse “Ali” Rivett	+1.415.442.1109	ali.rivett@morganlewis.com

Washington, DC

Frederick L. Block	+1.202.739.5125	fred.block@morganlewis.com
G. Jeffrey Boujoukos	+1.202.739.5283	jeff.boujoukos@morganlewis.com
Ivan P. Harris	+1.202.739.5692	ivan.harris@morganlewis.com
Carolyn Welshhans	+1.202.739.5695	carolyn.welshhans@morganlewis.com

Investment Management Practice

Abu Dhabi

Andrea Dougall	+971.2.697.8815	andrea.dougall@morganlewis.com
William L. Nash III	+971.2.697.8810	william.nash@morganlewis.com

Boston

Marion Giliberti Barish	+1.617.951.8801	marion.barish@morganlewis.com
Katherine Dobson Buckley	+1.617.341.7531	katherine.buckley@morganlewis.com
Lea Anne Copenhefer	+1.617.951.8515	leaanne.copenhefer@morganlewis.com
Richard A. Goldman	+1.617.951.8851	rich.goldman@morganlewis.com
Barry N. Hurwitz	+1.617.951.8267	barry.hurwitz@morganlewis.com
Jeremy B. Kantrowitz	+1.617.951.8458	jeremy.kantrowitz@morganlewis.com
Gerald J. Kehoe	+1.617.341.7840	gerald.kehoe@morganlewis.com
Justine Le	+1.617.341.7589	justine.le@morganlewis.com
Daniel A. Losk	+1.617.341.7783	daniel.losk@morganlewis.com
Paul B. Raymond	+1.617.951.8567	paul.raymond@morganlewis.com
Toby R. Serkin	+1.617.951.8760	toby.serkin@morganlewis.com
Stephen C. Tirrell	+1.617.951.8833	stephen.tirrell@morganlewis.com

Chicago

Stacie Hartman	+1.312.324.1592	stacie.hartman@morganlewis.com
Brian Jacobson	+1.312.324.1793	brian.jacobson@morganlewis.com
Zeke Johnson	+1.312.324.1783	zeke.johnson@morganlewis.com
Patrick Lucke	+1.312.324.1795	patrick.lucke@morganlewis.com

Dallas

Carrie J. Rief	+1.214.466.4159	carrie.rief@morganlewis.com

Dubai

Carolyn J.D. Abram	+971.4.312.1970	carolyn.abram@morganlewis.com
Alishia K. Sullivan	+971.4.312.1945	alishia.sullivan@morganlewis.com

Hartford

Mark F. Parise	+1.860.240.2551	mark.parise@morganlewis.com

Hong Kong

Alice Huang	+852.3551.8618	alice.huang@morganlewis.com

London

Ted Craig	+44.20.3201.5431	ted.craig@morganlewis.com
Simon Currie	+44.20.3201.5644	simon.currie@morganlewis.com
Steven Lightstone	+44.20.3201.5663	steven.lightstone@morganlewis.com
Robert Mailer	+44.20.3201.5339	robert.mailer@morganlewis.com
Tayne Rankine	+44.20.3201.5418	tayne.rankine@morganlewis.com
Oliver Rochman	+44.20.3201.5340	oliver.rochman@morganlewis.com
William Yonge	+44.20.3201.5646	william.yonge@morganlewis.com

Los Angeles

Ayman A. Khaleq	+1.213.612.7459	ayman.khaleq@morganlewis.com

Miami

Ethan W. Johnson	+1.305.415.3394	ethan.johnson@morganlewis.com

New York

John D. Cleaver	+1.212.309.6931	john.cleaver@morganlewis.com
Thomas V. D'Ambrosio	+1.212.309.6964	thomas.dambrosio@morganlewis.com
Christopher J. Dlutowski	+1.212.309.6046	christopher.dlutowski@morganlewis.com

Kristin Lee +1.212.309.6024 kristin.lee@morganlewis.com
Nathan R. Pusey +1.212.309.6340 nathan.pusey@morganlewis.com
Leonora Shalet +1.212.309.6823 leonora.shalet@morganlewis.com
Jedd H. Wider +1.212.309.6605 jedd.wider@morganlewis.com
Joseph D. Zargari +1.212.309.7020 joseph.zargari@morganlewis.com

Orange County
Laurie A. Dee +1.714.830.0679 laurie.dee@morganlewis.com
Jarrod A. Huffman +1.714.830.0633 jarrod.huffman@morganlewis.com

Paris
Hugues Bouchetemble +33.1.44.09.46.55 hugues.bouchetemble@morganlewis.com
Nicolas Capelli +33.1.44.09.46.10 nicolas.capelli@morganlewis.com
Hubert de Vauplane +33.1.44.09.46.80 hubert.devauplane@morganlewis.com
Gilles Saint Marc +33.1.44.09.46.17 gilles.saintmarc@morganlewis.com

Philadelphia
David W. Freese +1.215.963.5862 david.freese@morganlewis.com
Sean Graber +1.215.963.5598 sean.graber@morganlewis.com
Timothy W. Levin +1.215.963.5037 timothy.levin@morganlewis.com
Christine M. Lombardo +1.215.963.5012 christine.lombardo@morganlewis.com
John J. O'Brien +1.215.963.4969 john.obrien@morganlewis.com

Pittsburgh
Todd P. Zerega +1.412.560.7011 todd.zerega@morganlewis.com

San Francisco
Monica H. Chang +1.415.442.1283 monica.chang@morganlewis.com
Marina Kofsman +1.415.442.1394 marina.kofsman@morganlewis.com
Peter M. Phleger +1.415.442.1096 peter.phleger@morganlewis.com

Singapore
Divya Thakur +65.6389.3011 divya.thakur@morganlewis.com

Tokyo
Tomoko Fuminaga +81.3.4578.2503 tomoko.fuminaga@morganlewis.com
Tadao Horibe +81.3.4578.2506 tadao.horibe@morganlewis.com
Carol Tsuchida +81.3.4578.2611 carol.tsuchida@morganlewis.com

Washington, DC
Mana Behbin +1.202.373.6599 mana.behbin@morganlewis.com
Gregg S. Buksbaum +1.202.739.5080 gregg.buksbaum@morganlewis.com
Laura E. Flores +1.202.373.6101 laura.flores@morganlewis.com
Thomas S. Harman +1.202.373.6725 thomas.harman@morganlewis.com
Lindsay B. Jackson +1.202.739.5120 lindsay.jackson@morganlewis.com
Daniel R. Kleinman +1.202.739.5143 daniel.kleinman@morganlewis.com
Amy Natterson Kroll +1.202.739.5746 amy.kroll@morganlewis.com
W. John McGuire +1.202.373.6799 john.mcguire@morganlewis.com
Christopher D. Menconi +1.202.373.6173 christopher.menconi@morganlewis.com
Courtney C. Nowell +1.202.739.5223 courtney.nowell@morganlewis.com
Christopher M. Paridon +1.202.739.5138 christopher.paridon@morganlewis.com
Christine Ayako Schleppegrell +1.202.739.5259 christine.schleppegrell@morganlewis.com

Steven W. Stone	+1.202.739.5453	steve.stone@morganlewis.com
Joseph (Beau) Yanoshik	+1.202.373.6133	beau.yanoshik@morganlewis.com
Kyle D. Whitehead	+1.202.739.5717	kyle.whitehead@morganlewis.com
Betselot A. Zeleke	+1.202.739.5508	betselot.zeleke@morganlewis.com

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