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SEC Scrutinizes Sale of Mortgage Interests Among Affiliated Funds

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The sale of mortgage assets between investment vehicles managed by the same adviser has come under scrutiny by the Securities and Exchange Commission ("SEC"). In a recently settled case, the SEC alleged that an investment adviser arranged the sale of mortgage interests from one client (a CDO) to another (a private fund), but failed to run an adequate auction process for the loans.

The case is notable because it resembles other actions brought against advisers to enforce rules preventing cross trades. Such cases, however, have typically involved the purchase and sale of securities among affiliated client funds that are subject to specific cross trading rules, like registered investment companies such as mutual funds and funds holding ERISA assets. By contrast, the most recent case involves the purchase and sale of loan participations that occurred between private investment vehicles. Here, the case was based on the premise that an investment adviser owes a fiduciary duty to all clients, and that the conveyance of any illiquid investment instruments between client accounts must be executed not only at fair market value, but also through a thorough process designed to ensure fairness to both clients. The case therefore serves as a reminder to investment advisers that the SEC may look closely at any transaction between affiliated investment accounts, even those that do not involve registered funds or ERISA accounts.

I. In the Matter of Talimco, LLC

On March 15, 2019, the SEC filed and settled charges with the investment adviser Talimco, LLC ("Talimco") and its Chief Operating Officer ("COO"), instituting sanctions (including disgorgement and a penalty) and a cease-and-desist order related to Talimco's alleged manipulation of the auction process for the sale of one client's assets to another client.

As part of its real estate advisory business, Talimco advised both a collateralized debt obligation (the "CDO") and a commercial real estate investment fund (the "Fund"). The CDO owned participations in the mortgage loan of a Chicago hotel (the "Mortgage Loan Participations"), entitling the CDO to shares of principal and interest on the loan. After the loan went into default, the Fund — acting on Talimco's advice — acquired all but one of the Mortgage Loan Participations in November and December of 2014. The Fund sought to obtain the final participation in April 2015, for which Talimco recommended it bid 50% of face value.

As collateral manager to the CDO, Talimco also oversaw the sale of the Mortgage Loan Participations. The governing documents for the CDO required Talimco to hold an auction of at least three bidders before the assets could be sold. If three bids were not available, the governing documents required Talimco to wait 20 days, then attempt once more to maximize price through a three-bid process. However, while the COO of Talimco initially contacted four potential market makers to solicit bids, none was interested. Rather than wait the requisite 20 days, he allegedly convinced the market makers to bid below the Fund's offer by promising they would not win the auction. The Fund ultimately beat the straw bids, securing ownership of the final Mortgage Loan Participation.

By November 2015, a restructuring of the underlying loan failed to close and the Fund decided to bundle its Mortgage Loan Participations and auction them off. For this auction, unlike the first, Talimco retained an outside agent to solicit bids from a larger swath of the market. The bids came in high enough to generate a profit for the Fund. Before the auction concluded, the COO made a personal investment of $1 million in the Fund. Once complete, the sale of the Mortgage Loan Participations triggered about $74,000 in management and performance fees for Talimco; its COO personally benefitted in the amount of approximately $14,000. The results for the CDO were less bright: it could not repay its debts, including $410,000 in principal owed to noteholders.

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II. Section 206(2) of the Investment Advisers Act

The SEC alleged that Talimco and its COO breached Section 206(2) of the Investment Advisers Act (the "Act"), which makes it "unlawful for any investment adviser . . . directly or indirectly . . . to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon a client or prospective client." While not expressly stated in the statute, Section 206(2) has been frequently interpreted as imposing a fiduciary duty on investment advisers to act in the best interests of their clients. The Chief of the SEC Enforcement Division's Complex Financial Instruments Unit, Daniel Michael, flagged the allegedly rigged nature of the auction process as a violation of the adviser's fiduciary duty, adding that "firms are expected to have controls in place to detect and disclose conflicts of interest. This action evidences the vigilance of the SEC's exam and enforcement staff in identifying investment advisers that exploit client relationships and harm investors."

In addition to disgorgement and prejudgment interest on the fees it earned through the sale, the SEC levied a civil money penalty of $325,000 on the adviser. Talimco was censured and ordered to cease and desist from further violations of section 206(2). Likewise, the COO consented to a cease and desist order, a 12-month industry suspension, and a $65,000 fine.

III. Main Takeaways

In addition to potentially marking renewed attention on the securitized mortgage market by the SEC, this enforcement action is notable because it concerns a cross trade but does not involve a registered fund or ERISA account. The case is based on the concept that the selling fund may be harmed (and the buying fund may benefit) if an adequate process is not followed to ensure a fair market price for the asset being conveyed.

In the wake of this case, firms should be particularly attentive to any actions that could be perceived as manipulating the valuation process for the sale of an asset from one client to another. Advisers who manage clients with overlapping investment objectives should remain attentive to whether the potential for a conflict of interest will arise and ensure they have proper policies in place to govern them when they occur.

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