SEC Enforcement Case Summary
Improperly Withholding Investor Funds & Charging Excessive Fees

On December 23, 2024, the SEC charged private fund manager, Dolphin Associates III, LLC, and its principal, Donald T. Netter with improperly withholding withdrawals from a private fund that they managed, charging the fund with excessive fees, and making materially misleading statements to investors.

The SEC's complaint alleged that since November 2016, Dolphin and Netter have improperly suspended withdrawals from the Fund while causing the Fund to make long-term investments in various small-cap equities. The SEC's complaint further alleges that Dolphin and Netter failed to disclose that Netter himself owned the same securities and was incentivized to prevent the Fund from divesting them. The complaint further alleges that Dolphin and Netter charged the Fund excessive fees, failed to obtain annual audits and distribute financial reports as required by the Fund's organizational documents, and made materially misleading statements to investors regarding the liquidity of the Fund's portfolio and Dolphin and Netter's efforts to return money to investors.

The fund's limited partnership agreement (***LPA***) permitted the fund to create "designated investments" defined as investments that "are not publicly traded or otherwise have limited liquidity or which the General Partner…believes in good faith are likely to become private or have limited liquidity…." The SEC noted that in 2015 the defendants classified two fund holdings as designated investments and segregated those investments into a "side pocket," excluding them from investor withdrawals for up to four years (until 2019). Defendants stated they were making this classification because the investments had limited liquidity and trading restrictions. The SEC complaint noted that the trading restrictions for one holding resulted from the fact that Netter had been appointed to the company's board of directors. The second stock ceased to be publicly traded, and the Fund's interest in it became bound up in an illiquid trust. Investors made several redemption requests from 2016-2021 and the firm failed to honor the requests or take step to allow them to be honored.

Towards the end of 2016, the defendants improperly suspended all investor withdrawals from the Fund explaining that the suspension was "the concentration of several core positions and also based upon the concentrated holdings of the Partners." In the notification of such suspension to investor, the firm claimed that the suspension had been ordered under a provision in the LPA that gives Dolphin authority to suspend withdrawals altogether under specific circumstances, including, "a state of emergency or other unusual or extraordinary circumstances" that makes it difficult to dispose of a substantial part of, or fairly value, the Fund's assets, or that "might seriously prejudice the Partners." According to the SEC, it was clear that the suspension was due to the two side pocketed position. However, the SEC argued that 1) Netter resigned from the board of one holding, curing his trading restrictions; 2) there was trading volume in one of the positions during the period; and 3) that the Fund received cash from some of the designated investments but failed to return it to investors. Regardless, neither Dolphin nor Netter took any steps to resolve or reallocate the two designated investments. Moreover, the SEC noted that the side-pocketed positions would not have prevented the fund from selling other liquid and unrestricted portfolio assets to satisfy redemption requests.

During the period in question, the SEC noted that Netter told at least one Fund investor that Dolphin was winding down the Fund, refraining from making new investments, and selling positions to satisfy redemption requests. However, none of these representations were true. In fact, Netter and Dolphin used the Fund's available cash to make new investments. The SEC noted that the defendants further failed to disclose to investors various conflicts of interest between himself and his personal investment

activities, and the fund's investment activities, including that: a) Netter had personal long-term positions in and also traded large quantities of the same small-cap stocks owned by the fund; b) Netter sent "activist" letters on behalf of the fund to company management advocating corporate actions consistent with his long-term investment; c) Netter and the fund filed joint Section 13 beneficial ownership positions based on their combined position; d) Netter personally benefited from activist efforts for which the fund paid; and e) based on such conflicts, Netter had an incentive to prevent the Fund from selling its shares in certain positions, which could have caused prices to decline, or to trade his own stock in advance or in lieu of the Fund's.

The SEC further alleged that the firm failed to obtain and deliver required annual audits and quarterly financial reports to investors for multiple years. Finally, the defendants during were charged with failing to accurately calculate management fees, relying on rough approximations that resulted in overcharging the Fund by about $41,000.

This case is being litigated in U.S. District Court, District of Connecticut and the SEC seeks injunctive relief, disgorgement plus prejudgment interest, and civil monetary penalties from Dolphin and Netter. It highlights the obligation of private fund managers to act in the best interest of the fund and fund investors and cautions them not to aggressively rely on provisions in fund governing documents designed to protect investor interests to instead protect their own personal interests.

See Summary – https://www.sec.gov/enforcement-litigation/litigation-releases/lr-26203