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When Poor Investment Diligence Becomes an Advisers Act Violation

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The Securities and Exchange Commission (SEC) recently settled an enforcement action against Hatteras Investment Partners and its CEO and co-founder, David Perkins, arising from a transaction that resulted in losses of approximately $300 million. But the interesting part of the case is not the investment loss itself. It is the SEC's use of Section 206(2) of the Investment Advisers Act of 1940 (Advisers Act) to address what looks, at its core, like a seriously deficient investment process.

According to the order, Perkins ignored significant red flags, proceeded despite concerns raised by Hatteras' fractional chief financial officer (CFO), and misunderstood important terms of the transaction. At the same time, the order repeatedly describes Perkins as actually believing that the transaction would work. That makes the case a useful reminder that subjective good faith is not necessarily enough under Section 206(2): An honestly held investment judgment can still violate the Advisers Act if the adviser lacks a reasonable basis for it.

The investment

Hatteras advised registered funds holding a portfolio of illiquid alternative investments. As redemption requests increased, the funds' board asked Hatteras to explore options for liquidating the portfolio. Hatteras had previously presented the board with two proposals from established secondary brokers, each of which would have resulted in a roughly 20% discount to net asset value and taken close to a year to complete. The board rejected both and asked Hatteras to keep looking. Hatteras ultimately recommended a transaction with Beneficient, a company that provided liquidity solutions to holders of alternative assets, in which the funds would exchange their portfolio for preferred Beneficient shares. The expectation was that those shares could later be converted and sold after Beneficient became public.

The order describes a number of warning signs. Beneficient had reported significant losses, 88% of its assets were attributable to goodwill, and its then-parent had disclosed an SEC investigation relating in part to Beneficient's accounting practices and goodwill valuation. Perkins asked Hatteras' CFO to review Beneficient's financial statements, and the CFO opposed the transaction. Perkins nevertheless remained convinced that Beneficient was profitable as a stand-alone company and proceeded without conducting additional diligence to verify that belief.

Perkins then presented the transaction to the board as a plan to liquidate and terminate the funds, stating that Hatteras had completed thorough due diligence and determined that the transaction was in shareholders' best interests. The board unanimously approved it. But Perkins had misunderstood an important feature of the deal. Although he had negotiated for the Beneficient shares to be free of any contractual lockup, he did not realize that the shares would remain subject to a separate three-month regulatory lockup after Beneficient became public. Beneficient ultimately went public through a special purpose acquisition company (SPAC) merger, and its share price fell more than 40% on its first day of trading. The funds ultimately suffered losses of approximately $300 million. The transaction also failed to accomplish the intended liquidation. Three years after Beneficient's public listing, the funds remained in liquidation because the master fund still held underlying portfolio fund interests for which transfer approvals had not been obtained.

The Section 206(2) theory

The SEC found that Hatteras and Perkins breached their fiduciary duties, in violation of Section 206(2). Both were censured and ordered to cease and desist from future violations, and Perkins personally agreed to pay a $250,000 civil penalty.

Section 206(2), unlike Section 206(1), does not require scienter; negligence can be sufficient. As the SEC explained in its 2019 fiduciary interpretation, an adviser's duty of care requires a reasonable basis for investment advice, which in turn requires a reasonable investigation into the investment sufficient to ensure that the advice is not based on materially inaccurate or incomplete information.

That is what makes Hatteras interesting. Although the order notes that Perkins told the board Hatteras had completed "thorough due diligence," the SEC did not base its Section 206(2) finding on a separately articulated misstatement theory. Its Section 206(2) finding instead centers on the investment process itself: Hatteras and Perkins did not fully appreciate the risks, did not adequately review the offering materials, and did not perform additional diligence after the CFO raised concerns. In other words, the SEC's theory was directed squarely at whether the adviser had a reasonable basis for its investment advice – not simply whether Perkins honestly believed the transaction was a good investment.

Perkins' belief in the transaction did not save him. The order repeatedly describes what he believed about Beneficient and the transaction, but concludes that those beliefs were insufficiently investigated. Section 206(2) can be violated without an intent to deceive if the adviser lacks a reasonable basis for its investment advice.

The takeaway

Investment advisers do not guarantee investment results, and an investment loss does not, by itself, establish an Advisers Act violation. Hatteras is about the process underlying the investment decision and whether the adviser had a reasonable basis for the advice it provided.

Although Hatteras involved registered funds, the broader lesson is relevant to private fund managers as well. In a 2022 Risk Alert, the Division of Examinations identified private fund advisers that failed to reasonably investigate underlying investments, follow the diligence processes described to clients or investors, or maintain investment diligence policies tailored to their businesses. For registered advisers, Advisers Act Rule 206(4)-7 (the Compliance Rule) likewise requires policies and procedures appropriately tailored to the risks presented by the adviser's business.

None of this means that the Advisers Act prescribes a particular diligence process or requires an investment memorandum or any particular set of materials for every investment. The practical point is not that every adviser must follow the same process. Rather, an adviser should have a reasonable process that reflects how it actually makes investment decisions, accurately describe that process and follow it. Where significant red flags arise, the adviser should be able to show how it investigated and considered them before proceeding. An investment judgment can be made in good faith and still be negligent.

Notably, the order also found that the violations were committed "willfully." However, that finding is not inconsistent with a negligence-based Section 206(2) violation. As the order explains, willfulness in this context does not require that Perkins knew his conduct violated the Advisers Act. Rather, it is enough that he knew what he was doing.

Contributors

Tejal Shah
Bio

Stacey Song
Bio
