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SEC Enforcement Developments Regarding Mutual Funds: The Year In Review

For over a decade, since the winding down of the Commission's market timing, late trading and revenue-sharing initiatives, industry commentators and insiders alike have often asked: "What's the next big thing in mutual fund-related enforcement?" The answer has never been clear. Indeed, despite an increasingly sophisticated, aggressive and wide-ranging SEC enforcement program spearheaded by an Asset Management Unit (AMU) with six years of experience, no industrywide wave of enforcement actions centered around a single issue has come to pass. In our view, the lack of any such enforcement roundup is a testament to the strong emphasis that the mutual fund industry has placed on compliance.

Nonetheless, the SEC continues to focus intently on enforcement related to mutual funds. Speaking before Congress last March, Division of Enforcement Director Andrew Ceresney listed conflicts of interest, misrepresentations regarding performance or investment strategies, breaches of fiduciary duties, and other fraudulent conduct as staples of the Commission's mutual fund and other investment adviser enforcement program. He also outlined initiatives "concentrating on areas that have traditionally received less attention, including custody rule violations, the adequacy of investment adviser compliance programs and undisclosed adviser fees."[1] During the past year, the SEC has brought actions related to mutual funds in each of these areas.

This article aims to promote the industry's commitment to compliance by highlighting recent key SEC enforcement trends, along with certain specific actions presaged by Director Ceresney's remarks a year ago. Many of these specific actions involved mutual fund enforcement "firsts," demonstrating the Commission's continuing expansion of its enforcement program to cover additional actors and novel fact patterns. The article concludes by focusing on SEC priorities that may result in enforcement activity in 2016 and beyond.

Trends in Aggressive Enforcement

Statistics. The SEC filed 807 enforcement actions and obtained orders for approximately $4.2 billion in monetary sanctions in its fiscal year (FY) 2015.[2] These statistics were records for the agency. Even more noteworthy are the figures related to independent actions (i.e., enforcement actions other than those against issuers for delinquent SEC filings, or follow-on administrative proceedings seeking bars against individuals based on criminal convictions, civil injunctions or other orders). In FY 2015, the SEC filed 507 such actions, an increase of 23 percent over FY 2014 and more than 49 percent more than in FY 2013.[3] The significant growth in independent actions has served to blunt criticism that the SEC has historically padded its numerical enforcement accomplishments. Moreover, the SEC's FY 2017 budget request would authorize the hiring of over 50 additional Division of Enforcement (Enforcement) staff, which should help ensure that this growth trend continues.

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Coordination with OCIE. Referrals from the SEC's Office of Compliance Inspections and Examinations (OCIE) have traditionally been one of the principal sources of Enforcement's investigations. In the past year, cooperation between Enforcement and OCIE, including Enforcement staff's participation in OCIE initiatives and sweeps, has continued to be publicized by the SEC.[4] Such coordination may well accelerate in 2016 and beyond, as OCIE performed more exams than ever before in FY 2015,[5] is reportedly reallocating up to 100 examiners from broker-dealer exams to conduct exams of investment advisers and investment companies,[6] and has requested budget authority to hire more than 100 additional investment adviser examiners this year.[7] Advisers should pay close attention to day-to-day compliance in anticipation of more frequent and comprehensive OCIE exams and should cooperate with examiners to minimize the risk of a referral to Enforcement.

"The SEC as the Whistleblower's Advocate." In a speech with this title last April, Chair Mary Jo White underscored that whistleblowers are a growing source of Enforcement investigations. In FY 2015, both the overall statistics and the most prominent enforcement actions buttress White's description of the whistleblower program as a "game changer."[8] The Commission received over 3,900 tips in FY 2015, up from 3,600 in FY 2014 and 3,200 in FY 2013.[9] More notably, 325 tips resulted in the opening of enforcement investigations in FY 2015 (up from 291 in FY 2014 and 289 in FY 2013).[10] The SEC has issued 23 whistleblower awards totaling over $55 million, including at least four awards to whistleblowers who tipped the SEC to misconduct at investment advisers.[11] In the past year, the SEC issued its first awards to a compliance whistleblower who provided information necessary to prevent substantial injury to a company and its investors,[12] a whistleblower who was retaliated against by his or her former employer[13] and a company outsider whose independent analysis alerted the SEC to misconduct that led to a successful SEC enforcement action.[14] Finally, the Commission fined a public company $130,000 for including language in agreements with its employees related to internal investigative interviews that was deemed to impermissibly impede interviewees from communicating with the SEC about potential securities law violations.[15]

While the question of whether to self-report potential securities law violations is often a difficult one to answer, the SEC's increasing focus on whistleblowers has at least placed a thumb on the affirmative side of the scale. As Director Ceresney has noted: "Companies that choose not to self-report are [] taking a huge gamble because if we learn of the misconduct through other means, the result will be far worse."[16] At a minimum, reports of misconduct should be carefully investigated and retaliation should be assiduously avoided. In addition, internal policies, procedures and employment agreements should be carefully reviewed to ensure that they do not impede the ability of employees to "blow the whistle." It is also worth noting that, as discussed below, in several of the most significant recent mutual fund-related enforcement actions, the Commission gave credit to the respondents for undertaking prompt remedial acts and for cooperating with the staff's investigation.

Admissions. The SEC has continued to demand admissions in connection with certain settled enforcement actions. Under a policy announced by Chair White in 2013,[17] the SEC may require admissions from a respondent where a large number of investors were harmed or conduct was otherwise egregious, conduct posed a significant risk to the markets or investors, the respondent poses a potential future threat, admissions would significantly enhance the deterrence message of the enforcement action, or a respondent obstructed the SEC's investigative process.[18] The SEC has required admissions in at least 28 enforcement actions (including five involving investment advisers), encompassing at least 15 individuals and 32 entities. Half of the actions requiring admissions were brought in FY 2015. The Commission's increasing interest in admissions, coupled with the SEC's stated position that once demanded, admissions may not be bargained away, suggests that subjects of enforcement investigations should realistically assess their prospects for resolution sooner rather than later.[19]

Enforcement's Focus on the Mutual Fund Industry

Independent Trustees, Administrators and Auditors. The SEC brought two enforcement "firsts" involving mutual fund independent trustees in the past year: one concerning failures in the Section 15(c) advisory contract approval process and the other involving auditor independence. The auditor independence matter was also a first both for a fund administrator and for a fund auditor. These matters illustrate the Commission's asserted interest in ensuring that so-called gatekeepers do their jobs.[20]

The 15(c) Process. Last June, the SEC instituted and settled an administrative proceeding against an investment adviser, its principal and three independent trustees of a registered investment company for process failures in connection with the directors' evaluation of fund advisory contracts under Section 15(c) of the Investment Company Act of 1940 (1940 Act).[21]

Section 15(c) provides that it is the duty of the fund directors to request and evaluate, and the duty of a fund adviser to furnish, such information as may reasonably be necessary to evaluate the terms of any fund advisory contract. In this case, the SEC found the fund adviser's information was deficient in the following respects: it failed to provide comparative fee information for one investment company; provided inappropriate and confusing comparative fee information for a second investment company; provided only limited disclosures that left unclear what services it intended to provide versus those that would be provided by others; failed to provide all requested financial information; failed to explain its methodology for allocating expenses; and mistakenly provided inaccurate answers to some questions.

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The SEC's enforcement action included independent trustees of one of the investment companies. These trustees approved advisory contracts even though they did not receive the comparative fee information they requested, and the fund adviser's disclosures did not make it clear how responsibilities would be allocated among itself, a sub-adviser and an affiliated fund administrator. The SEC found that the independent trustees did not follow up to obtain this information, so their approval was given "without having all the information they requested as reasonably necessary for their evaluation." This was the first time that the SEC levied such findings against mutual fund independent trustees.

The fund adviser and its principal (together with the affiliated fund administrator, which inadvertently failed to make disclosures concerning the approval process) were required to pay a joint and several civil money penalty of $50,000, and three trustees, including two independent trustees, were each required to pay a civil money penalty of $3,250. The respondents neither admitted nor denied the SEC's findings.

Auditor Independence. Less than a month later, the SEC brought and settled an administrative proceeding against the independent auditor to three closed-end funds, an independent trustee of those funds and the fund's administrator, for violations of the funds' auditor independence requirements.[22] The independent trustee, who served on the funds' audit committees, had an undisclosed consulting relationship with an associated entity of the funds' auditor. The relationship yielded remuneration to the trustee exceeding 10 percent of both his total earnings and his net worth. The relationship eventually was detected by the auditor, which reported it to the funds and, subsequently, to the SEC.

The SEC found that the auditor violated the independence requirement; that the auditor and the trustee caused the funds to file reports that were not audited by independent public accountants; and that the fund administrator caused the funds to violate Rule 38a-1 of the 1940 Act. The settlement order stated the administrator's trustee and officer questionnaires did not expressly cover business relationships with the auditor's affiliates, and the funds did not provide sufficient training to assist their board members. The trustee did not disclose his consulting relationship in response to a question calling for identification of his "principal occupation(s) and other positions" or in response to a question whether he had any "direct or material indirect business relationship" with the auditor, nor did he disclose the relationship when he participated in annual audit committee votes to retain the auditor. This was the first time that the SEC found such violations with respect to a mutual fund trustee, administrator or auditor.

The auditor was required to disgorge approximately $614,000 and pay a civil money penalty of $500,000; the trustee disgorged approximately $35,000 and paid a $25,000 penalty; and the fund administrator paid a $45,000 penalty. In accepting the settlement, the SEC took into account that the auditor has taken steps to enhance its independence quality-control system and that the administrator has commenced working with its clients' boards and their counsel to enhance auditor independence policies and procedures. The respondents neither admitted nor denied the SEC's findings.

Chief Compliance Officers (CCOs). The SEC has been criticized for bringing certain enforcement actions against CCOs and other compliance professionals. Former commissioner Daniel Gallagher dissented from two SEC enforcement actions against CCOs in 2015. Gallagher later summarized his objections: "I recently voted against two settled SEC enforcement actions [against CCOs] . . . . Both settlements

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illustrate a Commission trend toward strict liability for CCOs . . . [and] are undoubtedly sending a troubling message that CCOs should not take ownership of their firm's compliance policies and procedures . . . ."[23] In August 2015, SEC Administrative Law Judge Cameron Elliot followed suit, dismissing in their entirety Enforcement's requested sanctions against a former compliance officer even after finding the officer to have improperly altered a document related to an insider trading review she conducted. In his decision, Judge Elliot quoted Commissioner Gallagher's comment that "we should strive to avoid the perverse incentives that will naturally flow from targeting compliance personnel who are willing to run into the fires that so often occur at regulated entities."[24]

Chair White has defended the SEC's actions against CCOs, saying the agency does not engage in "second-guessing compliance officers' good-faith judgments," but rather charges CCOs "when their actions or inactions cross a clear line that deserve sanction."[25] Expanding on Chair White's remarks, Director Ceresney outlined three situations in which the SEC charges CCOs: (i) where they are affirmatively involved in misconduct; (ii) where they obstruct an SEC investigation or mislead the SEC staff; and (iii) where they exhibit "wholesale failures in carrying out responsibilities that were clearly assigned to them."[26] Director Ceresney also noted that since 2003, the SEC has brought approximately 1,300 enforcement actions involving investment advisers or investment companies, and that only five of these were against CCOs for purely compliance-related violations.

In one of these five cases, the SEC instituted and settled an administrative proceeding against a fund adviser and its CCO for failure to report a portfolio manager's conflict of interest to the funds' boards of directors.[27] The matter involved a fund portfolio manager in the energy sector who also owned an energy company in which he had personally invested $50 million. His energy company had a joint venture with a publicly traded coal company that was held in the registered funds he managed. The adviser knew of the portfolio manager's outside business activity but did not report it to the funds' boards, even though the original formation and funding of the portfolio manager's energy company was in violation of the adviser's unwritten private investment policy. (The adviser had no written policies and procedures regarding the outside activities of its employees.)

The SEC found that the fund adviser violated the Investment Advisers Act of 1940 (Advisers Act) by failing to disclose the portfolio manager's conflict of interest to the funds' boards and to advisory clients, and that it violated Rule 38a-1 of the 1940 Act by failing to disclose the portfolio manager's violations of the adviser's private investment policy to the funds' boards. It also violated the Advisers Act and Rule 206(4)-7 thereunder by failing to adopt and implement written policies and procedures to assess and monitor the outside activities of its employees and to disclose conflicts of interest to the funds' boards and to advisory clients. The SEC found that the CCO, who knew about the violations but failed to act on them, caused the violations of Rule 38a-1 and Rule 206(4)-7. The Rule 38a-1 "causing" violation as to the CCO, which arose out of his failure to report the private investment policy violations to the board, was the first of its kind. The SEC required the fund adviser to retain an independent compliance consultant, subjected the fund adviser and the CCO to cease-and-desist orders, and assessed civil money penalties of $12 million against the fund adviser and $60,000 against the CCO. The respondents neither admitted nor denied the order's findings.

"Distribution-in-Guise." The SEC brought and settled an administrative proceeding against an investment adviser and its affiliated distributor for improperly using mutual fund assets to pay for the marketing and distribution of mutual fund shares. The SEC said that the case is the first arising out of its Distribution-in-Guise Initiative, a coordinated initiative between OCIE and Enforcement to ferret out improper uses of mutual fund assets to pay for distribution-related services.[28]

Under Rule 12b-1 of the 1940 Act, mutual fund assets may not be used to pay for the distribution and marketing of fund shares, unless the payments are made pursuant to a 12b-1 plan that has been approved by the fund's board. The SEC order states that the mutual funds made improper payments to two intermediaries (identified only as "Intermediary One" and "Intermediary Two") pursuant to contracts that clearly stated they were for distribution and marketing services. These payments were in addition to 12b-1 plan payments made to both intermediaries, as well as a Financial Services Agreement under which the funds paid Intermediary One for certain services.

The SEC found that the fund adviser and distributor caused the funds to violate Rule 12b-1, and that the fund adviser violated the antifraud provisions of Section 206(2) of the Advisers Act and Section 34(b) of the 1940 Act. The respondents were required to pay disgorgement and interest of approximately $27.2 million and a civil money penalty of $12.5 million. The order states that the SEC took into account remedial acts promptly undertaken by the respondents and cooperation afforded the SEC staff. The respondents did not admit or deny the SEC's findings.

The Distribution-in-Guise Initiative has been the subject of a great deal of commentary and discussion in the past two years. Based on the Initiative's high public profile, if there was any one area that some thought might result in an industrywide set of enforcement actions, this was it. And while at least one additional fund adviser has just announced its receipt of a Wells notice from the SEC staff[29] and there have been press reports of other advisers under investigation by Enforcement as part of the Initiative,[30] it does not appear likely that the Initiative will result in an enforcement tsunami.

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Manager-of-Managers' Responsibilities for Sub-Advisers' Performance Information. In another apparent first, the SEC instituted and settled an enforcement action against a registered investment adviser for the adviser's use of false performance information provided to it by a sub-adviser.[31] According to the settlement order, the adviser advised six mutual funds and certain separately managed accounts that used a sector rotation strategy managed by the sub-adviser. Based on information provided by the sub-adviser, the adviser falsely stated that (a) the strategy had a history dating back to 2001, and (b) the strategy significantly outperformed the S&P 500 Index from 2001 to 2008. In actuality, the SEC found, the strategy's track record during this period was hypothetical and back-tested, and was further miscalculated in such a way that substantially inflated its performance.

The SEC found that the adviser had concerns about the stated performance of the strategy from the outset of its relationship with the sub-adviser and had received warnings from time to time thereafter, but the adviser did not follow up on these concerns or take steps to determine whether the strategy was actually in use from 2001 to 2008. The settlement order faulted the adviser for negligently not knowing that the sub-adviser's track record and performance were false. The order stated further that the adviser should have adopted and implemented written policies and procedures to evaluate and monitor the accuracy of third-party performance information that it distributed, and should have made and kept sufficient records to substantiate the performance record of its investment products.

The SEC found that by this conduct the adviser violated Sections 206(2), 206(4) and 204 of the Advisers Act and Rules 206(4)-1(a)(5), 206(4)-7, 206(4)-8 and 204-2(a)(16) thereunder, and that it caused violations of Section 34(b) of the 1940 Act. The adviser agreed, without admitting or denying the findings, to pay disgorgement of $13.4 million, prejudgment interest of $1.1 million and a civil money penalty of $2 million.

Custody and Directed Brokerage. The SEC instituted and settled an administrative proceeding against a fund adviser for failing to maintain all of the funds' assets at the funds' custodial bank.[32] This, too, appears to be an enforcement "first." The funds were alternative mutual funds that traded equities and derivatives including swaps. For a nine-month period, the fund adviser caused the funds to post the contractually required cash collateral relating to certain total return and portfolio return swaps. As a result, the funds' broker-dealer counterparties (and not the funds' custodian bank) held assets consisting of roughly $247 million in cash collateral. This violated Section 17(f)(5) of the 1940 Act, which generally provides that if a fund maintains its securities and similar investments in the custody of a bank, the fund's cash assets shall likewise be kept in bank custody. The SEC noted that the cash collateral could instead have been maintained with the funds' custodian bank subject to a tripartite agreement among the custodial bank, the counterparty and the fund.

In the same action, the SEC also found that the fund adviser failed to fully implement Rule 12b-1(h) under the 1940 Act, which provides that a fund is permitted to direct fund portfolio transactions to brokers that sell fund shares, but only if the fund or its adviser has implemented policies and procedures reasonably designed to ensure that the selection of brokers for portfolio securities transactions is not influenced by considerations about the sale of fund shares. Without admitting or denying the SEC's findings, the fund adviser paid a $50,000 civil penalty and agreed to a cease-and-desist order. The SEC noted that it took into account remedial acts promptly undertaken by the adviser and cooperation afforded the SEC staff.

Undisclosed Change in Investment Strategy. The SEC brought and settled an enforcement action against two affiliated registered investment advisers related to the advisers' management of a closed-end fund.[33] The SEC found that the advisers materially changed the fund's investment strategy but did not disclose the change to investors or the fund's board of directors. As a result, the fund's disclosures became materially misleading.

From the fund's inception, the advisers marketed the fund as a product primarily invested in distressed debt (i.e., that the fund's investment strategy was predicated on debt assets increasing in value). The advisers pursued this strategy until 2008, when they changed course. Beginning in 2008, the advisers caused the fund to short credit through the purchase of large amounts of credit default swaps (CDS) for the fund (i.e., the fund's investment strategy changed such that its value would increase if debt assets decreased in value).

By fall 2008, the fund's investment strategy had become net short credit assets. The fund started incurring big losses due to its holdings of credit default swaps, which increased from under 2.6 percent of the fund's market value to more than 25 percent of the fund's value by March 2009. Thereafter, the fund remained net short credit through its CDS exposure until its board of directors liquidated the fund in 2012.

The SEC faulted the advisers for providing inadequate disclosure to the fund's investors and board of directors about this change in investment strategy. For example, a marketing brochure provided to potential investors from fall 2008 to May 2009 misstated the fund's strategy, while investor letters the adviser sent from fall 2008 to August 2011 contained false or misleading information about the fund's exposure to credit default swaps. The advisers also caused the fund to misrepresent its investment strategy in shareholder reports filed with the SEC.

As a result of this conduct, the SEC found the advisers variously liable for violating Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933; Sections 206(2), 206(4) and 203(e)(6) of the Advisers Act; and Rules 206(4)-8(a)(1) and 206(4)-8(a)(2) thereunder, and for causing the fund's violation of Section 34(b)

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of the 1940 Act and Rule 8b-16 thereunder. In settling the action, the advisers agreed (without admitting or denying the SEC's findings) to pay approximately $17.5 million, consisting of $8.2 million in disgorgement of advisory fees, $1.4 million in prejudgment interest, a $3 million penalty and $4.9 million to compensate investors for losses. While not a first, this was yet another case that dovetailed with Director Ceresney's stated priorities.

Looking Ahead

For more than a decade, the mutual fund world has avoided an industrywide set of enforcement actions on the scale of the market timing, late trading and revenue-sharing cases that were in the headlines in the early 2000s. In considering what mutual fund-related enforcement might look like over the next year or so, it is perhaps most useful to look at the stated priorities of both Enforcement and OCIE. Enforcement plans to focus on valuation, conflicts of interest and compliance failures.[34] The industry should expect enforcement action in each of these areas in the relatively near term. OCIE's examination priorities include liquidity controls, cybersecurity, and never-before-examined investment advisers and investment companies.[35] It is speculative to say whether any of these priorities will spawn enforcement activity. Based on these priorities, along with the general enforcement trends and specific actions from FY 2015 and early FY 2016 discussed above, we expect the SEC's enforcement program to continue to "cover the bases" for the remainder of FY 2016 and early FY 2017, as it did last year and has done for some time.[36]

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a settled enforcement action earlier in 2015 involving the 15(c) process. See In re Kornitzer Mgmt., Inc. and Barry E. Koster, SEC Release No. IC-31560 (Apr. 21, 2015), https://www.sec.gov/litigation/admin/2015/ic-31560.pdf (finding an investment adviser and its CFO/CCO liable for providing inaccurate expense allocation information to a mutual fund board in the board's 15(c) process).

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[32] *See SEC Charges Mutual Fund Adviser in Connection with Improper Handling of Fund Assets*, SEC Press Release 2015-31 (Feb. 12, 2015), https://www.sec.gov/news/pressrelease/2015-31.html. The SEC's press release noted that an OCIE examination led to this enforcement action.

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[36] Linda C. Thomsen, Speech: *Covering the Bases: Remarks Before the Directors' College* (Jun. 21, 2005), https://www.sec.gov/news/speech/spch062105lct.htm.VlXUnNaWGt1WTI5dExDQXpNREEwT0RZ-c0lERXpNelEyTmpFeE9UST0VlXUnNaWGt1WTI5dExDQXpNREE-wT0RZc0lERXpNelEyTmpFeE9UST0 (subscription required).

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