

# SECURITIES LITIGATION & REGULATION

## EXPERT ANALYSIS

### SEC Enforcement Developments Regarding Mutual Funds

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The Securities and Exchange Commission continues to focus intently on enforcement actions related to mutual funds.

Speaking before Congress in March 2015, SEC enforcement division 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 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."<sup>1</sup>

In 2015, the SEC brought actions related to mutual funds in each of these areas.

This analysis aims to promote the industry's commitment to compliance by highlighting recent key SEC enforcement trends and actions presaged by Ceresney's remarks.

Many of these 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 analysis concludes by focusing on SEC priorities that may result in enforcement activity in 2016 and beyond.

#### TRENDS IN AGGRESSIVE ENFORCEMENT

The SEC filed 807 enforcement actions and obtained orders for about \$4.2 billion in monetary sanctions in its 2015 fiscal year.<sup>2</sup>

These statistics were record numbers for the agency.

For fiscal year 2017, the SEC seeks a budget that would authorize the hiring of over 50 additional enforcement division staff, which would help ensure that this growth trend continues.

Referrals from the SEC's Office of Compliance Inspections and Examinations have traditionally been one of the principal sources of the enforcement division's investigations.

Such coordination may well accelerate in 2016 and beyond, as OCIE performed more exams than ever in the 2015 fiscal year, is reportedly reallocating up to 100 examiners from broker-dealer exams to conduct exams of investment advisers and investment companies, and has requested budget authority to hire more than 100 additional investment adviser examiners this fiscal year.



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Advisers should pay close attention to day-to-day compliance in anticipation of more frequent and comprehensive OCIE exams. They should also cooperate with examiners to minimize the risk of a referral to the enforcement division.

## **FOCUS ON THE MUTUAL FUND INDUSTRY**

### ***Independent trustees, administrators and auditors***

The SEC brought two enforcement firsts involving mutual fund independent trustees in 2015: 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.

The matters illustrate the commission's asserted interest in ensuring that so-called gatekeepers do their jobs.

In June 2015 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, 15 U.S.C.A. § 80a-15(c).<sup>3</sup>

Section 15(c) provides that it is the duty of a fund's 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 because 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.
- Mistakenly provided inaccurate answers to some questions.

Independent trustees of one of the investment companies 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 penalty of \$50,000. Three trustees, including two independent trustees, were each required to pay a civil penalty of \$3,250.

The respondents neither admitted nor denied the SEC's findings.

Less than a month later, the SEC brought and settled an administrative proceeding against the independent auditor of three closed-end funds, an independent trustee of those funds and the funds' administrator, for violations of the funds' auditor independence requirements.<sup>4</sup>

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 auditor eventually detected the relationship and 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, 17 C.F.R. § 270.38a-1.

The settlement order stated the administrator's trustee and officer questionnaires did not expressly cover business relationships with the auditor's affiliates and did not provide sufficient training to assist the funds' board members in the discharge of their responsibilities as to auditor independence.

This was the first time that the SEC found such violations with respect to a mutual fund trustee, administrator or auditor.

The auditor agreed to disgorge about \$614,000 and pay a civil penalty of \$500,000; the trustee disgorged about \$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 had taken steps to enhance its independence quality-control system and that the administrator had 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**

The SEC has been criticized for bringing certain enforcement actions against chief compliance officers and other compliance professionals.

Then-Commissioner Daniel Gallagher dissented from two SEC enforcement actions against CCOs in 2015.

"I recently voted against two settled SEC enforcement actions [against CCOs]," Gallagher said. "Both settlements 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."<sup>5</sup>

SEC chair Mary Jo 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."<sup>6</sup>

Expanding on White's remarks, Ceresney outlined three situations in which the SEC charges CCOs:

- They are affirmatively involved in misconduct;
- They obstruct an SEC investigation or mislead the SEC staff.
- They exhibit "wholesale failures in carrying out responsibilities that were clearly assigned to them."<sup>7</sup>

Ceresney noted that since 2003, the SEC has brought about 1,300 enforcement actions involving investment advisers or investment companies, and that only five of these were against CCOs for purely compliance-related violations.

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In one of those 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.<sup>8</sup>

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 violated 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 by failing to disclose the portfolio manager's conflict of interest to the funds' boards and to advisory clients, and that the fund violated Rule 38a-1 of the act by failing to disclose the portfolio manager's violations of the adviser's private investment policy to the funds' boards.

The fund violated the Advisers Act and Rule 206(4)-7 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 from 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 the enforcement division to ferret out improper uses of mutual fund assets to pay for distribution-related services.<sup>9</sup>

Under Rule 12b-1 of the 1940 Act, 17 C.F.R. § 270.12b-1, mutual fund assets may not be used to pay for the distribution or marketing of fund shares, unless the payments are made pursuant to a 12b-1 plan that the fund's board has approved.

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, 15 U.S.C.A. § 80b-6, and Section 34(b) of the 1940 Act, 15 U.S.C.A. § 80a-33(b).

The respondents were required to pay about \$27.2 million in disgorgement and interest and a civil penalty of \$12.5 million.

The order says 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.

### **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.<sup>10</sup>

This, too, appears to be an enforcement first.

The funds were alternative mutual funds that traded equities and derivatives, including swaps.

Over 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, 15 U.S.C.A. § 80a-17(f)(5), 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 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. The rule 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.

### **LOOKING AHEAD**

For more than a decade, the mutual fund world has avoided an industry-wide 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 the near term, the enforcement division plans to focus on valuation, conflicts of interest and compliance failures, while OCIE's priorities include liquidity controls, cybersecurity and never-before-examined investment advisers and investment companies.

Based on these priorities, along with the general enforcement trends and specific actions discussed above, we expect the SEC's enforcement program to continue to "cover the bases," albeit more proactively and expansively than ever before.

### **NOTES**

<sup>1</sup> Andrew Ceresney, *Testimony on "Oversight of the SEC's Division of Enforcement,"* U.S. SEC. & EXCH. COMM'N (Mar. 19, 2015), <http://bit.ly/29gTqiq>.

<sup>2</sup> Press Release, Sec. & Exch. Comm'n, SEC Announces Enforcement Results for FY 2015 (Oct. 22, 2015), <http://bit.ly/1MVhQ0K>.

<sup>3</sup> See Press Release, Sec. & Exch. Comm'n, SEC Charges Investment Adviser and Mutual Fund Board Members With Failures in Advisory Contract Renewal Process (June 17, 2015), <http://bit.ly/29o2oNo>. According to the SEC's press release, this action arose out of an OCIE examination. The commission also brought a settled enforcement action earlier in 2015 involving the 15(c) process. See *In re Kornitzer Mgmt.*, S.E.C. Release No. IC-31560, 2015 WL 1800393 (Apr. 21, 2015) (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).

<sup>4</sup> See Press Release, Sec. & Exch. Comm'n, SEC Charges Deloitte & Touche with Violating Auditor Independence Rules (July 1, 2015), <http://bit.ly/29w3Dtc>.

<sup>5</sup> Daniel M. Gallagher, Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7, U.S. SEC. & EXCH. COMM'N (June 18, 2015), <http://bit.ly/29o2zID>.

<sup>6</sup> Mary Jo White, Chairman, Sec. & Exch. Comm'n, Opening Remarks at the Compliance Outreach Program for Broker-Dealers (July 15, 2015), <http://bit.ly/29eMOQr>.

<sup>7</sup> Andrew Ceresney, Director, Sec. & Exch. Comm'n, 2015 National Society of Compliance Professionals, National Conference: Keynote Address (Nov. 4, 2015), <http://bit.ly/29LBgWG>.

<sup>8</sup> See Press Release, Sec. & Exch. Comm'n, SEC Charges BlackRock Advisors with Failing to Disclose Conflict of Interest to Clients and Fund Boards (Apr. 20, 2015), <http://bit.ly/29gTJtl>.

<sup>9</sup> See Press Release, Sec. & Exch. Comm'n, SEC Charges Investment Adviser with Improperly Using Mutual Fund Assets to Pay Distribution Fees (Sept. 21, 2015), <http://bit.ly/29lXH51>. This action arose out of an OCIE examination.

<sup>10</sup> See Press Release, Sec. & Exch. Comm'n, SEC Charges Mutual Fund Adviser in Connection with Improper Handling of Fund Assets (Feb. 12, 2015), <http://bit.ly/29fQIJ7>. The SEC's press release noted that an OCIE examination led to this enforcement action.



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