SEC’s enforcement priorities for 2015 – conflicts

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By:

In “Conflicts, Conflicts Everywhere,” her speech at the recent IA Watch 17th Annual Compliance Conference, Julie M. Riewe, Co-Chief of the Securities and Exchange Commission’s Enforcement Division’s Asset Management Unit, announced the AMU’s 2015 enforcement priorities, as well as its “overarching, perennial priority – conflicts of interest,” which AMU staff is examining in “nearly every ongoing matter.”

Looking back – the AMU’s five-year anniversary

Ms. Riewe’s speech came on the heels of the Unit’s five-year anniversary. The AMU was created in part so that Enforcement Staff could better comprehend the dynamics of the hedge fund industry and its investment strategies. The AMU accordingly focuses its efforts on investigating potential misconduct by registered investment companies, hedge funds and private equity funds, as well as separately managed accounts and retail accounts.

Ms. Riewe noted that the AMU today consists of about 75 professionals, including former mutual fund professionals with experience in marketing, distributing and servicing of mutual funds, as well as former hedge fund and private equity professionals with portfolio management and due diligence experience. Notably, the AMU maintains a presence at each of the SEC’s 12 offices across the United States.
According to Ms. Riewe, the Unit is engaged in “constant collaboration and coordination” with the Commission’s Office of Compliance Inspections and Examinations (OCIE) and the Division of Investment Management. For example, they have jointly initiated multiple “sweeps,” such as the Distribution in Guise, Alternate Mutual Fund, and are now engaged in the “Fund Fee Initiative” – a joint effort by the AMU, the Division of Investment Management and OCIE, which focuses on examining fee arrangements involving registered funds, their advisers, and boards of directors.

Top enforcement priorities for 2015

Next, Ms. Riewe addressed the AMU’s 2015 priorities for each of the primary investment vehicles it polices: (1) registered investment companies; (2) private funds (both hedge funds and private equity funds); and (3) other client accounts, such as separately managed accounts/retail accounts.

For registered investment companies, the AMU’s 2015 priorities include:

- valuation, performance and advertising of performance
- funds deviating from investment guidelines or pursuing undisclosed strategies
- fund governance, i.e., boards and advisers discharging their obligations under Section 15(c) of the Investment Company Act when they evaluate advisory and other types of fee arrangements and
- fund distribution, i.e., whether advisers are causing funds to violate Rule 12b-1 by using fund assets to make distribution payments to intermediaries outside of the funds’ Rule 12b-1 plan, whether funds’ boards are aware of such payments, and how such payments are disclosed to shareholders.

For private funds (i.e., hedge funds and private equity funds), the AMU will place particular emphasis on:

- conflicts of interest
- valuation and
- compliance and controls.

Specifically, with respect to hedge funds, the AMU anticipates actions involving undisclosed fees, undisclosed conflicts (e.g., related-party transactions), and valuation issues (e.g., use of friendly broker marks). Significantly, the AMU plans to continue refining “the analytics for the AMU’s signature risk initiative, the Aberrational Performance Inquiry, . . .which uses proprietary risk analytics to identify hedge funds with suspicious returns.” And for private equity funds, the AMU will continue to work closely with exam staff to bring more undisclosed and misallocated fee and expense cases.

Finally, with respect to other client accounts, the AMU’s 2015 priorities similarly include:

- conflicts of interest
- fee arrangements and
- compliance.

Significantly, the AMU brought numerous cases involving fee arrangements in 2014, including an action in which the Unit charged a firm “with failing to aggregate accounts for purposes of applying breakpoint discounts.” As to compliance, the Unit also brought a number of additional cases as part of its Compliance Program Initiative, “a joint effort with OCIE to identify advisory firms that lack effective compliance programs for possible enforcement action.”

A common theme emerges: conflicts of interest

Ms. Riewe closed her speech by addressing the AMU’s central concern across all of the investment vehicles it polices – conflicts of interest. “Conflicts of interest are material facts that investment advisers, as fiduciaries, must disclose to their clients.” Significantly, Ms. Riewe stated that, in nearly every ongoing matter, the AMU is examining “whether the adviser in question has discharged its fiduciary obligation to identify its conflicts of interest and either (1) eliminate them or (2) mitigate them and disclose their existence to boards or investors.” Still, the AMU has repeatedly found that advisers are failing to properly identify and address conflicts.

To round out her discussion of conflicts, Ms. Riewe offered three overarching talking points:

1) Conflicts of interest must be disclosed. Citing the Supreme Court’s decision in SEC v. Capital Gains
Research Bureau, Inc., Ms. Riewe emphasized that the types of conflicts of interest encompassed by the Investment Advisers Act of 1940 include “instances where there is a facial incompatibility of interests, as well as any situation where an adviser’s interests might potentially incline the adviser to act in a way that places its interests above clients’ interests, intentionally or otherwise.”

2) **Conflicts of interest will generate enforcement actions.** Notably, Ms. Riewe made clear that “an adviser’s failure to disclose conflicts of interest subjects it to [a] possible enforcement action.” Indeed, the AMU “has aggressively pursued enforcement cases” throughout the past year, and more are “in the pipeline” for 2015. The AMU expects to recommend numerous conflicts cases for enforcement, including “matters involving best execution failures in the share class context, undisclosed outside business activities, related-party transactions, fee and expense misallocation issues in the private fund context, and undisclosed bias toward proprietary products and investments.” Ms. Riewe also highlighted the fact that the AMU anticipates further enforcement actions from the Distribution in Guise Initiative, when “examining . . . conflicts presented by registered fund advisers using the fund’s assets to grow the fund and, consequently, the adviser’s own fee.”

3. **Advisers must identify and address conflicts of interest.** In closing, Ms. Riewe underscored that advisers must identify and address conflicts via elimination or disclosure in order to fulfill their obligations as fiduciaries. To accomplish this, Ms. Riewe suggested that advisers “step back and rigorously and objectively evaluate [their] firm, its personnel, its business, its various fee structures, and its affiliates.” And for each conflict identified, advisers must determine whether the conflict can be eliminated or mitigated and disclosed. “Only through complete and timely disclosure can advisers, as fiduciaries, discharge their obligation to put their clients’ and investors’ interests ahead of their own.”

In view of the AMU’s heightened scrutiny of conflicts of interest, industry professionals are well-advised to review potential conflicts in order to avoid an enforcement action. Ms. Riewe’s “Conflicts Everywhere” speech is the latest, but by no means the only, signal from the Commission that indicates conflicts of interest are a top priority throughout 2015. For example, at the SEC Speaks Conference in Washington, DC this past month, Ms. Riewe also made clear that conflicts of interest constitute an “overarching risk area . . . into which all of the more granular priorities” of the AMU fall.

Also this past month, the Division of Investment Management issued a guidance update regarding acceptance of gifts or entertainment by fund advisory personnel, pursuant to Section 17(e)(1) of the Investment Company Act. Consistent with the conflict of interest theme espoused by Ms. Riewe, the Division cautioned that “receipt of gifts or entertainment by fund advisory personnel, among others, may violate section 17(e)(1) of the 1940 Act.” Therefore, in the staff’s view, they “should be addressed by funds’ compliance policies and procedures . . . .”

One thing remains clear – conflicts of interest will be receiving much attention from the Commission in the coming months. We have been counseling our clients in this area, in order to help them avoid an SEC inquiry or, worse yet, an enforcement action. We suggest that you seek similar counsel.

To find out more about these SEC priorities, please contact the authors.

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1 Available here.


3 Available here.