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Non-Enforcement

- Form PF — What Purpose?
- Do SEC Enforcement Orders Need Further Clarification?
- U.S. and Cayman AIFMD Passports On Hold; Marketing Continues Under EU Passports and National Private Placements
- "Final Order" in Supreme Court Mutual Fund Fee Case: More Lessons for Fund Boards

Enforcement

- Investment Adviser's Failure to Disclose Conflicts of Interest, Properly Bill Clients, and Enforce Gifts and Entertainment Policy Result in $20 Million Penalty

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All Federal

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Form PF — What Purpose?

SEC registered investment advisers with at least $150 million of assets under management in private funds are required to periodically file Form PF with the SEC. The Dodd-Frank Act of 2010 directed the SEC to adopt rules requiring advisers of private funds to, among other things, file a report on the types of funds managed and who are the third party service providers. The rationale behind the requirement was to provide the Financial Stability Oversight Council (FSOC) sufficient information about such funds in order to assess systematic risk. In response to this directive, the SEC adopted Form PF.

The information collected by the SEC from the Form PFs as filed not only assists the FSOC but also the SEC.

According to a recent annual report by the SEC's Division of Investment Management (dated August 13, 2015) regarding the information collected from the filed Form PFs, the SEC uses such information to:

- Assist in the SEC's examination and enforcement programs regarding registered advisers to private funds
- Help formulate the SEC's risk monitoring activities
- Inform regulatory initiatives
- Help assist other federal and international regulatory agencies in regulation of private fund advisers.

Most noteworthy, with respect to preparation of examinations of a private fund adviser, the SEC uses the data filed by the adviser on Form PF to arrive at a more complete understanding of the adviser's business and investment strategy. The staff also looks for inconsistencies in data provided in Form PF with findings while conducting the actual examination, such as in the adviser's pitch books, private fund offering documents, reports to fund investors, and the adviser's disclosure brochure. After noting any inconsistencies, the staff is likely to make further inquiries with the adviser to determine the basis, if any, for the inconsistencies found.

Based on the SEC's use of such information, it makes sense for registered investment advisers who are required to file the Form PF to first, before hitting the "send" button, make sure that the information to be reported does not contradict what the adviser otherwise reports to investors and/or the SEC.

Do SEC Enforcement Orders Need Further Clarification?

In a recent public statement, SEC Commissioner, Luis A. Aguilar, argues that the SEC needs to make a greater effort in providing clarity and transparency in the orders it issues with respect to enforcement actions.

According to the Commissioner, the purpose of such orders is to not only publicize an enforcement action but also to send a clear message to others about what is acceptable and not acceptable behavior. In order to send a clear message, it is important that the SEC's enforcement order be clear and as complete as possible to explain the requirements of the law or regulation that was violated and how the violator's activities violated the law. An example given by the Commissioner is the recent enforcement actions taken by the SEC against chief compliance officers. Because the larger audience of chief compliance officers and their employers are taking note of such actions, it is imperative for the SEC to be as clear as possible in issuing such orders to define what the SEC and the law expects from chief compliance officers.

The Commissioner, in his statement, acknowledges that oftentimes the staff negotiates with the respondent about the language used in the enforcement order. However, the staff's desire to resolve the matter should not take a backseat to the needed clarity within the order to most accurately describe the activity that resulted in the violation of the law and the penalties levied.

U.S. and Cayman AIFMD Passports On Hold; Marketing Continues Under EU Passports and National Private Placements

The Alternative Investment Fund Managers Directive (AIFMD) creates a three-speed Europe. A pan-EU passport for EU domiciled Alternative Investment Fund Managers that authorizes marketing to professional investors, national private placements that must meet minimum regulatory criteria, but as to which national regulation in addition to EU regulation is authorized (so called "gold plating") and in at least some member states, "reverse solicitations".

At the moment non-EU funds of non-EU managers (e.g., a Cayman fund of a US domiciled fund manager) are not eligible for passporting. Upon adoption of the AIFMD, the EU determined to task the European Securities Markets Regulator with making the assessments by July 2015: are National Private Placement Regimes working well and whether or not third country managers, such as the U.S. managers and/or Cayman funds, might also gain passporting.

Third-Country Passports

The news here is essentially that sorting out 22 countries identified in Article 67 of AIFMD as candidate jurisdictions for acting as home countries for authorized managers with AIFMD passports will require a country by country analysis. Of the 22, six were attempted by the deadline. But, having worked through only three by the deadline, the European Securities and Markets Authority (ESMA) determined that it needs more time to get a critical mass of "yes" candidates that are eligible for passporting, and that should be accommodated by the EU through legislation. For now, the United States, Cayman, and Hong Kong were looked at but deferred for further study. Guernsey and Jersey were both tapped as "ready now". Switzerland was evaluated as ready, pending adoption of pending legislation.

The assessment of the United States simply got bogged down on assessing whether the differences between the US regulatory framework and that of the EU under AIFMD are different in material ways. For example the SEC regulation of custody — which does not forbid adviser custody as defined by the SEC seems at odds with the AIFMD requirement of an independent depositary (but might not be, at the end of the day). ESMA also noted that the U.S. law treats mutual funds that are registered under the Investment Company Act differently when it comes to custody than private funds subject to the Advisers Act rule. Further, FINRA and the CFTC also have regulations that ESMA should consider. ESMA noted no presence of remuneration regulation (much to the relief of U.S. fund managers, but potentially a hurdle to obtaining passports for U.S. managers). Also, the SEC is viewed as something of a laggard in adopting international best practices regulation as articulated by the International Organization of Securities Commissions (IOSCO). Interestingly, ESMA expressed concern with respect to parity of access to U.S. markets by EU managers, particularly bank sponsored fund managers that might find the Volker Rule a significant impediment. This lack of parity of market access (i.e., the EU has nothing like the Volker Rule) seemingly weighs against the U.S. case. Ultimately, the U.S. was deferred for further study. However, the degree of difficulty in assessing the United States suggests that it will not gain fast entry into the ranks of the approved third countries eligible to passport.

National Private Placements Assessed

AIFMD took quite a lot longer than anyone expected to be implemented, making the July 2015 deadline too soon for ESMA to express a clear view on National Private Placements. Accordingly, they live until another day, but were not reported on favorably.

National Private Placements were assessed, albeit tentatively, by ESMA, nonetheless. First, ESMA noted that the passport regime is in full force, and widely adopted with 348 AIFMs authorized and passporting (e.g., cross-border marketing a fund formed in the UK, Ireland, or Luxembourg elsewhere in the EU) some 1,678 instances. This led to quite a lot of passporting: 7,868 Alternative Investment Funds passported during the same period, mostly out of the UK, Ireland, and Luxembourg.

National Private Placements, however, are also an interesting story and contrast. During the same period noted above, across the entire EU, 1777 non-EU AIFMs marketed alternative investment funds in all 27 Member States using the National Private Placement regime set out in AFIMD (i.e., Article 42(1)), but of these, 1013 were marketed in the UK. A mere 64 were applications by non-EU AIMF's to market on a national private placement basis in other member states of the EU other than the UK. This comports with our own anecdotal evidence that national private placements outside of the UK are subject to impediments often referred to as regulatory "gold plating". But gold plating outside the UK has not proved a show stopper. Of the 4,356 AIFs privately placed in the EU, only 2,657 were privately placed in the UK. Thus, some relatively small number of non-EU firms are very active in non-UK national private placements and have worked through the gold plating. Plainly, it can and is being done. Our anecdotal evidence suggests that the focus of the intrepid managers has been on Germany. It is also clear that nearly all of the non-EU managers are U.S.-based, and almost all of the non-EU funds are based in Cayman, with U.S. funds a distant second place.

Bottom line: ESMA has decided that it needs more time to think about the future of National Private Placements, and that it intends to revisit them and make a new definitive recommendation, eventually. One thing seems clear, ESMA will simultaneously evaluate whether the passport can be extended to third countries.

Given the overall tone of ESMA's views on the United States as a potential regime for passporting, U.S. firms are well advised to anticipate that they will need to continue to work though utilization of national private placements and/or partnering with EU AIFMs for the foreseeable future.

"Final Order" in Supreme Court Mutual Fund Fee Case: More Lessons for Fund Boards

Having decided *Jones v. Harris* 559 U.S. 335, 346 (2010), the US Supreme Court sent the case back to the 7th Circuit Court of Appeals for application of its revised rule in 1940 Act Section 36(b) mutual fund excessive fee cases. The task before the 7th Circuit was to revisit the decision of the trial court, rendered in 2007. This the 7th Circuit finally did, on August 6, 2015, seemingly bringing the Harris Trust case to its end. In doing so, the 7th Circuit found that "the district court's decision has held up well." In taking up *Jones v Harris* once again, the 7th Circuit made plain that "[t]o face liability under [Section 36(b) of the Investment Company Act] and investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to an arm's length bargaining." Further, procedural errors (such as the potential lack of independence of one of the non-interested trustees) are not an "independent violation of Section 36(b)" even if one were to exist. Rather, the courts must focus solely on the question of whether or not the fees themselves were excessive. The 7th Circuit then put its finger on the essential outcome of the *Jones v. Harris* case. "The district court granted summary judgment to Harris after applying a legal standard similar to the one eventually adopted by the Supreme Court." This, of course, refers to the Second Circuit's 1982 Gartenberg decision. However, the 7th Circuit took pains to point out that the District Court standard was too hard on investment advisers. The 7th Circuit noted, "The standards [of the District Court applying the Gartenberg rule and that of the Supreme Court] are not identical, because the Supreme Court's approach does not allow a court to assess the fairness or reasonableness of advisers' fees; the goal is to identify the outer bounds of arm's length bargaining and not engage in rate regulation. This means that the Supreme Court's standard is less favorable to plaintiffs than the one the district court used—yet plaintiffs lost even under the district court's approach." In what may be something of a breakthrough for fund boards, the 7th Circuit emphasized the significance of competitor fees in the mutual fund industry. "This record shows that Harris's fee was comparable to that produced by bargaining at other mutual-fund complexes, which tells us the bargaining range" (emphasis added). The 7th Circuit again rejected plaintiff's final try to compare mutual fund fees to managed account fees charged by Harris Trust to institutional separate accounts, but not because such comparisons are always irrelevant. Rather, in this instance "Plaintiffs have not proffered evidence that would tend to show that Harris provided pension funds (and other non-public clients) with the same sorts of services that it provided to the Oakmark funds, or that it incurred the same costs when serving different types of clients."

The most recent decision in Harris Trust teaches us that *Jones v. Harris* offers fund boards some measure of assurance that a procedural slip up will not be fatal to the board's overall decision making, that use of industry data such as that provided by Lipper or Morningstar is perfectly sensible, and that institutional separate account fees may be relevant, if services and costs are of the same as those associated with servicing mutual funds.

Enforcement

Investment Adviser's Failure to Disclose Conflicts of Interest, Properly Bill Clients, and Enforce Gifts and Entertainment Policy Result in $20 Million Penalty

The SEC recently announced a settlement regarding (1) an investment adviser's breach of its fiduciary duty by failing to disclose a conflict of interest that resulted from a $50 million loan that one of its senior executives received from an advisory client, and (2) the investment adviser's violation of the Investment Advisers Act when, among other things, the adviser (a) inadvertently billed a client for asset management fees on non-managed assets and (b) failed to enforce its gifts and entertainment policy. The SEC stated that "as fiduciaries, investment advisors must be vigilant about disclosing all material facts to their clients, including actual and potential conflicts of interest … and the $20 million penalty reflects the significance of this and other regulatory failures."

Failure to Disclose Conflict of Interest

The investment adviser's client (Client A) made a $50 million loan to a senior executive of the adviser (Adviser Executive). Client A maintained accounts managed by the investment adviser and non-managed accounts outside of the adviser. The loan was negotiated and made by Client A, through one of its affiliates, as principal and not by the investment adviser on Client A's behalf.

At the time of the loan, the investment adviser's Code of Ethics (the Code) stated, "This Code is based upon the principle that [the adviser's] employees owe a fiduciary duty to [the adviser's] clients to conduct their affairs ... in such manner to avoid ... any actual or potential conflicts of interest[.]" The Code further directed that employees be familiar with the investment adviser's compliance manual. The compliance manual explained the requirement that the investment adviser, as a fiduciary, "make full and fair disclosure of all material facts, including potential conflicts of interest," to its clients. The investment adviser's Code also referred its employees to the guidance in a code of conduct for one of its affiliates, which prohibited employees from accepting loans from clients.

The SEC found that the investment adviser did not act reasonably in connection with the Adviser Executive's loan from Client A because it failed to adopt measures to provide meaningful oversight of the Adviser Executive's non-advisory business dealings that impacted the adviser's obligations as a registered investment adviser. Specifically, multiple senior individuals within the investment adviser and the adviser's corporate parent knew about the loan, but none of these individuals communicated its existence to the adviser's compliance staff because the adviser had an insufficient compliance process. As a result, the investment adviser did not inform its clients of the potential conflict of interest created by the loan, and the adviser failed to enforce its Code and implement its compliance policies and procedures regarding conflicts of interest.

Advisory Fees Charged on Non-Managed Assets

The SEC found that during a multi-year period, for one institutional client, the investment adviser inadvertently charged approximately $6.5 million in asset management fees for investments it did not manage. The charges resulted from inaccurate coding of the investments on the investment adviser's books and records. That coding, in turn, caused the investment adviser's accounting system to interpret the investments – incorrectly – as investments managed by the adviser on behalf of the client.

Violations Regarding Gifts and Entertainment

The investment adviser's Code stated that "Supervised Persons may only accept appropriate and reasonable gifts and entertainment of a de minimis value as provided in [the adviser's] Gifts and Entertainment Policy." The investment adviser's Code further defined de minimis as having a value of $250 or less. The investment adviser's policies and procedures required the chief compliance officer to approve any exceptions to the gift and entertainment limitation on a case-by-case basis.

The SEC found that at least 7 of the investment adviser's employees took at least 44 unreported flights on the private planes of the adviser's clients. However, the investment adviser's compliance logs only reflected one such flight, which had been mentioned to the adviser's chief compliance officer after the flight occurred. As a result, the investment adviser failed to enforce its Code with respect to gifts and entertainment and implement its compliance policies and procedures regarding gifts and entertainment.