

SEC discusses investment fund enforcement priorities for 2015

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In a speech entitled “Conflicts, Conflicts Everywhere”, Julie M. Riewe, Co-Chief of the Asset Management Unit (“AMU”) of the Securities and Exchange Commission’s (“SEC”) Enforcement Division spoke earlier this year at the 17th Annual Investment Adviser Compliance Conference. The SEC created the AMU 5 years ago to focus on and enhance regulation of investment funds and investment advisers. In her speech, Ms. Riewe identified what the AMU will be focusing their enforcement efforts on in 2015, and discussed the AMU’s overarching concern with conflicts of interest. Specifically, the AMU will focus its enforcement efforts with respect to the investment funds and advisers it oversees as follows:

(1) Registered Investment Companies:

- Valuation and performance.
- Advertising of performance.
- Fund adherence to investment guidelines or pursuance of undisclosed strategies.
- Fund governance, including boards and advisers discharging their obligations under Section 15(c) of the Investment Company Act of 1940 (“Investment Company Act”) when they evaluate advisory and other types of fee arrangements. Section 15(c) of the Investment Company Act requires, among other things, that the terms of any investment advisory agreement be approved by a majority of a fund’s board of directors who are not interested persons, and that a fund’s board of directors be provided with information necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve as an investment adviser of a registered investment company.
- Fund distribution, including whether advisers are causing funds to violate Rule 12b-1 of the Investment Company Act 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. Rule 12b-1 of the Investment Company Act permits funds to compensate, subject to certain conditions, brokers and other intermediaries out of the fund’s assets for services provided related to the distribution of fund shares.

(2) Private Funds (Hedge Funds and Private Equity Funds) :

- *Hedge Funds:*
 - Undisclosed fees.
 - Undisclosed conflicts (i.e., related-party transactions).
 - Valuation issues (i.e., use of friendly broker marks).
- *Private Equity Funds:*
 - Undisclosed and misallocated fees and expenses.

(3) Other Client Accounts (i.e., separately managed accounts/retail accounts)

- Conflicts of interest.
- Fee arrangements.
- Compliance.

As specified above, conflicts of interest and valuation are a major concern for the AMU across each type of investment fund it monitors. Significantly, these include funds that are not registered which, although not subject to registration, are subject to antifraud and other provisions. In describing the SEC's stance on conflicts, Ms. Riewe quoted the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.* that investors must be permitted to evaluate "overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest.'" Ms. Riewe defined conflicts of interest as "material facts that investment advisers, as fiduciaries, must disclose to their clients."

For the SEC, transparency around conflicts is key. If a fund manager cannot or chooses not to eliminate the conflict, the SEC, in evaluating whether to pursue an inquiry or enforcement action, will consider whether the fund manager has properly identified its conflicts of interest and either eliminated them, or mitigated them and disclosed them to boards or investors. It is failed or flawed disclosure that may spur an enforcement action.

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions concerning the material discussed in this client alert, please contact Michael Storck at mstorck@lippes.com or Eliza Friedman at efriedman@lippes.com.

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