

# Multitudes, Multitudes: the SEC's Asset Management Unit Delivers Important Messages for Investment Advisers

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**The SEC signals continued scrutiny of asset management firms for all manner of violations — including technical violations first identified in exams.**

On February 26, Julie Riewe, the Co-Chief of the SEC's Asset Management Unit (AMU), delivered a speech<sup>1</sup> to the IA Watch 17th Annual IA Compliance Conference that could fairly be described a "state of the unit" address. Titled "Conflicts, Conflicts Everywhere," Riewe's speech highlights the AMU's focus on what the SEC views as conflicts of interest in all shapes and sizes.

Among the key takeaways are:

- The close collaboration between the SEC Enforcement Division's AMU and the Office of Compliance Inspections and Examinations (OCIE)
- The use of OCIE exam findings as a basis for identifying recidivist conduct
- The several areas of ongoing AMU initiatives.

**OCIE and the AMU of the enforcement division are working together before, during and after examinations of advisers**

Riewe described the close collaboration between OCIE and the AMU. Notably, this collaboration begins well before an examination takes place. For example, OCIE and the AMU work together to identify risk areas, which OCIE then uses to finalise the list of firms it will examine. After the exams begin, the AMU monitors the progress of the exams, and often receives enforcement referrals that arise from the exams. Riewe pointed to two registered investment company exam sweeps that arose from this pre-exam collaboration: the Alternative Mutual Fund sweep and the so-called "Distribution in Guise" sweep. Advisers covered in exam sweeps often receive a standardised set of exam requests, likely the product of a pre-exam discussion between the AMU and OCIE.

Riewe emphasised that the close coordination between the AMU and OCIE is "not cause for alarm" and "nothing new," but undoubtedly the coordination has greatly energised the exam program. Indeed, Riewe noted that over the past five years, the "three-legged stool of collaboration — AMU, OCIE, and the Division of Investment Management — has yielded tremendous results."

Before the Enforcement Division created the AMU, enforcement referrals to the Enforcement Division were relatively rare in such technical compliance areas as best execution failures and custody issues. Now, as Riewe noted, OCIE can work with enforcement staff in the AMU "that understand the importance of regulatory violations such as compliance and custody rule violations." The AMU's greater appetite for OCIE referrals, particularly those involving technical violations that formerly did not result in enforcement actions, has enabled OCIE to come out of the shadows. Enforcement actions arising from exam referrals can be highly publicised, including in news reports and SEC staff speeches. The SEC staff (including individual examiners) are often named in SEC press releases announcing the enforcement action. The AMU's partnership with OCIE allows the AMU special access to OCIE's pipeline of investment adviser enforcement referrals. OCIE, on the other hand, is able to publicise specific matters with which it has assisted the AMU.

**OCIE findings as basis for "recidivism"**

Advisers should take special note of Riewe's comments regarding "recidivism," which reflect an expanded view of that term with significant implications for advisers. Riewe cited the *Transamerica Financial Advisors, Inc.* case, in which the SEC pursued an enforcement proceeding in which "the firm had been told by OCIE after a branch exam that it might have a firm-wide [account] aggregation issue, but Transamerica never undertook a global review." In the enforcement proceeding, the SEC treated Transamerica's failure to respond to the OCIE exam comment as an instance of recidivism. Historically, the SEC defined

<sup>1</sup> See <http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html#.VRy3tZhOWt8>

recidivism to refer to improper conduct that followed a disciplinary event, such as an SEC enforcement action. Riewe's remarks indicate that the SEC is expanding its view of recidivism to include failure to take enterprise-wide corrective action following a comment letter from OCIE — even if the comment letter noted only that a firm “might have” an issue. This wider approach to recidivism presents challenges to investment advisers, as OCIE routinely cites potential deficiencies in comment letters — potential deficiencies identified without an adjudication of facts, after what can be a broad review of a firm's activities, and which are often the product of firm-SEC interactions that do not involve outside enforcement counsel. Advisers should review their prior comment letters from OCIE to confirm whether the firm has appropriately addressed the examiners' comments.

### **The AMU's initiatives will continue**

Riewe also highlighted that the AMU has numerous initiatives underway, several of which began years ago. For example, the AMU continues to look for enforcement cases against hedge fund managers using what is referred to as an “Aberrational Performance Inquiry,” a years-old look at hedge fund managers that reported allegedly aberrational returns compared to peer funds. In 2011, the SEC announced that the AMU was investigating hedge funds identified through the Aberrational Performance Inquiry, and in 2012, the SEC brought the first of several cases resulting from the initiative. According to Riewe, the AMU is refining its analytics as it hunts for more hedge funds reporting suspicious returns. Riewe also indicated that the following three initiatives remain in existence long after the SEC's initial enforcement actions in each area: the Fund Fee Initiative (focused on mutual fund fees), the Compliance Rule Initiative, and the Custody Rule Initiative. Riewe also mentioned three newer initiatives: the Undisclosed Adviser Revenue Initiative (focused on undisclosed compensation agreements between investment advisers and brokers), the Cherry Picking Initiative (focused on preferential trade and investment allocations) and the Distribution in Guise Initiative (focused on whether advisers are causing mutual funds to make payments to intermediaries for distribution outside of a 12b-1 plan). Because individual cases receive greater publicity when brought through an initiative, the initiatives may make enforcement cases more attractive for the AMU. Initiatives also allow the agency to send messages to the industry regarding areas of concern.

### **Special considerations for private fund managers**

Riewe's remarks demonstrate that the AMU continues to focus on private fund managers. Regarding private equity fund managers, Riewe stated that the AMU continues to investigate “misallocated fee and expense cases” like the *Lincolnshire* enforcement action, which the AMU brought in 2014. In *Lincolnshire*, the SEC alleged that a private equity fund manager misallocated expenses of a portfolio company owned by two affiliated funds, and favoured one fund over another. *Lincolnshire* illustrates that the AMU and OCIE are using a highly detailed approach to reviewing fees and expenses, combing through individual portfolio company expenses with an eye toward uncovering possible misallocations in conflict-of-interest situations. Notably, in *Lincolnshire*, the agency cited not just misallocated expenses but also “undocumented” expenses as evidence of the alleged violation, shifting to the adviser the burden of proof if documentation no longer exists. In light of this result, private equity fund managers should be careful to retain documentation related to portfolio company expenses.

Regarding hedge funds, Riewe's remarks suggest that the AMU has a strong pipeline of investigations that likely will yield enforcement actions in the near future. She pointed to cases concerning related-party transactions (which under GAAP require disclosure in the audited financial statements for the fund and the adviser) and valuation issues involving “friendly broker marks” (which likely refers to accommodation quotes that an adviser received from brokers on illiquid assets, and which the SEC believes are not appropriately arms-length, to support the fund's valuation of the assets).

Further, Riewe's reference to the AMU's “Cherry Picking Initiative” suggests that the unit is looking into trade allocations by hedge fund managers and investment allocation decisions by private equity managers. In this regard, the unit is likely focused on issues arising from side-by-side management, in which a fund manager may face different incentives for different client accounts. For example, a manager of a hedge fund and an alternative mutual fund using the same strategy must be careful not to favour the hedge fund in trade allocations, as the hedge fund may be more lucrative for the manager in light of its performance fee.

Likewise, private equity managers should assess whether investment allocation decisions favour a particular fund or funds under their management. For example, a private equity manager should carefully scrutinise investment allocations that favour funds in which carried interest is more likely to be paid.

Finally, since the Aberrational Performance Inquiry is ongoing, hedge fund managers should assess whether their reported returns significantly outpace the returns of the fund's peer group. As a practical matter, hedge fund managers should focus on reported return series that are consistently two-to-three standard deviations above the peer group. OCIE and, in turn, the AMU

will likely view such persistent outperformance as suspicious and may target the adviser for an examination and review of the fund's performance calculations (and the valuations driving the performance) at a granular level.

### **Special considerations for registered investment company managers**

The AMU and OCIE are subjecting registered investment companies to additional scrutiny, marked by a series of cases involving mutual fund advisers and their boards. Riewe pointed to several areas likely to result in enforcement actions soon:

- The investment advisory agreement approval process under Section 15(c) of the Investment Company Act
- Performance advertising
- Best execution in share class selection
- Representations to fund boards regarding fees charged to the fund (e.g., so-called "distribution in guise")

According to Riewe, the AMU is focused on disclosures to mutual fund shareholders and the boards of mutual funds. Mutual fund advisers should look closely at both forms of disclosure in light of the operations of the mutual funds they manage.

### **Action item: analyse how conflicts are being handled**

Riewe laid out the AMU's view of conflicts of interest, which she characterised as "one of the Asset Management Unit's overarching concerns across all of the investment vehicles," and which rests on the Supreme Court's *Capital Gains Research Bureau* case. Noting that "nearly every ongoing matter" in the AMU involves some examination of conflicts, Riewe warned that advisers must either eliminate conflicts, or fully disclose each conflict. She also suggested that advisers mitigate conflicts wherever possible. Riewe emphasised there is no "good faith" exception to the requirement to eliminate or disclose conflicts.

Riewe cited several specific areas in which conflicts often arise:

- An adviser doing business with an affiliated broker-dealer
- Side-by-side management
- Proprietary trading
- Inter-fund lending and investing
- Compensation the adviser received from third-parties

Riewe also enumerated the documents that the AMU and OCIE will review to determine whether (and how well) a conflict has been disclosed: the adviser's Form ADV, PPMs (and supplements thereto), fund agreements, investment management agreements with clients, and prospectuses (where applicable).

Riewe concluded by suggesting a "homework" assignment for registered investment advisers. Legal and compliance personnel should closely examine specific conflicts that arise in the adviser's operations, and review each of the disclosure documents that apply to the adviser's clients. Given that the current climate at the SEC is quite strict regarding conflicts of interest, it is clear that the AMU and OCIE expect advisers to show efforts to mitigate conflicts. Advisers that mitigate conflicts become much less interesting to the SEC as candidates for a possible enforcement action, and are thus less likely to be referred by OCIE to the AMU.

Mitigating conflicts will mean different things to different advisers. In the private fund space, the best mitigation strategy may involve implementing a robust advisory committee process. In the registered investment company space, mitigation might involve setting up a conflicts committee through the board that is regularly apprised of how the adviser is handling conflicts, or dedicating time at each board meeting to discuss conflicts. In view of the SEC's current approach to examinations and enforcement, advisers should be prepared to explain the manner in which the adviser's conflicts have been mitigated and disclosed.

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