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Investment Advisers: Institutional Issues (MA:4)

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I. Trends in SEC Examinations

A. Asset Management "Sweeps"

1. Alternative Mutual Funds: OCIE is conducting a sweep examination of alternative mutual funds, focusing on valuation of illiquid assets, liquidity disclosures, use of leverage, and board oversight of alternative mutual funds. Additional areas of focus include staffing, funding, and empowerment of boards, compliance personnel, and back offices, and how funds are marketed to investors. In 2014, Norm Champ, then Director of the SEC's Division of Investment Management, stated that the sweep "will produce valuable insight into how alternative mutual funds attempt to generate yield and how much risk they undertake, in addition to how well boards are carrying out their oversight duties."[1]

2. Private Equity Funds: In October 2012, OCIE sent a letter to senior executives and principals of newly registered investment advisers describing a new presence exam initiative that would conduct focused, risk-based examinations of private equity fund advisers.[2] The presence exams are focused on five key areas: marketing, portfolio management, conflicts of interest, safety of client assets, and valuation.

B. OCIE's 2015 Examination Priorities[3]

1. "Alternative" Investment Companies: OCIE is continuing its review of funds that offer "alternative" investments or use alternative investment strategies, particularly (1) policies and practices related to leverage, liquidity, and valuation; (2) internal controls, with a focus on staffing, funding, and empowerment of board, compliance personnel, and back-offices; and (3) how these funds are marketed to investors.

2. Fixed Income Investment Companies: Building on pilot exams conducted in the Summer of 2014, OCIE is conducting a sweep to "review whether mutual funds with significant exposure to interest rate increases have implemented compliance policies and procedures and investment and trading

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* This outline was prepared with the help of associate Brian J. Baltz. The portions of this outline on current enforcement actions are drawn in part from our publication, *Select Broker-Dealer, Investment Adviser, and Investment Company Enforcement Cases and Developments: 2013 Year in Review,* available at http://www.morganlewis.com/pubs/Securities_LF_2013YearInReview_19feb14.pdf.

controls sufficient to ensure that their funds' disclosures are not misleading and that their investments and liquidity profiles are consistent with those disclosures."

3. Cybersecurity: OCIE is continuing an initiative launched in 2014 to review broker-dealers' and investment advisers' cybersecurity compliance and controls, and expand the review to transfer agents.

4. Potential Equity Order Routing Conflicts. OCIE is also looking to "assess whether firms are prioritizing trading venues based on payments or credits for order flow in conflict with their best execution duties."

5. Proxy Services. OCIE will examine how select proxy advisory service firms make recommendations on proxy voting and disclose and mitigate potential conflicts of interest, and whether they are complying with their fiduciary duties in voting proxies on behalf of investors.

6. Never-Before-Examined Investment Companies: Building on the exams conducted in 2014 for registered investment advisers that had not previously been examined by the SEC staff, OCIE will select registered investment companies that have not been examined and conduct focused, risk-based examinations of those entities.

7. Fees and Expenses in Private Equity: OCIE will continue examining fees and expenses in private equity given the high rate of deficiencies it has observed to date.

II. Regulatory Focus on Portfolio Management and Risk

A. As noted above, OCIE has been conducting examination sweeps concerning alternative mutual funds and fixed income mutual funds, and has prioritized these issues for broader examinations in 2015. In addition, the Financial Stability Oversight Council ("FSOC") has sought comment on whether the asset management industry presents a risk to financial stability, and SEC Chair Mary Jo White has stated that the SEC is separately considering rulemaking initiatives regarding portfolio management and risk.

B. On December 18, 2014, FSOC requested comment on asset management products and activities, specifically with respect to liquidity and

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[1] Norm Champ, Dir., Div. of Inv. Mgmt., Secs. and Exch. Comm'n, Remarks to the Practising Law Inst., Private Equity Forum (June 30, 2014).

[2] Letter from Securities and Exchange Commission, Office of Compliance Inspections and Examinations, to Senior Executives or Principals of Newly Registered Investment Advisers (Oct. 9, 2012), *available at* www.sec.gov/about/offices/ocie/letter-presence-exams.pdf.

[3] Securities and Exchange Commission, Office of Compliance Inspections and Examinations, National Exam Program, Examination Priorities for 2015 (Jan. 2015), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

redemptions; leverage; and operational risk.[4] FSOC is looking to understand the extent to which asset management products and activities, including risks related to liquidity and redemptions, leverage, and operational risk, could pose potential risks to U.S. financial stability. The comment period as extended closes on March 25, 2015.

C. On December 11, 2014, SEC Chair Mary Jo White previewed initiatives the SEC is considering to enhance risk monitoring and regulatory safeguards in the asset management industry.[5] In that speech, Chair White identified three initiatives that the staff has been developing recommendations to address. First, Chair White wants to improve the data and other information the SEC uses to draw conclusions about risks and develop appropriate regulatory responses. Second, she wants registered funds to enhance their fund-level controls in a manner that would allow them to identify and address risks related to the composition of modern portfolios Finally, Chair White would like firms to have plans for transitioning their clients' assets when circumstances warrant.

III. Cross Trading

A. *In the Matter of Western Asset Management Co.*, Admin. Proceeding File NO. 3-15688 (Jan. 27, 2014)

1. The SEC filed a settled administrative proceeding against Western Asset Management Co. ("WAMCO"), a registered investment adviser, in which it found that WAMCO engaged in prearranged dealer-interposed cross trades in which the counterparty dealers purchased fixed-income securities from certain WAMCO clients and then resold the securities to other WAMCO clients.

2. Since many clients involved in the cross trades were investment companies, the SEC found that WAMCO aided and abetted and caused those clients to unwittingly violate Sections 17(a)(1) and (2) of the Investment Company Act. The SEC also found that the cross trading resulted in undisclosed favorable treatment of certain clients over others by cross trading securities at the bid instead of the midpoint between the bid and the ask. Further, the SEC found that WAMCO did not adopt policies and procedures reasonably designed to ensure compliance with the cross trading provisions.

3. The SEC found that WAMCO violated Section 17(a)(1) and 17(a)(2) of the Investment Company Act; Sections 203(e)(6), 206(2), 206(4), and 207 of the Investment Advisers Act of 1940 ("Advisers Act"), and Rules 206(4)-7 and 206(4)-8(a)(2) thereunder.

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[4] Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77488 (Dec. 24, 2014).

[5] Mary Jo White, Chair, Secs. and Exch. Comm'n, Remarks at The New York Times DealBook Opportunities for Tomorrow Conference: Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014).

4. WAMCO was censured, ordered to engage a compliance consultant, ordered to cease and desist, and ordered to pay a civil penalty of $1,000,000.

IV. Trade Allocations

A. *In the Matter of Structured Portfolio Management, L.L.C.*, et al., Admin. Proceeding File No. 3-16046 (Aug. 28, 2014)

1. The SEC filed a settled administrative proceeding against Structured Portfolio Management, L.L.C. ("SPM") and its affiliated advisers for failing to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act concerning trade allocation and the review of investor disclosures.

2. As alleged in the SEC order, SPM disclosed and allowed a trader to trade the same securities across three SPM-advised hedge funds, but without having appropriate controls in place. In one of the funds, the trader's responsibility was to make a profit, while in the other two funds it was to hedge interest rate risk. Although trading the same securities across the three funds created a conflict of interest, which was disclosed, SPM did not update or modify its policies and procedures. The firm used trade blotters that did not identify the fund for which securities were traded.

3. In addition, SPM did not adopt and implement written policies and procedures reasonably designed to prevent inaccurate investor disclosures, which resulted in offering documents and other disclosures that did not indicate a fund was no longer trading in mortgage-backed securities.

4. The SEC found that SPM violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

5. SPM was censured, ordered to engage an independent compliance consultant, ordered to cease and desist, and ordered to pay a civil penalty of $300,000.

B. *In the Matter of J.S. Oliver Capital Management, L.P., Ian O. Mausner, and Douglas F. Drennan, Admin. Proc. File No. 3-15446 (Aug. 30, 2013)*

1. The SEC filed an administrative proceeding against J.S. Oliver Capital Management, L.P. ("J.S. Oliver"), a registered investment adviser, and Ian O. Mausner ("Mausner"), its founder, president, and sole owner, alleging that they engaged in separate schemes to (i) disproportionately allocate favorable trades to affiliated and/or favored hedge fund clients to the detriment of other clients; and (ii) with substantial assistance from Douglas F. Drennan ("Drennan"), an outside research analyst also named in the SEC's Order, used soft dollar credits from client commission arrangements for personal and other undisclosed and unauthorized purposes.

2. The SEC alleges that from June 2008 to November 2009, J.S. Oliver and Mausner allocated profitable equity trades on a preferential basis to six client accounts, including affiliated hedge funds, to the detriment of three other J.S. Oliver clients. The SEC's Order states that Mausner placed block trades in omnibus accounts at various broker-dealers, which were then reported to J.S. Oliver's prime broker. Thereafter, he allegedly used the prime broker's online platform to allocate the shares among client accounts, often waiting until after the close of trading so that he could determine the value of the securities and allocate to preferred accounts those that had increased in value and to disfavored accounts those that had decreased in value. Where there were multiple trades in the same security on the same day, Mausner allegedly allocated the most favorably priced trades to favored accounts.

3. The preferential allocations were contrary to J.S. Oliver's written policies and procedures and to representations made in client agreements, which required that allocations among clients would be fair and equitable and in proportion to account assets or target percentage levels. In addition, the SEC alleges that J.S. Oliver received performance fees from the favored funds, and Mausner and his family profited at certain clients' expense because they were personally invested in some of the favored funds.

4. The SEC alleges that a separate scheme operated from January 2009 through November 2011 in which J.S. Oliver misused over $1.1 million in soft dollar credits accrued from trading commissions paid by J.S. Oliver clients. J.S. Oliver disclosed in its Form ADV allowable uses of soft dollar credits, but Mausner, allegedly with substantial assistance from Drennan, misrepresented and falsely documented the purpose of certain payments, which were directed to unauthorized uses such as Mausner's personal expenses and salary and bonus payments to Drennan.

5. Finally, the SEC alleges that J.S. Oliver failed to maintain a memorandum of each order it gave for the purchase or sale of securities and to maintain originals of Mausner's email messages promoting one of the funds that he favored in his cherry-picking scheme.

6. The SEC's Order alleges (i) that J.S. Oliver and Mausner violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rule 206(4)-8 thereunder; (ii) that J.S. Oliver willfully violated, and Mausner willfully aided, abetted, and caused J.S. Oliver's violations of Sections 204 and 206(4) of the Advisers Act and Rules 204-1(a)(2), 204-2(a)(3), 204-2(a)(7), and 206(4)-7 thereunder; and (iii) that Drennan willfully aided, abetted, and caused J.S. Oliver's violations of Sections 17(a)(1) and (2) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

7. An initial decision, dated August 5, 2014, found (i) that Drennan willfully aided and abetted and caused J.S. Oliver's violations of Sections 17(a)(1) and 17(a)(2) of the Securities Act , Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder; (ii) that J.S. Oliver willfully violated Section 204 of the Advisers Act and Rules 204-5(a)(3) and 204-2(a)(7) thereunder, and that Mausner willfully aided and abetted and caused J.S. Oliver's violations; (iii) that J.S. Oliver willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and that Mausner willfully aided and abetted and caused J.S. Oliver's violations; and (iv) that J.S. Oliver and Mausner willfully violated Section 207 of the Advisers Act, and that J.S. Oliver violated Section 204 of the Advisers Act and Rule 204-1(a)(2) thereunder, violations that Mausner willfully aided and abetted and caused.

8. It was ordered (i) that J.S. Oliver, Mausner, and Drennan cease and desist from committing or causing violations of the securities laws; (ii) that J.S. Oliver and Mausner, jointly and severally, pay disgorgement of $1,376,430 plus prejudgment interest, and Drennan, J.S. Oliver, and Mausner, jointly and severally, pay $482,381 plus prejudgment interest; (iii) that J.S. Oliver pay a civil monetary penalty of $14,975,000, Mausner of $3,040,000, and Drennan of $410,000; (iv) that the investment adviser registration of J.S. Oliver be revoked; and (v) that Mausner and Drennan be permanently barred from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. The SEC has granted a petition for review of the initial decision.

V. Suitability

A. *In the Matter of Western Asset Management Co.*, Admin. Proceeding File NO. 3-15689 (Jan. 27, 2014)

1. The SEC filed a separate administrative proceeding against WAMCO in which it found that WAMCO failed to disclose its violation of an issuer-imposed restriction prohibiting pension plans subject to Part 4 of Subtitle B of Title 1 of ERISA from participating in a private placement despite being aware that it had allocated such securities to ERISA accounts.

2. WAMCO also failed to take prompt corrective action, contrary to the error correction policy it disclosed to clients. WAMCO did not notify affected clients until nearly two years after learning of the violation of the restriction, which was also more than a year after it had liquidated the securities out of all client accounts.

3. The SEC found that WAMCO violated Section 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder.

4. WAMCO agreed to pay affected ERISA clients $9,620,392. Further, WAMCO was censured, ordered to engage an independent compliance consultant, ordered to cease and desist, and ordered to pay disgorgement of $8,111,582 and prejudgment interest of $1,508,810.

B. *In the Matter of Manarin Investment Counsel, Ltd., Admin Proc. File No. 3-15549 (Oct. 2, 2013)*

1. The SEC filed a settled administrative proceeding against Manarin Investment Counsel, Ltd. ("MIC"), a registered investment adviser, Manarin Securities Corp. ("MSC"), a registered broker-dealer, and Roland R. Manarin ("Manarin"), the founder, owner, and president of MIC and MSC. The SEC alleged that MIC and Manarin failed to obtain best execution for three investment funds managed by MIC (including a mutual fund) (the "Funds") by purchasing higher-cost mutual fund shares, even though cheaper shares in the same mutual funds were available. As a result, the Funds paid avoidable fees on their mutual fund holdings and passed these fees through to MSC, the affiliated broker-dealer that executed the purchases.

2. According to the SEC, from at least June 2000 through mid-2010, Manarin and MIC breached their fiduciary duties as investment advisers by causing the Funds to buy the Class A shares of underlying mutual funds even when the Funds were eligible to own lower-cost, so-called "institutional" shares of the same mutual funds. As a result, the Funds paid approximately $3.3 million in avoidable 12b-1 fees on their mutual fund holdings, which were passed through to MSC. The SEC alleged that this practice was a violation of MIC's and Manarin's duty to seek best execution and was inconsistent with disclosures in the Fund's offering materials and MIC's Form ADV.

3. The SEC also alleged that, between October 2008 and December 2011, MSC executed transactions in ETF shares on behalf of its affiliated mutual fund and charged commissions that exceeded the usual and customary broker's commission for such transactions.

4. The SEC's settled Order charged that MIC and Manarin violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder, (ii) that Manarin violated Section 34(b) of the Investment Company Act of 1940 ("Investment Company Act"); (iii) that MIC, MSC, and Manarin violated Section 17(a)(2) of the Securities Act; and (iv) that MSC violated Section 17(e)(2)(A) of the Investment Company Act.

5. Pursuant to the settlement, MIC, MSC and Manarin consented to cease-and-desist orders and censures. MSC and Manarin also agreed, jointly and severally, to pay disgorgement totaling $685,006.90 and prejudgment interest totaling $267,741.72. Further, Manarin agreed to pay a civil penalty of $100,000.

VI. Soft Dollars and Use of Dealing Commissions

A. *In the Matter of Instinet, LLC*, Admin. Proc. File No. 3-15663 (Dec. 26, 2013)

1. In a follow-up to the J.S. Oliver matter, discussed above, the SEC filed a settled administrative proceeding against Instinet, LLC ("Instinet") for allegedly paying approximately $430,000 in client commission credits (soft dollars) as requested by its investment adviser customer, J.S. Oliver, for expenses that J.S. Oliver had not properly disclosed to its clients, including improper personal expenses of J.S. Oliver's president. The SEC alleged that Instinet made the payments pursuant to J.S. Oliver's requests despite the fact that the information J.S. Oliver provided to Instinet when requesting approval of the payments contained significant red flags that suggested that each payment was improper.

2. The SEC alleged that J.S. Oliver, through Instinet, used soft do*llar credits on brokerage comm*issions to pay for personal expenses that fell outside of the safe harbor provided under Section 28(e) of the Exchange Act and that were not properly disclosed to clients. For example, the SEC alleged that in June 2009 Instinet, pursuant to J.S. Oliver's request, paid J.S. Oliver $329,365 using soft dollar credits for a payment to Mausner's ex-wife based on J.S. Oliver's representations to Instinet that the payment was for employee compensation. The SEC further alleged that an Instinet employee knew of significant red flags that the payment to Mausner's ex-wife was improper, including that (i) the recipient of the payment was Mausner's ex-wife; (ii) the payment was purportedly related to the Mausners' parting ways professionally after their divorce; (iii) J.S. Oliver gave Instinet a series of inconsistent justifications for the payment; (iv) despite Instinet's requests, J.S. Oliver never provided Instinet with the purported employment agreement or a legal opinion from counsel stating that the use of soft dollars for the payment was permissible; and (v) J.S. Oliver provided Instinet an excerpt of the purported employment agreement (that had been materially altered by J.S. Oliver) and did not indicate that Mausner's ex-wife had conducted any work for J.S. Oliver in three years and did not substantiate the amount paid. The SEC alleged that despite these red flags, the Instinet employee approved the payment.

3. The SEC further alleged that Instinet employees knew of additional red flags relating to the subsequent payment of soft dollars for increased rent on office space located in Mausner's home and for Mausner's personal time-share property in New York City. The SEC alleged that despite significant red flags, Instinet employees approved such soft dollar payments.

4. The SEC's Order charged that Instinet willfully aided and abetted and caused J.S. Oliver's violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

5. Pursuant to the settlement, Instinet consented to a cease-and-desist order, a censure, and to pay disgorgement of $378,673.76, prejudgment interest of $59,607.66, and a civil monetary penalty of $375,000. Instinet further consented to retain an independent consultant to undertake to review and report on Instinet's policies, procedures, and practices relating to the payment of soft dollars.

B. European Securities and Markets Authority (ESMA), Portfolio Manager Use of Client "Dealing Commissions" for Research[6]

1. On December 19, 2014, the European Securities and Markets Authority (ESMA) published its final technical advice to the European Commission to assist it on the content of delegated acts required for the implementation of the Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR). Among other things, the Technical Advice addresses the acquisition of research by investment firms for use in managing client assets. The Technical Advice still permits investment firms to acquire research through the use of client assets requires firms to pay for research with their own money or specifically charge clients for the purpose of contributing to a research budget (and prohibits firms from linking these charges to client transactions).

2. Background

a. On October 20, 2011, the European Commission adopted two legislative proposals (a directive and a regulation) for the review of MiFID I. After agreeing on a compromise text on January 14, 2014, the European Parliament and European Council each approved the final legislative texts on April 15, 2014 and May 13, 2014, respectively. On April 23, 2014, ESMA received a formal request from the European Commission to provide technical assistance on the content of various delegated acts required by several provisions of MiFID II and MiFIR. On May 22, 2014, ESMA published a consultation paper in order to present its views and seek comment from interested parties for the purpose of producing the Technical Advice.

3. Consultation Paper

a. Article 24(7)(b) and 24(8) MiFID II generally state that an investment firm that provides investment advice on an independent basis or portfolio management is prohibited from accepting fees, commissions, or any monetary or non-monetary benefits paid or provided by a third party or a person acting on behalf of a third party in relation to the provision of services to clients. Excluded from these provisions, however, is the receipt of minor non-monetary benefits capable of enhancing the quality of service provided to a client that are of a scale and nature such that they could not be judged to impair compliance with a duty to act in a client's best interest.

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6 Final Report, ESMA's Technical Advice to the Commission on MiFID II and MIFIR, ESMA /2014/1569 (December 19, 2014), *available at* http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf.

b. In the Consultation Paper, ESMA took the view that these provisions should be read as prohibiting the receipt of research unless the research qualified as a minor non-monetary benefit. In furtherance of this reading, ESMA proposed to establish an exhaustive list of minor non-monetary benefits and explained in the Consultation Paper the circumstances under which research would be a permissible minor non-monetary benefit. Under the approach outlined in the Consultation Paper, bespoke research, access to research analysts, analytical models, investor field trips, and services linked to research such as corporate access and market services would have not been considered minor non-monetary benefits . As a result, the Consultation Paper if adopted as drafted would have effectively banned the use of dealing commissions to acquire research.

c. The Consultation Paper generated a robust response from stakeholders with 330 formal responses filed. Respondents to the Consultation Paper generally objected to the treatment of research as a non-monetary benefit for purposes of the inducement provisions of Article 24(7)(b) and 24(8) and the proposal for an exhaustive list. While many respondents recognized concerns over conflicts of interest, they also indicated that the use of commission sharing arrangements (CSA) between portfolio managers and brokers was an effective response to these concerns since use of CSAs help ensure that research and execution costs would not necessarily be tied to one another.

4. Technical Advice

a. ESMA conceded the lack of support for an exhaustive list of non-monetary benefits and modified its advice with the recommendation that the list be supplemented via ESMA guidelines. In light of the pushback received, ESMA has modified its initial approach to treating research as a prohibited non-monetary benefit. Under the Technical Advice, ESMA takes the view that the provision of research by third-parties (such as firms executing orders or independent research providers) to investment firms providing portfolio management (or other investment or ancillary services) to clients should not be restricted as an inducement if: (i) Investment firms pay for the research out of their own resources (i.e., hard cash); or (ii) The payments for research are made from a separate research payment account controlled by the investment firm, subject to certain conditions (Research Payment Account), described below.

b. Conditions for Use of Research Payment Account: The use of a Research Payment Account is subject to a number of conditions specified by the Technical Advice, which include: (1) the Research Payment Account being funded by a specific research charge; (2) the investment firm setting and regularly assessing a research budget as an internal administrative measure; (3) the investment firm being responsible for operation of the Research Payment Account; (4) the investment firm regularly assessing the quality of the research obtained; and (5) adequate disclosures to clients.

(i) Specific Research Charge: Under the Technical Advice, a Research Payment Account can only be funded through specific charges to clients. More specifically, the specific research charge: (1) can only be based on a research budget set by the investment firm for the purpose of establishing the need for third party research in respect of investment services rendered to clients; and (2) cannot be linked to the volume or value of transaction executed on behalf of clients. The Technical Advice further states that: (1) the total amount of specific charges received cannot exceed the research budget amount; (2) investment firms must agree with each client on the research charge as budgeted by the firm and the frequency with which the specific research charge is to be deducted from the client's assets over the course of the year; (3) research budgets may only be increased with the client's written consent; and (4) surplus amounts in the Research Payment Account should either be rebated to clients or offset against future specific charges.

(ii) Research Budget: As part of establishing a research budget and agreeing a reasonable charge with clients, the Technical Advice requires firms to set and regularly assess the research budget. In particular, the research budget would have to be: (1) managed solely by the investment firm; (2) based on a reasonable assessment of the need for third party research; (3) subject to appropriate controls and senior management oversight; and (4) the controls would have to include clear audit trails of payments made to research providers and the amounts. Internal research would not be funded from the Research Payment Account.

(iii) Responsibility for Research Payment Account: Although investment firms would be responsible for managing and operating the Research Payment Account, the Technical Advice permits firms to delegate the administration of the research payments to a third party.

(iv) Quality Assessments: Investment firms would have to regularly assess the quality of research purchased based on robust criteria and its ability to contribute to better investment decisions. In this connection, the Technical Advice states that firms should be able to demonstrate these elements in a written policy that can be provided to clients. More specifically, the written policy would have to (1) address the extent to which purchased research may benefit client portfolios; and (2) the approach the firm would take to allocate such costs as fairly as practicable across various clients' portfolios.

(v) Disclosures: The Technical Advice requires that investment firms provide certain disclosures to their clients. In particular, investment firms would have to: (1) disclose the budgeted amount of research; (2) disclose the amount of expected research charge to each client; (3) provide clients with information on an annual basis regarding the total costs that each client has incurred for third party research; and (4) at the request of client (or regulators), provide a summary of the providers who were paid from the Research Payment Account, the total amount they were paid over a defined period, the goods and services received, and how the total amount spent from the Research Payment Account compares to the research budget (noting any rebates or carryover of surpluses).

c. Consequences to Brokers: The Technical Advice also briefly touched on obligations of brokers, indicating that they should separately identify execution charges (which reflect the cost of executing the transaction) and any other goods and services rendered should be subject to a separately identifiable charge. This area must be addressed to enable portfolio managers to meet the new restricted approach to inducements. The Technical Advice states that the provision of these goods and services should not be influenced by (or be conditional on) levels of payment for execution services. ESMA offers to issue guidelines in this respect. In addition, ESMA indicates that the European Commission should consider clarifying that an investment firm providing execution and research services, which also conducts underwriting and placement activities, should ensure that adequate controls are in place to manage any potential conflicts of between those activities and between their different clients receiving those services.

VII. Dark Pools

A. *In the Matter of UBS Securities LLC*, Admin. Proceeding File No. 3-16338 (Jan. 15, 2015)

1. The SEC filed a settled administrative proceeding in which it found that UBS Securities LLC ("UBS") operated an ATS and provided disclosures in violation of the federal securities laws.

2. According to the allegations in the order, UBS accepted and ranked hundreds of millions of sub-penny orders, UBS (a) failed to disclose a certain order type, the PrimaryPegPlus, to all subscribers; (b) failed to notify all subscribers that the ATS include a feature that might prevent orders from executing against subscribers whose flow was designated as "non-natural"; and (c) failed to update Form ATS and o limit access to confidential trading information of subscribers.

3. The SEC found that UBS violated Section 17(a) and 17(a)(2) of the Exchange Act, and Rule 17a-4(b)(1) thereunder; Rule 301(b)(2), 301(b)(5)(ii)(A), 301(b)(5)(ii)(B), 301(b)(5)(ii)(D), 301(b)(8), and 301(b)(10) of Regulation ATS; and Rule 612 of Regulation NMS.

4. UBS was censured, ordered to cease and desist, and ordered to pay a civil penalty of $12,000,000, disgorgement of $2,240,702.50, and prejudgment interest of $235,686.14.

B. On June 5, 2014, SEC Chair Mary Jo White gave a speech regarding current equity market structure issues in which she discussed potential regulatory enhancements of the equity markets, including, among other things, with respect to dark pools.[7] Chair White discussed the ways in which dark pools lack transparency,

[7] Mary Jo White, Chair, Secs. and Exch. Comm'n, Remarks Before the Sandler O'Neill & Partners, L.P. Global Exch. and Brokerage Conference: Enhancing our Equity Market Structure (June 5, 2014).

including that they do not publicly display quotes or provide pre-trade price transparency, provide limited information about how they operate, and do not disclose the identities of the participants. Chair White indicated that she has asked the staff for a recommendation "to expand the information about ATS operations submitted to [the SEC] and to make the information available to the public" and stated that the SEC "must continue to examine whether dark trading volume is approaching a level that risks seriously undermining the quality of price discovery provided by lit venues."

VIII. <u>Private Equity and Hedge Fund Advisers</u>

A. SEC Private Equity Fund Examinations

1. On May 6, 2014, OCIE's Director, Andrew J. Bowden, gave a speech titled, "Spreading Sunshine in Private Equity," in which he discussed insights learned from OCIE's examinations of private equity advisers.[8] These insights focused on (1) expenses, (2) hidden fees, and (3) marketing and valuation.

2. Expenses

   a. OCIE has observed that private equity firms may use consultants, or "Operating Partners," that are paid directly by the portfolio companies or funds without sufficient disclosure to investors. In Mr. Bowden's view, this creates at least two concerns: "First, since these professionals are presented as full members of the adviser's team, investors often do not realize that they are paying for them a la carte, in addition to the management fee and carried interest. The adviser is able to generate a significant marketing benefit by presenting high-profile and capable operators as part of its team, but it is the investors who are unknowingly footing the bill for these resources. Second, most limited partnership agreements require that a fee generated by employees or affiliates of the adviser offset the management fee, in whole or in part. Operating Partners, however, are not usually treated as employees or affiliates of the manager, and the fees they receive therefore rarely offset management fees, even though in many cases the Operating Partners walk, talk, act, and look just like employees or affiliates."

   b. OCIE has also observed firms that shift expenses to clients during the middle of a fund's life without disclosing this practice to limited partners. Examples include (1) presenting

[8] Andrew J. Bowden, Dir., Office of Compliance Inspections and Examinations, Secs. and Exch. Comm'n, Remarks at the Private Equity Int'l Private Fund Compliance Forum 2014: Spreading Sunshine in Private Equity (May 6, 2014).

individuals as employees during the fundraising stage and later terminating and hiring back those individuals as consultants; (2) billing for back-office functions that were typically included in the management fee; and (3) charging investors for software used to automate the investor reporting function.

3. Hidden Fees

   a. OCIE has observed some private equity advisers use accelerated monitoring fees that are triggered by termination of the monitoring agreement, which might occur following a merger, acquisition, or IPO, without disclosing the practice when the monitoring agreements are signed.

   b. Mr. Bowden identified other hidden fees he found troubling, including (1) charging undisclosed "administrative" or other fees that were not contemplated by the limited partnership agreement; (2) exceeding transaction fee limits or charging transaction fees in situations, such as recapitalizations, not contemplated by the limited partnership agreement; and (3) hiring related-party service providers that may provide services of questionable value.

4. Marketing and Valuation

   a. Mr. Bowden identified as an issue advisers using a different valuation methodology than was disclosed to investors, citing the *Williamson* matter discussed below.

   b. Mr. Bowden also discussed the focus in scrutinizing valuation practices, stating that examiners look at whether the actual valuation process is consistent with the process that was promised to investors. Specifically, examiners are looking at:

      (i) "Cherry-picking comparables or adding back inappropriate items to EBITDA – especially costs that are recurring and persist even after a strategic sale – if there are not rational reasons for the changes, and/or if there are not sufficient disclosures to alert investors."

      (ii) "Changing the valuation methodology from period to period without additional disclosure – even if such actions fit into a broadly defined valuation policy – unless there's a logical purpose for the change."

c. OCIE examiners also review marketing materials for inconsistencies and misrepresentations, including with respect to performance marketing and misstatements about the investment team.

B. Broker Status Questions

1. In April 2013, then-Chief Counsel of the Division of Trading and Markets, David Blass, gave a speech in which he questioned whether there may be instances in which a private fund adviser may need to register as a broker-dealer because they or their personnel or affiliates are receiving transaction-based compensation.[9] Mr. Blass identified a few questions private fund advisers might ask in determining whether broker-dealer registration is required: (1) how does the adviser solicit and retain investors? (2) do the adviser's employees who solicit investors have other responsibilities? (3) how does the adviser compensate personnel who solicit investors for a private fund? (4) does the adviser charge a transaction fee in connection with a securities transaction? An example of fees he cited that might cause a private fund adviser to be a broker-dealer include those paid in connection with the acquisition or disposition of, or a recapitalization of, a portfolio company. In Mr. Blass's view, the "combination of success fees which cause the adviser to take on a salesman's stake and the activities involved in effecting securities transactions appear, at least on their face, to cause such an adviser to fall within the meaning of the term 'broker.'"

C. Selected Enforcement Actions

1. <u>*In re William M. Stephens*, Admin. Proceeding File No. 3-15233 (Mar. 8, 2013)</u>

a. On March 8, 2013, the SEC instituted a settled administrative proceeding against William M. Stephens, an independent consultant hired by Ranieri Partners LLC, a private equity firm, to find and introduce potential investors in private funds managed by Ranieri Partner's affiliates, alleging that Stephens exceeded his role as a "finder" and operated as an unregistered broker in violation of Section 15(a) of the Exchange Act. In a separate settled administrative proceeding instituted the same day, the SEC charged Ranieri Partners and Donald W. Phillips, a senior

9 David W. Blass, Chief Counsel, Div. of Trading and Mkts., Secs. and Exch. Comm'n, Remarks to the Am. Bar Ass'n, Trading and Mkts. Subcomm.: A Few Observations in the Private Fund Space (Apr. 5, 2013).

managing partner in the firm, with having aided and abetted Stephens' violations. The firm was also charged with having caused those violations.

b. Stephens is a former investment strategist at a registered investment adviser who had previously been found to have violated the federal securities laws and had been barred for two years from associating with a registered investment adviser, with the right to re-apply. He never re-applied. The SEC alleged that Phillips, who was a friend of Stephens and was aware of his disciplinary history with the SEC, caused Ranieri Partners' affiliates to hire Stephens as an independent consultant to act as a finder for potential investors in private funds managed those affiliates. According to the SEC, Phillips told Stephens that his responsibilities were limited to contacting potential investors to arrange introductions, and that he was not permitted to provide offering materials directly to potential investors or to contact investors directly to discuss his views of the funds.

c. The SEC alleges that Phillip and others at Ranieri Partners thereafter sent Stephens with materials relating to the funds, including the private placement memorandum, subscription documents and presentation and marketing materials. The SEC alleged that Stephens in turn provided these materials to investors, met with potential investors both with and without Phillips after making initial introductions, and encouraged at least one investor to consider adjusting its asset allocation plan to facilitate an investment in the funds. In so doing, he engaged in the business of effecting transactions in securities without first being registered as a broker.

d. In its proceeding Ranieri Partners and Phillips, the SEC alleged that Ranieri Partners caused Stephens to violate the Exchange Act by failing to adequately oversee his conduct and by allowing him to obtain PPMs and subscription agreements. Phillips was alleged to have willfully aided and abetted Stephens' violations because he failed to stop Stephens even after he learned of Stephens' conduct.

e. For his actions, Stephens was ordered to cease-and-desist continued violations of the Exchange Act and barred from 1) participating in any offering, 2) associating with a broker, dealer, investment adviser, statistical rating organization, or similar entity, and 3) serving or acting as an employee, officer, director, board member, investment adviser, depositor, or principal underwriter for any registered investment adviser, depositor, or principal underwriter. Stephens was also ordered to pay disgorgement of $2.4 million and prejudgment interest of $410,248, but those payments were waived because of his financial condition.

f. Ranieri Partners was ordered to cease-and-desist continued violations of the Exchange Act and to pay a civil penalty of $375,000. Phillips was ordered to cease-and-desist continued violations of the Exchange Act, suspended for nine months from associating in a supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent, or statistical rating organization, and ordered to pay a $75,000 civil penalty.

D. *In the Matter of Lincolnshire Management, Inc.*, Admin. Proc. File No. 3-16139 (Sept. 22, 2014)

1. The SEC filed a settled administrative proceeding against Lincolnshire Management, Inc. ("LMI"), a private equity fund adviser, for allegedly allocating expenses improperly between two private equity funds that each owned a portion of the same portfolio companies, and failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.

2. The SEC alleged that a portion of shared expenses for the two portfolio companies was misallocated and undocumented, which caused one portfolio company to pay more than its share of expenses that benefitted both companies. Following the integration of the two portfolio companies, LMI allocated to only one of the portfolio companies expenses for third-party administrators that provided payroll services and administered the 401(k) programs for both of the portfolio companies. In addition, the salaries of certain employees that performed work for both of the portfolio companies were not properly allocated between the two companies; one of the companies did not pay overhead costs for certain employees of a wholly owned Singapore subsidiary of the other company; and transaction bonuses of two executives who were only employees of one of the companies were partly paid by an owner of the other company.

3. The SEC also alleged that LMI did not adopt or implement written policies or procedures reasonably designed to

prevent violations of the Advisers Act arising from the integration of the two portfolio companies.

4. The settled Order charged that LMI violated Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder.

5. Pursuant to the settlement, LMI agreed to a cease-and-desist order and to pay disgorgement of $1.5 million, prejudgment interest of $358,112, and a civil penalty of $450,000.

E. In the Matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC, Admin. Proc. File No. 3-15238 (Mar. 11, 2013)

1. The SEC filed a settled administrative proceeding against registered investment advisers Oppenheimer Asset Management Inc. ("OAM") and Oppenheimer Alternative Investment Management, LLC ("OAIM") alleging that the firms made misrepresentations and omissions to investors and prospective investors about the net asset value of a fund of funds private equity vehicle (the "Fund of Funds") that they managed. The SEC further alleged that the firms' policies and procedures did not contain provisions reasonably designed to prevent such misrepresentations and omissions.

2. The SEC alleged that from October 2009 through 2010, OAM and OAIM disseminated marketing materials to prospective investors and quarterly reports to existing investors stating that the Fund-of-Fund's net asset values were "based on the underlying managers' estimated values" when in fact, the portfolio manager for the Fund-of-Funds decided to value its largest holding at par, which was a significant markup to the underlying manager's estimated value. The change in the valuation methodology for its largest holding made the Fund-of-Fund's performance appear significantly better as measured by its internal rate of return. The employees of OAIM allegedly made further representations in connection with marketing the Fund-of-Funds, including that the increase in the value of the portfolio holding was attributable to performance, when, in fact, it was due to the change in valuation methodology.

3. According to the SEC, the above misrepresentations and omissions were made possible, in part, by the firms' failure

to adopt and implement policies and procedures reasonably designed to ensure that valuations were determined in a manner consistent with written representations provided to investors.

4. The SEC's settled Order charged that the firms violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder.

5. Pursuant to the settlement, OAM and OAIM consented to a censure and a cease-and-desist order. OAM and OAIM also agreed to distribute $2,269,098 to investors who invested in the Fund-of-Funds during the period of the alleged misrepresentations. This amount represented $2,128,232 in disgorgement and $140,866 in prejudgment interest. The firms also agreed to pay a civil penalty of $617,579. The firms agreed to retain an independent consultant to conduct a review of the firms' valuation policies and procedures, send a copy of the Order to existing advisory clients and prominently post a hyperlink to the Order on their website.

6. In considering whether to accept the civil penalty offered by OAM and OAIM, the SEC took into account the firms' cooperation in the investigation and enforcement action.

7. In a separate action brought by the Commonwealth of Massachusetts, OAM and OAIM agreed to pay $376,700 in disgorgement and $23,935 in prejudgment interest. The firms also agreed to pay a penalty of $132,421.

F. *See In the Matter of Brian Williamson*, Admin. Proc. File No. 3-15430 (Jan. 22, 2014).

1. In a separate administrative proceeding, the SEC brought charges against the portfolio manager, Brian Williamson ("Williamson"), alleging that he made material false and misleading statements and omissions to investors related to the valuation and performance of the Fund-of-Funds. The SEC alleged that Williamson violated Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act and Rule 10b-5 thereunder and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. In the alternative, the SEC alleged that OAM and OAIM violated the aforementioned statutes and rules and Williamson willfully aided and abetted and caused OAM's and OAIM's violations. This matter was settled on

January 22, 2014, with Williamson agreeing to be barred from the securities industry and to pay a $100,000 penalty.