

# Investment Management Regulatory Update

December 21, 2015

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## SEC Rules and Regulations

### SEC Staff Grants No-Action Relief Relating to Rule 482 Requirements as Applied to Performance Information Provided by Certain Non-ERISA Retirement Plans

On November 16, 2015, the SEC Staff issued a no-action letter (the “**Letter**”) clarifying the no-action guidance previously issued in the SEC Staff No-Action Letter to the American Retirement Association dated February 18, 2015 (the “**ARA Letter**”). As discussed in the [March 26, 2015 Davis Polk Investment Management Regulatory Update](#), the ARA Letter extended relief previously granted in the SEC Staff No-Action Letter to the U.S. Department of Labor (“**DOL**”) dated October 26, 2011 (the “**DOL Letter**”).

In the DOL Letter, the SEC agreed to treat certain investment-related information provided by a plan administrator (or its designee) to participants and beneficiaries in participant-directed individual account plans subject to the Employee Retirement Income Security Act of 1974 (“**ERISA**”), pursuant to the disclosure requirements set forth in Rule 404a-5(d) under ERISA (such information, “**DOL Required Investment Information**,” and such rule, the “**DOL Rule**”), as if it were a communication that satisfies the requirements of Rule 482 under the Securities Act of 1933 (the “**Securities Act**”). Rule 482 under the Securities Act generally permits investment companies to advertise investment performance data, as well as other information, subject to the requirements of the rule. Rule 404a-5(d) under the Securities Act mandates that plan participants receive certain plan information, including performance data, comparative benchmarks, and fees and expenses. The ARA Letter extended this relief to DOL Required Investment Information furnished to other retirement savings plans that are not subject to ERISA and participants and beneficiaries in such plans.

The ARA Letter covered the following types of plans: retirement savings plans under section 403(b) of the Internal Revenue Code of 1986, as amended (the “**Code**”) (such plans, “**403(b) Plans**”), governmental 457(b) plans, governmental 401(a) plans, 415(m) plans, church 401(a) plans, non-governmental 457(b) plans, and 409A plans or 457(f) plans of governmental or tax-exempt entities (together, the “**Non-ERISA Plans**”). However, the incoming letter (the “**Incoming Letter**”) giving rise to the Letter argued that

because the analysis in the ARA Letter dealt primarily with 403(b) Plans, certain definitions of terms provided were narrowly tailored to reflect the limited options available in 403(b) Plans and did not expressly include the broader range of options provided by other Non-ERISA Plans. The SEC agreed to clarify the definition of the following terms used in the ARA Letter as follows:

- **“Investment Vendors.”** The ARA Letter defined “Investment Vendors” as insurance company and custodial account vendors that offer annuity contracts and registered open-end investment companies as “Investment Options” to participants in a Non-ERISA Plan. The ARA Letter stated that an “Investment Option” also includes any other lawful investment alternative, as long as such alternative meets the definition of “designated investment alternative” in the DOL Rule (“**Other Investment Options**”). The SEC agreed that the term “Investment Vendor,” as used in the ARA Letter, may also be read to include broker-dealers, banks or other entities that are selected by the employer to offer such Other Investment Options to the participants in the employer’s Non-ERISA Plan.
- **Written Agreement.** The ARA Letter also included a representation that each Investment Vendor would provide the DOL Required Information “pursuant to a written agreement with the employer (or its designee).” The SEC agreed with the Incoming Letter that the term “written agreement” may be read to include written instructions or directives communicated electronically, such as by e-mail, by the employer (or its designee) and agreed to electronically by the Investment Vendor. In addition, the ARA Letter stated that Investment Vendors could satisfy the “written agreement” condition by giving “written notice” to the employer (or its designee) that the Investment Vendor is in compliance with the condition. In the Letter, the SEC agreed that such “written notice” may be interpreted to include notice provided electronically, such as by e-mail.
- **Specified Date.** The ARA Letter provided that each “written agreement” between the employer (or its designee) and the Investment Vendor would specify a date on or before which the Investment Vendor will provide the DOL Required Information and, to the extent applicable, all fee and expense information as specified in Rules 404a-5(c)(2)(i)(A) and 404a-5(c)(3)(i)(A) under ERISA (together, the “**Information**”). The SEC stated that it agreed with the interpretation set forth in the Incoming Letter that such requirement to specify a date will be satisfied if an Investment Vendor states to the employer (or its designee) that it will provide the Information to all current participants in the Non-ERISA Plan as quickly as administratively possible after the date of the written agreement.
- **Registration Statement.** The ARA Letter stated, in relevant part, that the Information provided by an Investment Vendor should not include “information about an Investment Option prior to the effective date of the registration statement for that Investment Option.” The SEC agreed that this limitation should be read to apply only to an Investment Option for which a registration statement has been or will be filed.
- **Timing of Information.** The ARA Letter included as a condition for relief a requirement that “the Information will be furnished to new participants in the Non-ERISA 403(b) Plan prior to their initial investment.” The Incoming Letter proposed, and the SEC agreed, that the phrase “prior to” be interpreted as “on or before the date on which a participant can first direct his or her investments,” arguing that this interpretation would serve to reflect situations where participants are immediately eligible to participate and direct investments in a Non-ERISA Plan upon being hired by the relevant employer, in which case the Information could not be provided earlier than the date on which the participant can direct his or her investments. The ARA Letter also required that the Information be provided to “each participant at least annually in accordance with the timing requirements in the DOL Rule.” With respect to this requirement, the SEC stated that the phrase “at least annually” is appropriately interpreted to mean at least once in any 14-month period, in accordance with DOL timing requirements.

- ▶ [See a copy of the Letter](#)
- ▶ [See a copy of the Incoming Letter](#)
- ▶ [See a copy of the ARA Letter](#)
- ▶ [See a copy of the DOL Letter](#)

## SEC Proposes New Rule Governing the Use of Derivatives by Registered Investment Companies

On December 11, 2015, the SEC proposed new measures to govern the use of derivatives by registered investment companies and business development companies (“registered funds”). The proposal would impose restrictions on a registered fund that engages in derivatives transactions. For a summary of these proposed new measures, please see the December 11, 2015 Davis Polk Client Newsflash, [SEC Proposes New Rule Governing the Use of Derivatives by Registered Investment Companies](#).

- ▶ [See a copy of the SEC Fact Sheet](#)
- ▶ [See a copy of the Proposal](#)

## Industry Update

### Director of Enforcement Addresses National Society of Compliance Professionals

On November 4, 2015, Andrew Ceresney, Director of the Division of Enforcement of the SEC (the “**Division**”), delivered the keynote address at the 2015 national conference of the National Society of Compliance Professionals. Ceresney addressed the Division’s perspective on compliance professionals and how the Division approaches enforcement cases that implicate compliance professionals, certain recent cases of which have, according to Ceresney, caused concern among the compliance community.

Ceresney began his speech by discussing two recent enforcement actions that, in his view, demonstrate the Division’s efforts to protect the compliance function within an investment adviser firm. First, Ceresney discussed the *Pekin Singer* enforcement action, a case in which the SEC charged an investment adviser with, among other things, failing to conduct timely annual compliance reviews and failing to implement and enforce provisions of its policies and procedures and its code of ethics. Ceresney highlighted that the SEC’s order found that the firm failed to dedicate sufficient resources to its compliance program and that the CCO, who was not charged, was tasked with various non-compliance responsibilities and repeatedly requested additional compliance resources from the president of the firm. For further discussion of the *Pekin Singer* enforcement action, please see the [July 14, 2015 Davis Polk Investment Management Regulatory Update](#). Next, Ceresney discussed the 2013 enforcement action in *Carl Johns*, the first-ever case where an individual was charged for misleading and obstructing a CCO. In that case, an assistant portfolio manager failed to pre-clear or report his personal securities transactions, submitted false reports regarding such trading and altered trade confirmations and securities holding reports with respect to the same. The CCO in that case detected the irregularities, but when he confronted the employee, the employee misled the CCO about the transactions and physically altered hard copy files of his brokerage statements. According to Ceresney, the takeaway from *Pekin Singer* and *Carl Johns* is that, while compliance professionals have certain responsibilities within a firm, ultimately it is the business that is primarily responsible for compliance with the law, and the Division will aggressively pursue business personnel who mislead or deceive CCOs, who obstruct the compliance function or who fail to support the compliance function in a manner that causes compliance violations.

Ceresney then discussed Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the “**Advisers Act**”), which was allegedly violated in both actions. Rule 206(4)-7 generally requires registered investment advisers to adopt and implement written policies and procedures reasonably

designed to prevent violations of the Advisers Act and the rules promulgated thereunder and to periodically review the adequacy of such policies and procedures and the effectiveness of their implementation. Rule 206(4)-7 also requires that a registered investment adviser designate a CCO. According to Ceresney, Rule 206(4)-7 was adopted after the SEC discovered that certain fund advisers, broker-dealers and other service providers were engaging in and/or facilitating market timing and late trading, misusing material, non-public information and breaching their fiduciaries duties to their funds. Ceresney stated that he believed that the SEC adopted Rule 206(4)-7 to both empower the role of the CCO within an organization and to also place certain responsibilities directly on the CCO.

Next, Ceresney addressed compliance officer liability generally and began by reiterating SEC Chair White's remarks from two years earlier that compliance officers should not worry about facing an enforcement action if they perform their responsibilities "diligently, in good faith and in compliance with the law." According to Ceresney, enforcement actions against compliance professionals generally fit into three categories: (i) cases in which the CCO was affirmatively involved in misconduct that is unrelated to the compliance function; (ii) cases in which the CCO engaged in efforts to obstruct or mislead the SEC staff; and (iii) cases in which the CCO wholly failed to carry out his or her compliance responsibilities. Ceresney explained that the third category involves CCOs charged for causing their firm's compliance failures under Rule 206(4)-7 and other compliance-related rules, and is the rarest of the three categories.

Finally, Ceresney discussed two enforcement actions in which the SEC charged CCOs. In the *BlackRock* enforcement action, according to Ceresney, BlackRock did not have any written policies and procedures regarding the outside business activities of its employees, even though the firm's CCO was aware of and approved numerous outside activities engaged in by the firm's employees, including a senior portfolio manager's outside family business that posed a conflict with the investments held by that the funds that employee managed. The CCO was charged, according to Ceresney, with a wholesale compliance failure because he failed to adopt any written policies and procedures to address employees' outside business activities despite the presence of clear red flags. In the *SFX* enforcement action, the SEC alleged that an employee misappropriated client assets for more than five years by withdrawing money from accounts over which he had full signatory authority. According to Ceresney, the CCO was charged with causing his firm's violation of Rule 206(4)-7 because the CCO was specifically tasked with implementing his firm's policy requiring the review of cash flows in client accounts, yet for more than five years he failed to ensure that such a review occurred. For further discussion of the BlackRock charges, please see the [May 20, 2015 Davis Polk Investment Management Regulatory Update](#). For further discussion of the SFX charges, please see the [July 14, 2015 Davis Polk Investment Management Regulatory Update](#). Ceresney underscored that the facts in the *BlackRock* and *SFX* enforcement actions demonstrate the CCOs' complete failure to carry out their compliance responsibilities and do not signal a change in how the Division's staff or the SEC approaches the issue of compliance officer liability.

Ceresney closed his remarks by highlighting key takeaways. Ceresney first noted that compliance professionals have the SEC's full support, and that the SEC will bring enforcement actions against business personnel within a firm in circumstances where such personnel have deceived or misled a compliance professional or where their failure to provide the compliance function with sufficient resources has caused compliance rule violations. Ceresney finally underscored that the SEC takes a careful and measured approach in determining when it is appropriate to charge a CCO, and this approach has not changed recently, as reflected in the relatively small number of enforcement actions brought against CCOs for their compliance work.

- ▶ [See a copy of the Speech](#)

## Litigation

### SEC Charges Private Equity Advisers with Improper Allocation of Expenses

On November 5, 2015, the SEC issued an order (the “**Order**”) instituting and settling administrative and cease-and-desist proceedings against two private equity fund advisers, Cherokee Investment Partners, LLC and Cherokee Advisers, LLC (together, “**Cherokee**”), for violations under Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. The SEC charged Cherokee for improperly allocating its legal, consulting and compliance-related expenses to its advised funds (the “**Funds**”), along with related compliance deficiencies.

According to the Order, Cherokee improperly allocated various legal and compliance-related expenses incurred by the relevant adviser to the Funds during a period from 2011 to 2015. The SEC alleged that Cherokee improperly allocated costs totaling \$455,698 relating to (1) consulting fees, registration-related legal fees and compliance-related expenses incurred in connection with its preparations for registration as an investment adviser under the Advisers Act and its legal obligations arising from registration, (2) consulting and legal expenses incurred in connection with preparing for an SEC examination related to Cherokee’s status as a newly-registered adviser and relying adviser and (3) expenses incurred in relation to an investigation by the staff of the SEC’s Division of Enforcement relating to, among other things, Cherokee’s expense allocation practices. According to the Order, Cherokee received the advice of counsel for each of the expense allocations. The SEC stated that although the governing documents for each of the Funds disclosed that the Funds would be charged for expenses that “in the good faith judgment of the general partners arose out of the operation and activities of the Funds,” the governing documents did not explicitly state that the Funds would be charged for a portion of the advisers’ own legal and compliance expenses.

Investment advisers are prohibited under Section 206(2) of the Advisers Act from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. Section 206(4) under the Adviser Act and Rule 206(4)-8 thereunder generally prohibit investment advisers from making any untrue statement of material fact or omitting a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to any investor or prospective investor. The SEC alleged that Cherokee violated Sections 206(2) and 206(4) of the Investment Advisers Act and Rule 206(4)-8 thereunder by failing to specifically disclose to investors that the Funds would pay for the legal and compliance expenses of the adviser. In addition, the SEC found that this conduct violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. According to the SEC, Cherokee failed to review, no less frequently than annually, the adequacy of those written policies and procedures and the adequacy of their implementation, as required by Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

Cherokee agreed to settle the charges without admitting or denying the SEC’s findings. The SEC ordered Cherokee to pay a civil money penalty of \$100,000 and to cease and desist from future violations of Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder.

- ▶ [See a copy of the SEC Order](#)

### SEC Charges Private Equity Firm and Four Executives with Failing to Disclose Conflicts of Interests

On November 3, 2015, the SEC issued an order (the “**Order**”) instituting and settling administrative and cease-and-desist proceedings against New York-based private equity firm Fenway Partners, LLC

(“**Fenway Partners**”), three of its principals and an executive who was its Chief Financial Officer and Chief Compliance Officer (the “**CCO**,” and collectively, the “**Respondents**”).

According to the SEC, Fenway Partners served as the investment adviser to a private equity fund Fenway Partners Capital Fund III, L.P. (“**Fund III**”), which invested primarily in branded consumer products and transportation and logistics companies. Prior to December 2011, according to the SEC, Fenway Partners charged certain of Fund III’s portfolio companies periodic monitoring fees pursuant to management services agreements with such portfolio companies, which were offset against the advisory fee paid by Fund III to Fenway Partners in accordance with the governing documents of Fund III. Beginning in December 2011, however, the SEC alleged that the Respondents caused certain Portfolio Companies to terminate the payment of such monitoring fees to Fenway Partners and instead enter into consulting agreements with Fenway Consulting Partners, LLC (“**Fenway Consulting**”), pursuant to which Fenway Consulting would provide similar services (often with the same employees) as Fenway Partners had provided under the terms of the management services agreements. According to the Order, Fenway Consulting was affiliated with Fenway Partners and principally owned and operated by the three principals.

The SEC alleged that the approximately \$5.74 million in fees paid to Fenway Consulting from 2011 to 2013 were not offset against the advisory fee payable by Fund III to Fenway Partners, and that the Respondents failed to disclose to investors in Fund III the conflict of interests presented by the new payment arrangement. The SEC further alleged that in January 2012, Fenway Partners and two of the principals failed to disclose that, out of \$4 million requested by Fenway Partners from Fund III investors in connection with a potential investment in a portfolio company, \$1 million would be used to pay Fenway Consulting. In addition, according to the SEC, in a June 2012 transaction involving the sale by Fund III of an equity interest in a portfolio company, one principal and two other former Fenway Partners employees, ultimately received \$15 million from the proceeds of such sale due to their participation in such portfolio company’s cash incentive plan. The Order alleged that the principal and the two former employees were employees of Fenway Consulting when the payment was made and that the services of the principal and the two former employees were almost entirely performed while they were employees of Fenway Partners. According to the SEC, Fenway Partners, the two principals and the CCO failed to disclose the conflict of interests presented by such payment.

The Order alleged that as a result of these conducts, the Respondents violated or caused the violations of Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. The Order further alleged that Fenway Partners, the two principals and the CCO caused the violations of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibit any fraudulent, deceptive or manipulative act, practice or course of business by an investment adviser to an investor or prospective investor in a pooled investment vehicle. According to the Order, Fenway Partners and the CCO did not consider the portfolio company payments to Fenway Consulting to be “related party transactions” and therefore did not include them in the 2011 and 2012 Fund III financial statements. However, the SEC stated that Fenway Consulting’s relationship with Fenway Partners and such payment from the portfolio companies should have been disclosed because Fenway Consulting is an affiliate of Fenway Partners and Fund III, and indeed were required to be disclosed by Fund III’s independent auditor when such auditor learned of the payments.

The Respondents settled the charges without admitting or denying the SEC’s findings. Fenway Partners and the three principals agreed to jointly and severally pay \$8,716,471.10, consisting of \$7,892,000 in disgorgement and \$824,471.10 in prejudgment interest. The Respondents also agreed to severally pay \$1.525 million in civil money penalties, with Fenway Partners paying \$1,000,000, the three principals each paying \$150,000 and the CCO paying \$75,000.

- ▶ [See a copy of the Press Release](#)
- ▶ [See a copy of the Order](#)

## SEC Charges Virtus Investment Advisers for Falsely Advertising Performance Claims

On November 16, 2015, the SEC issued an order (the “**Order**”) instituting and settling administrative and cease-and-desist proceedings against Virtus Investment Advisers, Inc. (“**Virtus**”) for allegedly misleading mutual fund investors with advertisements containing false historical performance data about AlphaSector, an exchange-traded fund (“**ETF**”) portfolio strategy, in violation of Sections 204, 206(2), and 206(4) of the Advisers Act, Rules 204-2(a)(16), 206(4)-1(a)(5), 206(4)-7, and 206(4)-8 thereunder and Section 34(b) of the Investment Company Act.

In the Order, the SEC stated that Virtus advised six mutual funds and certain separately managed accounts that used AlphaSector. According to the Order, F-Squared Investments, Inc. (“**F-Squared**”)—Virtus’ subadviser for such mutual funds and separately managed accounts—admitted in a December 2014 SEC enforcement order that it had substantially overstated the AlphaSector strategy’s performance track record by falsely back dating its performance history to April 2001 and by incorrectly implementing signals earlier than they actually could have occurred in F-Squared’s calculations, resulting in a substantially overstated track record. Please see the [January 20, 2015 Davis Polk Investment Management Regulatory Update](#) for further discussion of the enforcement action against F-Squared. The SEC alleged that in early 2009, Virtus recommended to the boards of trustees and the shareholders of two mutual funds it advised that the management of such funds be taken over by F-Squared and that the strategy of such funds follow AlphaSector, despite its alleged skepticism over the AlphaSector’s track record. Further, in late 2009, the Financial Industry Regulatory Authority, according to the SEC, warned Virtus that the use of back-tested data in mutual fund marketing materials is misleading and Virtus continued to include such misleading returns in the mutual fund marketing materials. More generally, the SEC alleged that throughout the period from 2009 to 2013, Virtus did not follow up with F-Squared and its CEO when market participants raised questions about the historical performance of AlphaSector indexes and the CEO gave “conflicting representations” concerning AlphaSector.

Virtus had agreed to settle the charges without admitting or denying the SEC’s findings. Virtus agreed to be censured and to pay \$13.4 million in disgorgement, \$1.1 million in prejudgment interest and \$2 million in a civil money penalty. In its determination to accept the offer of Virtus to settle, the SEC considered the retention of an Independent Compliance Consultant by Virtus in April 2015, among other things.

- ▶ [See a copy of the Press Release](#)
- ▶ [See a copy of the Order](#)

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

<b>John G. Crowley</b>	<b>212 450 4550</b>	<a href="mailto:john.crowley@davispolk.com">john.crowley@davispolk.com</a>
<b>Nora M. Jordan</b>	<b>212 450 4684</b>	<a href="mailto:nora.jordan@davispolk.com">nora.jordan@davispolk.com</a>
<b>Yukako Kawata</b>	<b>212 450 4896</b>	<a href="mailto:yukako.kawata@davispolk.com">yukako.kawata@davispolk.com</a>
<b>Leor Landa</b>	<b>212 450 6160</b>	<a href="mailto:leor.landa@davispolk.com">leor.landa@davispolk.com</a>
<b>Gregory S. Rowland</b>	<b>212 450 4930</b>	<a href="mailto:gregory.rowland@davispolk.com">gregory.rowland@davispolk.com</a>
<b>Beth M. Bates</b>	<b>212 450 4062</b>	<a href="mailto:beth.bates@davispolk.com">beth.bates@davispolk.com</a>

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