Mutual Fund Litigation And Enforcement Update

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Agenda

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- Mutual Fund Litigation: Key Current Topics
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SEC Enforcement Update

Emergence of Duty of Care

- An adviser's fiduciary duty
  - The Duty of Care
  - The Duty of Loyalty
- Prior enforcement focus on the Duty of Loyalty and Disclosure
- The SEC's June 2019 interpretation regarding Standard of Conduct for Investment Advisers

Emergence of Duty of Care

- Share Class Selection Disclosure Initiative
  - SEC has filed numerous actions alleging that an investment adviser:
    - failed to make disclosures relating to its selection of mutual fund share classes that paid the adviser (as a dually registered broker-dealer) or its related entities or individuals 12b-1 fees when a lower-cost share class for the same fund was available to clients
    - breached its duty of care, including its duty to seek best execution
- Compare with the Language of Advisers Act Section 206(1) & (2)
  - It shall be unlawful for any investment adviser
    - (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
    - (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client

Emergence of Compliance Rule

- Rule 206(4)-7 requires a registered investment adviser to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.
- Rise of Standalone Compliance Rule Enforcement Actions
  - (e.g.) *In the Matter Sciens Investment Management, LLC*
  - Sciens advised private funds that primarily invested in equity and debt of private companies or assets for which there is frequently no readily available market pricing information and for which no significant observable inputs are available" or "Level 3 Investments."
  - Auditors provided qualified opinions on financial statements because auditors were unable to obtain "sufficient appropriate audit evidence supporting the fair value of a material Level 3 portfolio investment."
  - An audit opinion was ultimately withdrawn and financial statements were restated to write-down a Level 3 Investment by $32.9 million.

Emergence of Compliance Rule

- SEC Finding: Sciens violated the Compliance Rule because its policies and procedures regarding valuation did not provide sufficient guidance or parameters as to how to value Level 3 Investments.
- Basis for finding:
  - Sciens' P&Ps did not mention any valuation techniques or methodologies applicable to Level 3 Investments.
  - Sciens lacked procedures designed to promote consistency in the valuation process and to reduce the potential conflicts of interest.
  - Sciens lacked procedures and guidance regarding:
    - how it would develop and utilize unobservable inputs to ensure a fair and consistent process for measurements, and
    - how to analyze or whether to adjust its own data to the data of other market participants with respect to Level 3 Investments, as was required by the calibration requirement in ASC 820.3

Fund Fees and the 15(c) Process

- Following remarks by SEC Investment Management Director William Birdthistle at the March 2022 ICI Conference, the SEC's Division of Enforcement kicked off a 15(c) sweep focusing on fund fees
  - **"No plaintiff has yet won a 36(b) case, but if no adviser can ever lose one – and none has, so far – one wonders whether the duty enacted in the statute is truly being honored."** (William Birdthistle, Remarks at the ICI Investment Management Conference, Mar. 28, 2022)
- Requests sent to advisers, funds, and boards
- EXAMS focusing on the 15(c) process and 15(c)-related policies and procedures
- Potential theories of '40 Act liability: Sections 15(c), 36(a), 36(b)

Liquidity Rule: *Pinnacle Advisors* Litigation

- On May 5, 2023, the SEC brought a civil action in federal court alleging:
  - Two fund board members, as well as Pinnacle Advisors, LLC ("Pinnacle"), its President, and its CCO, aided and abetted violations of Rule 22e-4(b)(1) of the 1940 Act
  - Pinnacle, its President, and its CCO, aided and abetted violations of Rule 30b1-10 of the 1940 Act
- SEC settled with a third fund board member
- SEC alleges violations of the Liquidity Rule for failure of the adviser to classify certain restricted shares as an "illiquid investment" when those shares had underlying restrictions, contractual transfer limitations, and a lack of a market for the shares
- Further, the SEC alleges two board members violated the Liquidity Rule because they were aware of the "facts that rendered the shares illiquid," including through information they learned as members of the fund's valuation and audit committees, and through advice they received from fund counsel and auditors

Liquidity Rule: *Pinnacle Advisors* Litigation

- The Liquidity Rule:
  - expressly requires the board to (a) initially approve the LRMP; (b) approve the designation of the administrator of the LRMP; and (c) review at least annually, a written report prepared by the administrator regarding the operation, adequacy, and effectiveness of the LRMP
- The SEC cited the Liquidity Rule's Adopting Release to support its allegations against the fund board members:
  - "the role of the board under the rule is one of general oversight … [the Commission] expect[s] that directors will exercise their reasonable business judgment in overseeing the [LRMP] on behalf of the fund's investors."
  - "The rule's requirements are designed to facilitate the board's oversight of the adequacy and effectiveness of the fund's [LRMP]."

Liquidity Rule: *Pinnacle Advisors* Litigation

- Basis for SEC claims:
  - Board members frequently discussed the challenges of valuing the allegedly illiquid shares at issue during the quarterly meetings of the independent trustees, the valuation committee, and the audit committee;
  - Board members knew the shares were illiquid, had no identifiable market, were restricted securities, and subject to transfer restrictions;
  - Fund valuation procedures stated all restricted securities are deemed to be illiquid;
  - Auditors "expressed concern" to board members that the shares were the second largest portfolio holding;
  - Board members acknowledged to auditors that the fund had "no exit strategy" for its investment in the shares; and
  - Rejected the advice of fund counsel and the auditors who later resigned.

Off-Channel Communications

- J.P. Morgan Securities LLC (JPMS) settles recordkeeping and supervision charges with the SEC and CFTC for $200M and related undertakings (Dec. 17, 2021)
- 16 Wall Street firms (including one investment adviser) settles with the SEC and CFTC for recordkeeping and supervisory violations -- $1.8B in fines and related undertakings (Sept. 27, 2022)
- The SEC found that:
  - Employees routinely communicated about business matters using text messaging applications on their personal devices
  - The firms did not maintain or preserve the substantial majority of these off-channel communications
  - The firms' actions likely deprived the SEC staff of these off-channel communications in various Commission investigations
  - The failings involved employees at multiple levels of authority, including supervisors and senior executives

Off-Channel Communications

- SEC Enforcement Adviser Sweep underway regarding Off-Channel Business Communications to determine the extent of such usage by employees (including senior executives) and efforts to oversee and police the usage:
  - Business-related communication that takes place on a platform not subject to retention and monitoring by employer
- Advisers Act vs. Exchange Act
- SEC focus regarding advisers
  - Investment decisions, trade execution, investor relations
  - Policies and procedures, training, certifications, monitoring/testing, discipline

ESG Investing

- March 3, 2021 – Division of Examinations announces 2021 examination priorities which include a greater focus on the consistency and adequacy of the disclosures RIAs and fund complexes provide to clients regarding these ESG strategies
- March 21, 2021 – Enforcement Division announces creation of a Climate and ESG Task Force.
- Just a handful of ESG –related enforcement actions have been brought to date and involved alleged
  - misstatements and omissions about ESG considerations in making investment decisions for certain mutual funds that it managed
  - policies and procedures failures involving the ESG research its investment teams used to select and monitor securities marketed as ESG investments
- Certain State AGs increasingly critical of ESG investing – claiming that it distracts from what should be the main goal of increasing shareholder returns

Fiscal 2022 Enforcement Division Results

- **The Numbers**
  - Over 760 enforcement actions; 9% increase over 2021
  - Record $6.436 billion in disgorgement, civil penalties, and prejudgment interest.
  - Civil money penalties nearly tripled from $1.456 billion to $4.194 billion
  - $937 million paid to affected investors, compared to $521 million in fiscal year 2021.
  - Over 12,300 whistleblower tips that led to 103 awards totaling $229 million.

SEC 2023 Exam Priorities for IAs and RICs

- Oversight processes related to fees and expenses
- Retention and monitoring electronic communications and use of third-party service providers
- Mutual fund conversions to ETFs
- Loan-focused funds, such as leveraged loan funds, for liquidity concerns and to review the impact on the funds of elevated interest rates
- Non-transparent ETFs to assess compliance with exemptive relief
- ESG-related investment products and strategies

Mutual Fund Litigation: Key Current Topics

New Wave of Fiduciary Breach Litigation

- A plaintiff's firm has become increasingly active in asserting breach of fiduciary duty claims against fund directors and advisors, eschewing traditional federal claims
- Playbook is to make "books-and-records" demand under state statute in advance of filing complaint to build record
- State corporate and statutory trust laws provide access to a company's or trust's "books and records" to certain types of persons for certain purposes
  - For mutual funds, the most relevant laws are Section 3819 of the Delaware Statutory Trust Act, Massachusetts common law for MBTs (although informed by Chapter 156D, Section 16.02 of the Massachusetts General Law), and Maryland Corp. and Assoc. Code Sections 2-512 and 2-513
  - Governing documents may modify these rights in certain cases
- Suits to date have alleged directors failed to provide adequate oversight over advisor/sub-advisor and investment strategy

ESG-Related Litigation Involving Mutual Funds

- Many funds have adopted ESG strategies and investment policies in recent years that commit to invest funds in "socially conscious" ways
- Potential litigation around:
  - (1) What complies with ESG?
    - E.g., Do any investments in China/Russia comply?
    - Fossil fuels?
  - (2) Monitoring compliance with ESG standards
    - Failures in initial due diligence in confirming ESG bona fides of investments
    - Failure to monitor compliance with ESG policies over time
  - (3) Greenwashing
  - (4) Affirmative claims based on investment targets' failure to live up to their representations and obligations?
- No significant civil litigation by or against funds to date, but it seems to be only a matter of time …

Anti-ESG Actions by Certain State AGs

- Numerous “red state” AGs have issued letters to asset managers raising objections to their pursuit of ESG objectives
- These AGs claim that the pursuit of ESG objectives potentially violate fiduciary duties and consumer protection laws by putting political agendas ahead of investor interests
- They also claim that asset managers’ participation in certain ESG-related groups – particularly the Net Zero Asset Managers Initiative and Climate Action 100+ – may constitute coordinated action in violation of antitrust laws
  - The same AGs sent requests for information to insurers participating in the similar Net-Zero Insurance Alliance, prompting several to leave

Anti-ESG Actions by Certain State AGs (cont.)

- These AGs have indicated they may seek various commitments, including:
  - Withdrawing from organizations that expect members to undertake ESG initiatives not mandated by law
  - Modifying proxy voting policies
  - Providing additional investment products
- It is likely that investment managers will face competing demands from state officials with opposing views of ESG investment strategies (i.e., states who believe asset managers are taking insufficient actions in connection with ESG objectives)
- AGs have indicated that the may pursue claims against asset managers for breach of fiduciary duty, fraud / breach of the duty of disclosure, antitrust violations, restraint of trade and unfair business practices, or other business torts

A Return to Fund Disclosure Litigation?

- In 2007-08 financial crisis, plaintiffs focused on fund disclosures surrounding valuation, liquidity, and leverage
  - These remain likely targets for disclosure-based claims
- Focus on funds with:
  - Potential style drift (esp. “capital preservation”)
  - Outlier underperformance
  - Significant redemptions
  - Derivatives (highly levered)
  - Lurking big bets
- Market volatility and losses brings out the plaintiffs’ lawyers
  - Potential for “double whammy” if the SEC also becomes involved

Other Investment-Related Litigation

- Bankruptcy Clawback Claims
  - Claims brought against funds and other large institutional shareholders by liquidation/litigation trustee of bankruptcy estate of public issuer for fraudulent transfer based upon pre-insolvency LBO
  - Shareholders (and 1940 Act funds in particular) have "safe harbor" defenses as affirmed by Second Circuit in *Tribune*
- Litigation Involving Fund Investments
  - Numerous cases involving 401(k) plans that allege imprudent management through use of "expensive" funds or share classes
  - Potential new set of cases involving fund affiliated donor-advised funds that as claim imprudence based on investment in affiliated mutual funds
- Closed-End Fund/Control Shares Provisions
  - Several cases brought by/against activist investors challenging control shares bylaws

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