The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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April 21, 2015

SEC Sanctions Fund Adviser and Its CCO for Failing to Disclose a Portfolio Manager's Conflicts of Interest to Fund Boards

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TO:

CHIEF RISK OFFICER COMMITTEE No. 8-15
COMPLIANCE MEMBERS No. 12-15
INTERNAL AUDIT ADVISORY COMMITTEE No. 5-15
INVESTMENT COMPANY DIRECTORS No. 9-15
SEC RULES MEMBERS No. 26-15
SMALL FUNDS MEMBERS No. 16-15

RE:

SEC SANCTIONS FUND ADVISER AND ITS CCO FOR FAILING TO DISCLOSE A PORTFOLIO MANAGER'S CONFLICTS OF INTEREST TO FUND BOARDS

Overview

The SEC has announced the settlement of an administrative proceeding involving a fund adviser and its Chief Compliance Officer (CCO) for various violations of law relating to a portfolio manager's outside business activities. [1] In particular, based upon the conduct described below, the SEC found that the adviser had violated (1) its fiduciary duty under Section 206(2) of the Investment Advisers Act by failing to disclose conflicts of interest to the fund boards and (2) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder by failing to adopt and implement policies and procedures regarding outside business activities of its employees. In addition, the adviser and its CCO were found to have caused certain funds advised by the advisor to violate Rule 38a-1 under the Investment Company Act of 1940 by failing to have the funds' CCO report the portfolio manager's violations to the funds' board. As a result of these violations, the adviser was censured and required to: retain an independent compliance consultant to conduct a comprehensive review of the

adviser's compliance policies and procedures regarding outside activities of the adviser's employees and any conflicts of interest they present; cease and desist from further violations; and pay a civil penalty of $12 million. The adviser's CCO was ordered to cease and desist and pay a penalty of $60,000.

The Respondents' Conduct

The conduct that resulted in these violations of law involved a portfolio manager of the adviser who managed energy-focused funds. [2] In December 2006, while still employed by the adviser, the portfolio manager formed and funded a personal family energy trust to hold interest in a family energy company for which his three sons served as CEO, CFO, and Vice President. Between 2007 and mid-2010, he had invested in and loaned to the family energy company a total of approximately $50 million. The portfolio manager used his email address at the investment adviser to conduct business on behalf of his company and he included references to the adviser on his company's website. Funds and separate accounts managed by the portfolio manager invested in a publicly-traded company with which the portfolio manager's company had a joint venture. By the end of the first quarter of 2010, the largest fund managed by the portfolio manager maintained a 3.5% ownership interest in the publicly-traded company, making it one of the fund's top ten largest holdings. By the end of 2011, this interest had grown to a 9.4% interest, making it the fund's largest holding.

By no later than January 2007, the adviser learned that the portfolio manager had formed and funded the energy company and related ventures, which violated the adviser's private investment policy. The adviser reviewed the portfolio manager's activities and determined that it did not raise any conflicts of interest. The adviser did not report any the portfolio manager's involvement with these companies to the funds' board of directors, nor did it monitor or assess the portfolio manager's business activities and any conflicts associated with them between January 2007 and January 2010.

In January 2010, the portfolio manager informed the adviser that he wanted to serve on the board of directors of a joint venture involving one of his energy companies. In reviewing this request, the adviser did not recall that in 2007 it had reviewed the portfolio manager's involvement with these companies. While the adviser recognized the potential conflicts of interest with the portfolio manager's involvement with these companies, it permitted him to continue his involvement with them while serving as a portfolio manager. He was, however, instructed not to participate in any decisions regarding the joint venture, not become a board member of the joint venture, not receive material information about the joint venture that could impact his trading activities at the adviser, and pre-clear with the adviser any future board seats he intended take with his company. No disclosure was made to the board regarding this issue.

Thereafter, the adviser did not follow up with the portfolio manager regarding his outside business activities; nor did it monitor his activities or verify his compliance with their instructions. Instead, the adviser expected the portfolio manager to keep it informed of his activities. In June 2012, the *Wall Street Journal* published the first of three articles detailing the portfolio manager's connection to energy companies that he owned and his role as an energy sector portfolio manager for the adviser.

The Respondents' Violations of Law

According to the Order, the adviser breached its fiduciary duty by failing to disclose to the funds' boards and advisory clients the conflict of interest created when the adviser permitted the portfolio manager to form, invest, and participate in an energy company while he was simultaneously managing several billion dollars in energy sector assets held by funds and separate accounts he managed. The Order also notes that the adviser did not have any written policies and procedures regarding the outside activities of its employees. Instead, it only required pre-approval for an employee to serve on a board of directors and it had a general conflicts of interest provision in its Code of Business Conduct and Ethics that addressed conflicts or potential conflicts that could arise from the personal activities or interest of employees of the adviser. The adviser failed, however, to adopt and implement policies and procedures to address how the outside activities of its employees were to be assessed for conflicts purposes, as well as who was responsible for determining whether the outside activities should be permitted. It also failed to adopt and implement policies and procedures to monitor those employees with outside activities that the adviser had approved, in order to stay informed about any changes in the employee's outside activities and re-evaluate such activities, if necessary.

While the adviser's CCO knew and approved of numerous outside activities engaged in by advisory personnel, including the portfolio manager, he did not recommend written policies and procedures to assess and monitor those outside activities and to disclose conflicts of interests to the funds' boards and advisory clients. As a result, the Order found the CCO caused the adviser's failure to adopt such compliance policies and procedures. In January 2013, the adviser adopted such policies and procedures.

The Order also found that the adviser had a private investment policy that, among other things, required its employees to receive the adviser's approval before making any private investments. While the portfolio manager violated this policy through his involvement with his energy companies, the violation was never reported to the funds' board as a "material compliance matter" as required by Rule 38a-1.

As noted above, based upon this conduct, the adviser was found to have breached its fiduciary duty and violated the compliance rule under the Advisers Act. In addition, the adviser and its CCO were found to have caused funds to have violated the portion of Rule 38a-1 that requires a CCO to report to the fund's board any material compliance matter. The portfolio manager was not named as a respondent in the Order.

Tamara K. Salmon
Associate General Counsel

endnotes

[1] *See In the Matter of Blackrock Advisor, LLC and Bartholomew A. Battista*, SEC Release No. 40-4065 (April 20, 2015) (the "Order"), which is available at: http://www.sec.gov/litigation/admin/2015/ia-4065.pdf. The press release the SEC published announcing this Order is available at: http://www.sec.gov/news/pressrelease/2015-71.html.

[2] The portfolio manager joined the adviser in January 2005. His compensation included a portion of the annual investment adviser fees earned on the funds and separate accounts that he managed. As a result of this arrangement, the portfolio manager "was one of [the adviser's] most highly compensated portfolio managers." Order at p. 3.
