PRESENTATION

Spring Compliance Roundtable
2015 SEC Targets and 2016 Labor Law Challenges

Thursday, March 3, 2016

BAKER DONELSON

EXPAND YOUR EXPECTATIONS℠

2015 SEC Targets

- **Overview of 2015 Enforcement Actions and the Conduct We Expect to be Targeted in 2015:**
  - Unauthorized or Inadequately Disclosed Fees
  - Violation of the Duty of Best Execution Relating to Share Classes
  - Valuations of Illiquid Assets
  - Inadequately Disclosed Conflicts of Interest
  - Misrepresentations and Omissions
  - Cybersecurity Policies and Procedures
  - Compliance Officer Liability

Unauthorized or Inadequately Disclosed Fees

- The fees advisers are paid for their services should be consistent with governing documents and clearly disclosed.
- Investment Advisers Act Release No. 4219 (Oct. 7, 2015)
  - The SEC concluded that three investment advisers to private equity funds failed to adequately disclose their receipt of “accelerated monitoring fees.” As background, upon either the private sale of a portfolio company or an IPO, the advisers would terminate certain portfolio company monitoring agreements, and accelerate the payment of future monitoring fees as set forth in the agreements. Despite the fact that the advisers disclosed that they may receive monitoring fees from portfolio companies held by the funds they advised, and disclosed the amount of the fees that had been accelerated after an acceleration took place, the SEC concluded that the advisers did not disclose to their funds, prior to their commitment of capital, that they may accelerate future monitoring fees upon the termination of the monitoring agreements. The SEC concluded this was a breach of the advisers’ fiduciary duties. The matter was settled for nearly $39 million.
- Securities Exchange Act Release No. 75814 (Sept. 2, 2015)
  - An investment adviser to CDO clients charged and retained “exchange fees” from issuers of securities held by the CDOs, when the adviser recommended exchange transactions to its CDO clients. The SEC concluded the exchange fees should have gone to the CDOs because, while the governing documents authorized the adviser to take certain delineated actions with respect to exchanges, it did not provide for the receipt of exchange fees by the adviser. The SEC further charged that the adviser sought to obscure these exchange fees by referring to them as payment of “third-party costs.” The SEC also charged that the fees were not disclosed to the adviser’s CDO clients, to the investors in the CDOs or on the adviser’s Form ADV. In addition, the SEC sanctioned the adviser’s managing director who drafted language in exchange transaction documents that mischaracterized the exchange fee payments as compensation for actual third-party costs, as well as its chief legal officer who both supervised and participated in exchange transactions, and was aware of the mischaracterized descriptions of the exchange fees. The SEC concluded these actions constituted breaches of the adviser’s fiduciary duties. The matter was settled for $21 million.

Violation of the Duty of Best Execution Relating to Share Classes

- The SEC has stated that by failing to place clients in lower cost share classes, an adviser may be failing "to seek best execution for their clients on these transactions."
- Investment Advisers Act Release No. 4126 (June 23, 2015)
  - The SEC charged that an investment adviser to a mutual fund and separately managed accounts violated its duty of best execution by selecting a more expensive share class for clients that would generate more fees for the adviser. The SEC found that the adviser placed a substantial number of clients in the "investor share class" of a mutual fund, rather than in the less expensive "institutional share class" for which they were eligible. Clients in the more expensive "investor share class" paid an additional 25 basis points in fees, which in turn, was paid to the adviser. The SEC concluded that by selecting the less economical share class for its clients, the adviser failed to seek best execution for its clients, and failed to adequately disclose its conflict of interest in selecting a share class for clients that would generate more fees for the firm.

Valuations of Illiquid Assets

- Valuation issues involving illiquid securities continue to generate enforcement actions.
- Investment Advisers Act Release No. 4135 (July 1, 2015)
  - The SEC charged an advisory firm with inflating the valuations of certain unlisted, thinly traded residential mortgage-backed securities held in the portfolio of private investment funds managed by the adviser. The adviser told the funds' investors, administrator, and auditor (including a valuation group working for the auditor) that the adviser obtained independent, market-grounded price quotes for the securities at issue from registered representatives of two reputable broker-dealers. However, the adviser itself actually supplied its own internal valuations to the registered representatives for them to pass off as their own to the funds' administrator and auditor. The SEC further alleged that the adviser affirmatively acted to mislead the auditor, and ultimately the funds' investors, by scripting the broker-dealer's conversation with the auditor. The matter settled for $5 million.
- Investment Advisers Act Release No. 4053 (Mar. 30, 2015)
  - The SEC charged that an adviser to three Collateral Loan Obligation funds, who raised more than $2.5 billion from investors and used these investments to make loans to distressed companies, intentionally and consistently directed that nearly all valuations of these assets be reported as unchanged from their valuations at the time the assets were originated (even though many of the borrowers had made only partial or no interest payments).

Inadequately Disclosed Conflicts of Interest

- For several years, the SEC has been particularly focused on investment advisers' disclosures of conflicts of interest.
- Securities Act Release No. 9992 (Dec. 18, 2015)
  - The SEC charged that the firm negligently failed to disclose conflicts of interest arising from its preference for investing in mutual funds affiliated with the firm, as well as funds that provided the firm an additional economic incentive as a result of discounted pricing for services provided by affiliates. The firm also failed to disclose to certain clients the availability of less expensive share classes of affiliated mutual funds. The matter settled for $127.5 million in disgorgement, a $127.5 million fine and $11.8 million in prejudgment interest.
- Investment Advisers Act Release No. 4163 (Aug. 10, 2015)
  - The SEC alleged that an adviser failed to disclose conflicts of interest related to a $50 million loan that a senior executive of the adviser had received from an advisory client (thus creating a potential conflict of interest whereby the adviser might then place that client's interests over those of its other clients), and that the adviser failed to disclose the senior executive's loan when it then invested certain of its other clients in two transactions in which the client who made the loan invested on different terms. The SEC stated that the adviser failed to make both its compliance department and its other clients aware of the potential conflicts of interest. The matter settled for a civil monetary penalty of $20 million.

Inadequately Disclosed Conflicts of Interest

- Investment Advisers Act Release No. 4065 (Apr. 20, 2015)
  - The SEC charged that an adviser failed to disclose a conflict of interest involving the outside business activity of one of its portfolio managers. The SEC concluded that the adviser should have disclosed to the fund's board of directors and its advisory clients that the fund invested in a public company that had a joint venture with a private company in which the fund's portfolio manager had an interest. The matter settled for $12 million.
- SEC v. Lee Weiss et al., Case 1:15-cv-13460 (D. Mass., filed Sept. 29, 2015)
  - The SEC charged that an investment adviser caused clients to invest more than $40 million in companies in which the owner of the adviser had a significant interest, and received, directly or indirectly, over $600,000 in payments from the companies, without disclosure of the conflicts of interest.
- SEC v. Atlantic Asset Management LLC (S.D.N.Y. Dec. 15, 2015)
  - The SEC charged that an investment adviser invested over $40 million of its clients' funds without telling its clients that the investments would benefit individuals affiliated with one of the adviser's owners. The SEC described the investments as "dubious, illiquid bonds," and charged that an entity that had a significant (undisclosed) ownership interest in the parent company of the adviser, used its undisclosed ownership interest to dictate the adviser's investment of its client funds in ways that benefited the entity, its principals and affiliates.

Misrepresentations or Omissions

- Investment advisers are required to provide accurate information about investment strategies and investments.
- Securities Act Release No. 9964 (Oct. 16, 2015)
  - The SEC charged that an investment adviser to a continuously offered, closed-end, registered investment company made material misrepresentations and omissions concerning a material change in the fund's investment strategy. For nearly a decade, the fund had invested primarily in distressed debt; however, in 2008 the fund changed its investment strategy and shorted credit. By the fall of 2008, the fund had transitioned its historical long-credit position and became short net credit (primarily through credit default swaps), which resulted in significant losses. The commission charged that the adviser misrepresented the fund's investment strategy in various communications to investors, prospective investors and the Board, and caused the Fund to misrepresent its strategy in filings with the Commission (including its offering memorandum). As part of the settlement, the adviser agreed to pay $17.5 million, which included disgorgement, compensation to investors and a $3 million penalty.

Misrepresentations or Omissions

- Each year, the commission charges a number of advisers in misrepresentation cases. Misrepresentations can include facts regarding a fund's performance, assets under management or the adviser's background.
- There were numerous cases brought in this area in 2015.
  - *See e.g., SEC v. Paul Lee Moore*, Case 3:15-cv-01575 (S.D. Cal., filed July 16, 2015); *SEC v. William J. Wells and Promitor Capital*, Case 1:15-cv-07738 (S.D.N.Y., filed Oct. 1, 2015); *SEC v. Michael Donnelly*, Civil Action No.15-5873 (E.D. Pa. Oct. 19, 2015)
- Investment Advisers Act Release No. 4266 (Nov. 16, 2015)
  - The SEC charged that an adviser made misstatements to certain of its mutual fund clients, to those funds' shareholders and to clients in separately managed accounts concerning the materially inflated, hypothetical and back-tested, performance track record of its subadviser's algorithm-based "AlphaSector" rotation strategy. This case is significant because the adviser relied on the representations of the subadviser, which was much more familiar with the strategy, in its presentations, marketing materials, filings with the Commission and other communications. The matter was settled for $16.5 million.

Failure to Adopt and Implement Cybersecurity Policies and Procedures

- Rule 30(a) of Regulation S-P under the Securities Act of 1933 requires every registered investment adviser (as well as brokers, dealers and investment companies) to adopt written policies and procedures reasonably designed:
  (1) to insure the security and confidentiality of customer records;
  (2) to protect against any anticipated threats or hazards to such records and information; and
  (3) to protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to a customer.
- Investment Advisers Act Release No. 4204 (Sept. 22, 2015)
  - The SEC concluded that from at least September 2009 through July 2013, an adviser stored sensitive personally identifiable information of clients and other persons on its third party-hosted web server without adopting written policies and procedures regarding the security, confidentiality and protection against unauthorized access. In July 2013, the firm's web server was attacked by an unauthorized, unknown intruder, who gained access rights and copy rights to the data on the server. As a result of the attack, the "PII" of more than 100,000 individuals, including thousands of the adviser's clients, was rendered vulnerable to theft. The SEC conceded that after the breach, the adviser took appropriate action; however, they concluded nevertheless that the adviser failed to adopt written policies and procedures reasonably designed to protect customer records and information, in violation of Rule 30(a) of Regulation S-P (17 C.F.R. § 248.30(a)). The matter was settled for a $75,000 civil penalty.

Compliance Officer Liability

- Investment Advisers Act Rule 206(4)-7 requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Act, and to appoint a chief compliance officer responsible for "administering" the policies and procedures.
- Compliance officers may be vulnerable because they can be charged either with failing to adopt procedures that would have prevented an underlying violation or with failing to "administer" those procedures.
- The SEC has stated that CCOs who do their jobs "competently, diligently and in good faith" should not worry about being targeted in SEC enforcement actions. However, between 2010 and 2014, the SEC brought enforcement actions against 72 chief compliance officers.
- In its list of "SEC Accomplishments" for the period April 2013 to August 2015, the commission highlighted that it brought a number of enforcement actions "holding gatekeepers accountable" for "the important roles they play in the securities industry." It singled out "attorneys, accountants and compliance professionals" as the gatekeepers who were being held accountable.

Compliance Officer Liability

- Investment Advisers Act Release No. 4065 (Apr. 20, 2015)
  - (Discussed above). The SEC also charged the chief compliance officer with causing certain violations, including the failure to report the adviser's outside business activity (and the resulting conflict of interest) to the Board. The SEC concluded that the CCO was responsible for the fund's failure to have adequate written policies and procedures governing outside business interests, including how they should be assessed and monitored for conflict purposes, and when an employee's outside activity should be disclosed to the board of directors. The CCO was fined $60,000.
- Investment Advisers Act Release No. 4116 (June 15, 2015)
  - The former vice president and then president of an investment adviser was found to have misappropriated at least $670,000 in assets from three client accounts. The SEC concluded that the adviser failed to adopt policies and procedures reasonably designed to prevent the misappropriation of client assets, failed to implement the policies it did have, violated the custody rule and falsely stated in its Form ADV that it reviewed client accounts used for bill-paying services. Specifically, the SEC charged the adviser's CCO with failing to "effectively implement" a compliance policy requiring review of "cash flows in client accounts." The SEC also charged the CCO with failing to conduct an annual review, and with responsibility for the material misstatement in the adviser's Form ADV. The CCO was fined $25,000.

Questions?

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2016 Labor Law Challenges

- **The U.S. Department of Labor's Interpretation of the Classification of Independent Contractors**

- **The U.S. Department of Labor's Proposed Overtime Regulations**

U.S. Department of Labor - Administrator's Interpretation No. 2015-1 (July 15, 2015)

- Subject: "Application of the Fair Labor Standards Act's Suffer or Permit Standard in the Identification of Employees Who Are Misclassified as Independent Contractors"
- Administrator David Weil doubles down on DOL's ongoing efforts to combat independent contractor misclassification and provides "additional guidance" for deciding who is an employee
- After noting DOL's long standing six-part "economic realities" test, Administrator Weil defines the ultimate goal as "determin[ing] whether the worker is economically dependent on the employer (and thus its employee) or is really in the business for him or herself (and thus an independent contractor)."
- Available at: www.dol.gov/whd/workers/Misclassification/AI-2015_1.pdf

What Has Changed?

- In Administrator Weil's opinion, the DOL's new guidance does not change the legal landscape; it is just another installment in an ongoing DOL initiative.
- Indeed, the DOL announced back in 2010 that it would target the "growing problem" of independent contractor misclassification.
- September 2011 - DOL and IRS enter a Memorandum of Understanding to coordinate their efforts to combat independent contractor misclassification.
- Labor departments in 25 states have entered similar Memorandums of Understanding with DOL (AK, AL, CA, CT, CO, FL, HI, IA, ID, IL, KY, LA, MA, MD, MN, MO, MT, NH, NY, RI, TX, UT, WA, WS, WY).

Things Have Indeed Changed

- DOL's new emphasis on "economic dependence" and its bold statement that "most workers are employees under the Fair Labor Standards Act" should embolden DOL to more aggressively combat independent contractor misclassification.
- Courts may not agree with DOL's new interpretation, but employers must recognize that the independent contractor classification is in the DOL's crosshairs.
- DOL's new economic dependence analysis must be considered as an overarching consideration when reviewing the more familiar economic realities test.

The Economic Realities Test (Six Parts)

1. Is the work an integral part of the employer's business?
   - The thought here is that workers are more likely to be employees of a company if they perform the company's primary work.
   - Independent contractors, by contrast, are more likely to provide ancillary services to the company.
   - Example: In a construction company, framers most likely are employees, but software developers who design software to tracks bids may be classified as independent contractors.

2. Does the worker's managerial skill affect the worker's opportunity for profit or loss?
   - Independent contractors in business for themselves can make management decisions (such as hiring an assistant, purchasing materials, advertising) which can directly affect their opportunity for profit or loss.
   - Employees, by contrast, do not have this ability, and their opportunities to earn more (or less) depend almost entirely on the amount of work provided by their employer, which does not depend on the employees' managerial skills.

The Economic Realities Test (con't)

3. How does the worker's relative investment compare to the employer's investment?
   - All employees make minimal investments in their jobs; the key to this factor is to compare the worker's investment in the business to the employer's investment.
   - Independent contractors typically make capital investments to such a degree that they can operate as independent businesses.

4. Does the work performed require special skill and initiative?
   - This factor is the source of much confusion. According to the DOL (and some courts), "special skill" does not mean the technical skills required to perform a particular job since many employees are skilled laborers.
   - The DOL interprets this factor to require "special skill and initiative" that permits independent contractors to operate as economically independent businesses.

The Economic Realities Test (con't)

5. Is the relationship between the worker and the employer permanent or indefinite?
   - The concept here is that true independent contractors generally do not work for one company for extended periods of time; instead they are engaged for set periods of time, typically on a project basis.
   - As a result, an exclusive independent contractor relationship lasting for years is a common misclassification red flag.
   - On the other hand, short duration seasonal work does not equate to an independent contractor relationship.

6. What is the nature and degree of the employer's control?
   - Historically, courts have considered this the most important of the six factors, but the DOL disagrees.
   - Here, the DOL places much emphasis on their new economic dependence consideration. They argue:
     - A worker must control <u>meaningful</u> aspects of his/her work.
     - His/Her control must be more than theoretical, he/she must actually exercise it.

Other Red Flags

- Do you have employees performing essentially the same duties as your independent contractors?
- Have you classified the independent contractor as an employee in the past while she was performing essentially the same tasks as she is now?
- If the answer to either of these questions is YES, you may need to reconsider your classification of the worker as an independent contractor.

Factors to Keep in Mind

- Employers have the burden to prove their classification of a worker as an independent contractor is correct.
- If it's a close question, the best choice is to classify the worker as an employee.
- Penalties for misclassification include:
  - Payments to the government: unpaid payroll taxes (both portions), interest, statutory penalties, and/or
  - Payments to the worker: back pay (typically overtime), value of lost benefits, coverage of work-related injuries under workers' comp., unemployment comp.

Other Government Agencies

- The IRS has its own way of analyzing whether a worker is an independent contractor, which seems to emphasize the control factor more than the DOL. See http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Independent-Contractor-Self-Employed-or-Employee

- The National Labor Relations Board is interested in this topic as well because employees are members of a bargaining unit but independent contractors are not.

DOL's Proposed Regulations

March 13, 2014 Presidential Memorandum to the Secretary of Labor

- The "white collar exemption regulations are outdated.
- Millions of Americans should be paid overtime and are not because the regulations are outdated.

"Therefore, I hereby direct you to propose revisions to ***modernize and streamline*** *the existing overtime regulations... and* ***simplify*** *the regulations to make them easier for both workers and businesses to understand and apply."*

DOL's Proposed Regulations

DOL went to work
and 15 months later (on June 30, 2015). . .

The ***proposed*** changes to the FLSA regulations on the "white collar exemptions" were published.

295-page Notice of Proposed Rulemaking (NPRM)
Find on DOL's webpage or www.regulations.gov RIN 1225-AA11

WHAT CHANGES DID THE DOL PROPOSE?

Remember, exemption depends on three things:

1. How employees are paid → **SALARY BASIS**
   – employee must be paid a pre-determined and fixed salary that is not subject to reduction because of variations in the quality or quantity of work performed
   – no partial day deductions
2. How much they are paid → **SALARY LEVEL**
   – currently this is $455/week or $23,660 per year
3. What ***kind of work*** do they do → **JOB DUTIES TEST**
   – each category of exemption – Executive, Administrative and Professional - has different required job duties as set forth in the regulations

WHAT CHANGES DID THE DOL PROPOSE?

To currently qualify for exemption, employees must be paid on a **salary basis** at not less than **$455 per week**

($23,660.00 annually).

The new proposed salary threshold for exemption is $50,440 ($970 per week)!

- More than **<u>two times</u>** the current salary basis.

WHAT CHANGES DID THE DOL PROPOSE?

To currently qualify for exemption as a highly compensated employee (HCE), the salary level is $100,000 annually.

The new proposed salary threshold for exemption for HCE is $122,148.

- 90th percentile of earning for full-time salaried workers.

WHAT IS INCLUDED IN THE $50,440?

- **Bonuses or Incentive Pay??** probably . . . but
  - no “catch up” payments
  - non-discretionary
  - “strictly limit[ed]” – 10%?
  - tied to productivity, profitability and/or specified performance metrics
  - paid frequently “employees would need to receive the bonus payments monthly or more frequently”
- **Commissions?** doubtful but seeking comments
- **Other paid benefits?** no

SUMMARY OF PROPOSED CHANGES

1. Increase of salary level test.
   – to 40th percentile of weekly earnings for full-time salaried worker ($50,440/year for 2016)
2. Increase total compensation requirement for highly exempt employees (HCE).
   – to 90th percentile of weekly earnings for full-time salaried worker ($122,148/year for 2016)
3. Establish a mechanism for automatically updating the salary and compensation levels annually.
   – percentage or tied to CPI

Questions?

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