Mutual Fund Adviser Sanctioned for Deficiencies in Custody of Funds' Derivatives Collateral and Directed Brokerage Compliance

On February 12, 2015, the SEC announced that Water Island Capital LLC ("Water Island") agreed to settle enforcement proceedings arising from alleged violations of the Investment Company Act of 1940 (the "1940 Act") found during an SEC exam of Water Island and the mutual funds it advises (the "Funds"). The alleged violations related to custody of cash collateral posted as security for derivatives transactions and the requirements of Rule 12b-1(h) under the 1940 Act (which governs the direction of fund portfolio transactions to brokers that sell fund shares), as well as weaknesses in the design of the Funds' compliance program. The settlement imposed only a modest monetary penalty, and the underlying facts are not recited in great detail in the SEC's order, but the enforcement action nevertheless illustrates an SEC focus on technical compliance with the 1940 Act rules in the context of mutual funds implementing "alternative" investment strategies.

Custody Violation: Section 17(f)(5)

In the words of the settlement order (the "Order"), Water Island serves as the investment adviser to several "alternative mutual funds" that engage in specialized trading strategies, including merger arbitrage. To implement these strategies, the Funds trade derivatives, including swaps. The Order alleges that during a nine-month period in 2012, Water Island permitted the Funds' broker-dealer counterparties to hold approximately $247 million of the Funds' cash as collateral for certain total return and portfolio return swaps, rather than maintaining it with the Funds' custodian in a tri-party arrangement. The size of these positions was significant relative to Water Island's total assets under management of approximately $3.5 billion.

Section 17(f)(5) of the 1940 Act requires that if a fund maintains its securities and similar investments in the custody of a qualified bank, then it must also maintain the cash proceeds from the sale of such securities and similar investments in the custody of a qualified bank. The Order alleges that Water Island did not ensure the transfer of the cash assets to the Funds' bank custodian, and states that Water Island could have complied with these requirements if it had followed the "standard industry practice" of maintaining the swaps-related cash collateral at the Funds' bank custodian pursuant to a tri-party agreement among the custodian, the Funds and the counterparty. While the Order does not explore broader industry practice, we note that the custom of leaving cash collateral with the broker-dealer counterparty is commonplace for hedge fund managers and other managers of alternative investments outside the 1940 Act fund context.

Directed Brokerage Violation: Rule 12b-1(h)

Rule 12b-1(h) under the 1940 Act prohibits an open-end fund from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker. Under the rule, a fund is permitted to direct portfolio transactions to brokers that sell fund shares, but only if the fund or its adviser has implemented policies and procedures reasonably designed to, among other things, ensure that the selection of brokers for portfolio transactions is not influenced by considerations about the sale of fund shares.

The Funds adopted directed brokerage policies and procedures under Rule 12b-1(h), which Water Island was responsible for implementing. The Order alleges that Water Island failed to implement the Rule 12b-1(h) policies and procedures by failing to create and maintain an approved list of executing brokers for the Funds, and by failing to maintain documentation reflecting the monitoring of the Funds' compliance with those policies and procedures.

Further Observations

In accepting Water Island's offer of settlement, the SEC imposed a modest civil money penalty in the amount of $50,000. This relatively minor penalty may reflect that the two violations were technical in nature and did not result in alleged loss to investors. Although it is highly unusual for the SEC to bring enforcement actions for violations of Section 17(f)(5) or Rule 12b-1(h), the proceedings are indicative of some of the SEC's current examination and enforcement priorities. By bringing this enforcement action, the SEC seems to be seizing an opportunity to send an educational message to managers of so-called "alternative" funds that they must strictly comply with all the requirements applicable to operating a registered fund under the 1940 Act, including implementing compliance policies and procedures adopted by the funds. The action for custody violations with regard to collateral on derivatives, in particular, illustrates a willingness to pursue enforcement for trading practices that may be commonplace among private fund managers, but that run afoul of the more stringent protections imposed by the 1940 Act, even in situations where no harm to shareholders is alleged. Recently, the SEC has expressed a heightened level of concern with regard to the management of registered funds employing so-called alternative strategies, and these types of funds (and their advisers) have been subjected to more intense scrutiny in recent SEC examinations, including additional required questions and requests reserved for funds that the examination staff decides to classify as alternative investment companies.