K&L GATES

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SEC Enforcement, OCIE, NFA and FINRA Exams

Vince Martinez, Partner, Washington, D.C.
Cary Meer, Partner, Washington, D.C.
Kenneth Juster, Partner, Boston

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OVERVIEW OF PRESENTATION

- SEC Enforcement Trends and Significant Matters
- Examination Initiatives and Activities
  - OCIE Examination Priorities
  - NFA Exams
  - FINRA Examination Priorities
- Recent FINRA Enforcement Actions
- Looking Ahead

SEC Enforcement Trends and Significant Matters

ENFORCEMENT TRENDS

- Amendments to administrative proceedings rules went into effect:
  - Extended prehearing periods, up to a maximum of 10 months for 120-day initial decision proceedings
  - Granted the right to hold depositions in 120-day proceedings
  - Expanded admissibility exclusions for “unreliable” evidence
  - Simplified the appeal request procedure
- Focus on cybersecurity failures:
  - R.T. Jones Capital Equities Management, Advisers Act Rel. No. 4204 (Sept. 22, 2015)
  - Craig Scott Capital, Exchange Act Rel. No. 77595 (Apr. 12, 2016)
  - Morgan Stanley Smith Barney LLC, Exchange Act Rel. No. 78021, Advisers Act Rel. No. 4415 (June 8, 2016)

ENFORCEMENT TRENDS (CONT.)

- Continued use of the admissions policy, including against advisers
  - JPMorgan Chase Bank, N.A. et al., Advisers Act Rel. No. 4295 (Dec. 18, 2015)
- Emphasis on whistleblower anti-retaliation enforcement
  - Merrill Lynch, Exchange Act Rel. No. 78141 (June 23, 2016)
  - BlueLinx Holdings, Exchange Act Rel. No. 78528 (Aug. 10, 2016)
  - Health Net, Exchange Act Rel. No. 78590 (Aug. 16, 2016)
  - Anheuser-Busch InBev, Exchange Act Rel. No. 78957 (Sept. 28, 2016)
  - International Game Technology, Exchange Act Rel. No. 78991 (Sept. 29, 2016)
- Emphases on fiduciary duties of advisers and conflicts of interest (discussed below)

PRIVATE EQUITY ENFORCEMENT FOCUS

In a May 2016 speech, Andrew Ceresney, Director of the Division of Enforcement, highlighted three types of "problematic conduct" involving private equity fund advisers:

1. Advisers that receive undisclosed fees and expenses
2. Advisers that impermissibly shift and misallocate expenses
3. Advisers that fail to adequately disclose conflicts of interest, including conflicts arising from fee and expense issues

1. UNDISCLOSED FEES AND EXPENSES

- WL Ross & Co. LLC, Advisers Act Rel. No. (Aug. 24, 2016)
  - Action involving management fee offsets for such things as break-up, origination, commitment, broken deal, cancellation, banking and monitoring fees ("Transaction Fees")
  - The governing documents provided for offset of the Transaction Fees against management fees but did not address how the allocation would occur when multiple funds and co-investment vehicles were investing in the same portfolio company. The adviser allocated fees pro rata across funds and co-investment vehicles based on their ownership of the underlying portfolio company
  - Because the firm construed the ambiguity in its favor and did not disclose the methodology, it received about $10.4 million more in management fees than it would have by simply allocating the transaction fees pro rata among the funds
  - The adviser paid a $2.3 million civil penalty, and reimbursed $11.8 million in fees with interest

UNDISCLOSED FEES AND EXPENSES (CONT.)

- Apollo Management V, L.P., et al.,
  Advisers Act. Rel. No. 4493 (Aug. 23, 2016)
  - The SEC found that, while Apollo had disclosed that it had entered into monitoring agreements with portfolio companies and would receive fees under these agreements, Apollo had not disclosed adequately that it would receive accelerated monitoring fees upon the termination of these agreements until after the limited partners had committed capital to the funds and the fees were paid
  - The SEC noted that, because of the conflict of interest associated with the decision to accelerate the monitoring fees, Apollo could not have effectively consented to the acceleration on behalf of the funds. The SEC also found that the payment of the accelerated monitoring fees by portfolio companies ultimately reduced the returns to the limited partners
  - $37.5 million disgorgement, $12.5 million civil penalty, and $2.7 million interest

UNDISCLOSED FEES AND EXPENSES (CONT.)

- Blackstone Management Partners L.L.C., et al., Advisers Act Rel. No. 4219 (October 7, 2015)
- Blackstone was charged with two distinct breaches of fiduciary duties:
  - First, Blackstone terminated certain portfolio company monitoring agreements between Blackstone and its funds' portfolio companies and accelerated the payment of future monitoring fees. Although Blackstone disclosed that it might receive monitoring fees from portfolio companies, it failed to disclose that it might accelerate future monitoring fees upon termination of the monitoring agreements
  - Second, fund investors were not informed about a fee arrangement that provided Blackstone with a substantially greater discount on legal services provided by an outside law firm than the discount that the law firm provided to the funds. In doing so, Blackstone secured greater benefits for itself than the funds it advised, without properly disclosing and obtaining informed consent for the arrangement
  - Blackstone paid nearly $39 million to settle charges with $29 million being distributed to investors

2. EXPENSE SHIFTING

- Lincolnshire Management, Inc., Advisers Act Rel. No. 3927 (Sept. 22, 2014)
  - This matter involved a "horizontal misallocation" of expenses across two funds. Lincolnshire had integrated two portfolio companies, each owned by a different fund with different investors, and managed as a single company. Lincolnshire intended to integrate the two companies and sell them together
  - However, Lincolnshire caused one of the portfolio companies to pay a disproportionate share of the companies' joint expenses
  - "[W]hen an adviser manages multiple funds, it must be mindful of the fact that it owes a separate fiduciary duty to each fund and must ensure that its actions do not fraudulently benefit one fund at the expense of another"
  - The SEC focused on the failure of documented policies for the consistent allocation of expenses
  - The cases settled for approximately $2 million, including a $450,000 penalty

EXPENSE SHIFTING (CONT.)

- Cherokee Investment Partners, LLC, et al., Advisers Act Rel. No. 4258 (Nov. 5, 2015)
  - This matter involved "vertical misallocation." Cherokee adviser entities improperly allocated their own consulting, legal, and compliance-related expenses to their private equity fund clients in contravention of the funds' organizational documents
  - While the funds' organizational documents disclosed that the funds would bear expenses arising out of the operation and activities of the funds, the documents did not indicate that the funds would be charged for the advisers' legal and compliance expenses
  - The adviser entities reimbursed the funds $455,698 in misallocated expenses and paid a $100,000 penalty

3. FAILURES TO DISCLOSE CONFLICTS

- Fenway Partners, LLC et al.,
  Advisers Act Rel. No. 4253 (Nov. 3, 2015)
  - The SEC charged Fenway and four executives with failures to disclose several conflicts of interest:
    - First, Fenway Partners and four executives replaced monitoring agreements, for which fees received offset Fenway Partners' management fee with respect to its fund, with consulting agreements entered into with an affiliated entity called Fenway Consulting Partners LLC. The consulting agreements provided similar services, often through the same employees, but the fees paid were not offset against the management fee. This altered arrangement was not disclosed to the LPAC or investors
    - Second, Fenway Partners and three respondents asked fund investors to provide $4 million in connection with an investment in a portfolio company without disclosing that $1 million of the investment would be used to pay its affiliate, Fenway Consulting

FENWAY PARTNERS, LLC (CONT.)

- Third, without disclosure to the LPAC or investors, Fenway Partners and two respondents caused three former Fenway Partners employees to receive $15 million in incentive compensation from the sale of a portfolio company for services that they had almost entirely provided when they were Fenway Partners employees
- Finally, Fenway Partners failed to disclose each of these payments as related-party transactions in the financial statements they provided to investors
- The parties paid approximately $10.2 million, including a $1.5 million penalty

FAILURES TO DISCLOSE CONFLICTS (CONT.)

- JH Partners, LLC,
  Advisers Act Rel. No. 4276 (Nov. 23, 2015)
  - The SEC charged JH Partners with failing to disclose and obtain fund advisory board consent for a series of transactions, including: (a) a series of working capital loans (totaling $62 million) by JH Partners to the funds' portfolio companies, resulting in the adviser obtaining interests in portfolio companies that were senior to the interests held by the funds; (b) causing more than one of its funds to invest in the same portfolio company at differing priority levels, potentially favoring one fund client over another; and (c) causing certain of the funds' investments to exceed concentration limits set forth in the funds' governing documents
  - JH Partners agreed to a cease and desist order and a $225,000 penalty as part of its agreement to settle the case

FAILURES TO DISCLOSE CONFLICTS (CONT.)

- The Robare Group, Ltd. et al., Advisers Act Rel. No. 4566 (Nov. 7, 2016)
  - Robare, a separate account manager, received revenue sharing payments from Fidelity for investments in certain no-load mutual funds, which were initially not disclosed, then were not adequately disclosed as a conflict
  - Five key takeaways:
    - First, firms need to be extremely careful in drafting Form ADV disclosures
    - Second, the SEC may act on minor conflicts that effect customers minimally
    - Third, the SEC may regard ambiguous wording about conflicts as misleading
    - Fourth, do not assume that reliance on consultants or other experts to draft disclosures will protect the firm from an enforcement action
    - Fifth, expect the SEC to move easily from a finding that a disclosure was not adequate to a finding that it was negligent and thus actionable

CERESNEY'S OBSERVATIONS

- The SEC is <u>not</u> sympathetic to arguments about:
  - The fairness of charging advisers for disclosure failures in organizational documents drafted before the SEC began its focus on private equity and before many advisers were required to register
  - Whether investors benefited from conflict-of-interest services that an adviser provided in the absence of full disclosure. Such an argument is only a factor to consider when assessing the potential remedy
  - Whether the adviser received advice from counsel before taking an action. The adviser is still ultimately responsible for its conduct

OTHER PRIVATE EQUITY CASES

- Gatekeeper Failure
- Failure to Supervise
- Custody
- Broker-Dealer

GATEKEEPER FAILURE

- Apex Fund Services (US), Inc.,
  Advisers Act Rel. Nos. 4428 and 4429 (June 16, 2016)
  - A private fund administrator failed to recognize “red flags” of fraud even after detecting undisclosed brokerage and bank accounts, margin and loan agreements, and inter-series and inter-fund transfers made in violation of fund offering documents
  - The administrator failed to correct materially false accounting records and capital statements, and sent monthly statements to clients that it knew or should have known contained material overstatements of investors’ holdings
  - Compounding the appearance of negligence was the fact that Apex received multiple warnings from a prior fund administrator about investor complaints and a lack of communication with investors by the investment adviser
  - Apex was sanctioned $350,000 for failing to heed red flags and correct faulty accounting by two clients

FAILURE TO SUPERVISE

- Cambridge Investment Research Advisors, Inc., Advisers Act Rel. No. 4361 (Apr. 5, 2016); Alexander R. Bastron, Advisers Act Rel. No. 4362 (Apr. 5, 2016)
  - Cambridge decided to place a new employee on heightened supervision given his poor credit and a FINRA investigation into his prior termination. The employee's supervisor failed to implement the supervision plan
  - From 2009 – 2011, the employee misappropriated more than $300,000 by forging signatures on and adding costs to financial planning agreements
  - The compliance department lacked systems to verify that its supervisory plan was implemented. Cambridge and the supervisor paid penalties of $225,000 and $20,000, respectively, and the supervisor was barred for one year
  - The Commission considered remedial efforts, including self-reporting, refunding misappropriated funds, reviewing and improving compliance and supervision policies and procedures, and the retention of a compliance consultant

CUSTODY

- Fortius Financial Advisors, LLC, et al., Advisers Act Rel. No. 4483 (August 15, 2016)
  - This matter involved several allegations, including unsuitable investments, misappropriation, failure to supervise, failure to adopt and implement policies and procedures. The client in question was elderly and in deteriorating health
  - An employee was a named trustee and signatory with the ability to effectuate transactions in all of the client's accounts. Fortius, as a result, had custody, but it did not engage an independent public accountant to conduct a surprise examination of any of the client accounts
  - Expect to see more of these cases, where violations of the custody rule are appended to allegations of failure to supervise and misappropriation

BROKER-DEALER

- Blackstreet Capital Management, LLC, et al., Advisers Act Rel. No. 4411 (June 1, 2016)
  - The SEC found that a private equity fund adviser performed brokerage services for and received brokerage fees from portfolio companies, instead of using investment banks or registered broker-dealers to provide such services, and that Blackstreet and engaged in conflicted transactions, improperly used fund assets and failed to adequately disclose certain fees and expenses that were charged to the funds and/or the portfolio companies
  - Settlement included disgorgement of transaction fees of $1,877,000, related prejudgment interest and a civil monetary penalty of $500,000
  - Although the action includes several Advisers Act violations, the SEC's press release emphasizes the failure to register
  - Proceeding reopens the debate on the scope of comfort provided the January 2014 M&A no-action letter, which some had thought might be a harbinger of good news for private equity fund sponsors

Examination Initiatives and Activities

OCIE Examination Priorities

SEC EXAMINATION PRIORITIES

- OCIE's stated 2016 Examination Priorities included:
  - Conflicts / fiduciary duty
  - Fee selection and reverse churning
  - Liquidity controls
  - Focus on private fund advisers
  - Cybersecurity
- Recent relevant National Exam Program Risk Alerts included:
  - 2015 Cybersecurity Examination Initiative
  - Advisers and Funds That Outsource Their Chief Compliance Officers
  - Supervision Practices at Registered Investment Advisers [for disciplined employees]
  - Whistleblower Rule Compliance [Rule 21F-17]

NFA Exams

RISK FACTORS THAT MAY PROMPT AN EXAMINATION

- Customer complaints
- Business background of principals
- Concerns noted during a review of the firm's promotional materials, disclosure documents and/or filings
- Referrals received from other agencies/members
- Use PQR and PR data
- Time since registration or last exam
- Generally, NFA examines IBs, CPOs and CTAs every 4-5 years
- More frequent exams if risk factors deem necessary

AREAS OF FOCUS

- Governance – Committees, responsibilities, frequency of meetings, procedures, reporting and escalation of issues
- Administrators and Custodians – due diligence, ongoing supervision/validation and conflicts of interest
- Counterparty Risk and Concentration Risk – how is it assessed and managed
- Liquidity Policies – portfolio repositioning, stress testing and sources of liquidity. Extra challenges with illiquid investments – how are they managed to meet redemption requests and pay fees/expenses
- Disclosure and Performance Reporting
- Handling of Pool Funds
- Financial Reporting and Valuation of Assets
- Internal Controls – policies and procedures, separation of duties, access, backgrounds of key personnel
- Due Diligence and Risk Management – governance, administrators and custodians, counterparty risk, concentration risk, liquidity policies
- Promotional Materials and Sales Practices – procedures, review and approval; balanced presentation
- Registration, Common Deficiencies – unlisted principals and branch offices; unregistered APs; APs not terminated; failing to update registration records

DISCLOSURE DOCUMENTS AND PERFORMANCE REPORTING DEFICIENCIES

- Operations inconsistent with disclosure
  - Fees and expenses
  - Redemptions
  - Trading strategy
  - Conflicts of interest
  - Banks, carrying brokers, custodians
  - General Partner and/or CTA ownership interest
- Performance Recordkeeping
  - Supporting worksheets
  - Notional funding documentation

BYLAW 1101 DEFICIENCIES: DUE DILIGENCE AND WHERE TO LOOK

- Due Diligence
  - Does the account appear to require registration?
  - If not, why not (exemption, offshore)?
  - If yes, why and is it registered?
  - Is the pool operator an NFA member?
  - Annually, review exempt entities (exemption affirmation for CTFC Regulations 4.5, 4.13(a)(3) and 4.14(a)(8))
- Where to Look
  - BASIC-Registration Status
  - Part 4 Exemption Look-Up in ORS and BASIC
  - Ask client for copy of exemption
  - In all cases, document findings

OTHER DEFICIENCIES

- Incomplete Account Statements
  - Information only included for the individual pool participant
  - Statements must include information for the pool as a whole
- Pool Expenses
  - What do certain payments represent?
  - How was this information disclosed to pool participants?
- Affirmations
- Bunched Orders
- NFA Compliance Rule 2-45: loans to CPO or affiliates

FINRA Examination Priorities

2016 EXAMINATION PRIORITIES

- Culture, Conflicts of Interest and Ethics
- Conflicts of interest in incentive structures
- Cybersecurity
- Outsourcing
- AML
- Liquidity Risk
- Sales practices:
  - Seniors and vulnerable investors
  - Sales charge discounts and waivers
  - Private placements
- Financial and operational controls
  - Internal audit
  - Fixed income prime brokerage
  - Assessment of credit, liquidity and operational risks when onboarding new clients

TARGETED EXAMINATIONS AND SWEEPS

- Review of Cross Selling Programs (October 2016)
  - Reviewing extent to which broker-dealers are promoting bank products of affiliated or parent companies to retail customers and adding different features to retail customer accounts such as securities-based loans, or opening additional broker-dealer accounts
- UIT Rollover Review (September 2016)
  - Focused on assessment of early rollovers, defined as the sale of a UIT 100 days or more prior to the portfolio ending date
- Non-Traded BDCs (August 2016)
  - Focused on due diligence that firms conduct of the BDCs (initially and ongoing) and due diligence of participating broker-dealers with which the firm has selling agreements
- Mutual Fund Waiver (May 2016)
  - Focus on controls to ensure mutual fund sales charge waivers are provided to eligible accounts, including retirement plans and charitable accounts
- Cultural Values (February 2016)
  - Focused on assessment of how firms establish, communicate and implement cultural values, and whether cultural values are guiding business conduct.

LOOKING FORWARD – 2017 PRIORITIES

- FINRA is expected to focus on the following areas in 2017:
  - AML
  - Protection of senior citizens
  - Cybersecurity
  - Hiring of problematic brokers
  - Appropriate discounts/breakpoints
- 2017 Exam Priorities Letter will be released in January 2017

Recent FINRA Enforcement Actions

ANTI-MONEY LAUNDERING

- Raymond James & Associates, Inc., Raymond James Financial Services, Inc. and Linda L. Busby,
  FINRA AWC No. 2014043592001
  - In this case, FINRA found systemic AML deficiencies that resulted in the failure to properly prevent or detect, investigate, and report suspicious activity for several years
  - In FINRA's assessment, the rapid growth of the firms from 2006 to 2014 was not matched by a corresponding growth in AML systems and processes, leaving the firms unable to adequately detect and investigate "red flags" of suspicious activity
  - The two firms were fined a total of $17 million, and the firm's former AML Compliance Officer was fined $25,000 and suspended for three months

SHARE CLASS SUITABILITY

- VOYA Financial Advisors, five broker-dealer subsidiaries of Cetera Financial Group, Kestra Investment Services, LLC, and FTB Advisors, Inc.
  - Eight firms were fined a total of $6.2 million for failing to supervise sales of variable annuities (VAs)
  - Each of the cases involved the sale of L-share variable annuities, which are designed for short-term investors willing to pay higher fees (typically 35 to 50 bps higher than B-shares) in exchange for shorter surrender periods (typically 3 to 4 years instead of 7 years)
  - These actions involved failures to establish policies and procedures related to the sale of multi-share class VAs, and failure to provide training for reps and principals on the sale and supervision of multi-class VAs

CONFLICTS OF INTEREST

- VALIC Financial Advisors, Inc.,
  FINRA AWC No. 2014042360001
  - The firm was fined $1.75 million for failing to identify and reasonably address certain conflicts of interest in the firm's compensation policy, and failure to adequately supervise its VA business, including the sale of VAs with multiple share classes
  - From late 2011 to late 2014, the firm incentivized registered reps to recommend that customers move their funds from VALIC variable annuities to the firm's fee-based platform or into a VALIC fixed index annuity, and paid no compensation to reps for moving customer funds to non-VALIC VAs, mutual funds or other non-VALIC products
  - FINRA determined that the failure to address, analyze or review conflicts of interest in its compensation program violated Rule 3010 (Supervision) and Rule 2010 (Standards of Commercial Honor and Principles of Trade)
  - Notably, there was no allegation of fraud or unsuitable recommendations

Looking Ahead

POSSIBLE DEVELOPMENTS

- Increased focus on advisers given realignment of examiners
- Increased focus on adviser safeguards
  - More cybersecurity exams with closer focus on controls
  - Investment management business continuity guidance
- Increasing use of data analytics to identify out-of-cycle exam candidates and subjects for enforcement
- Continued focus on current enforcement priorities, including:
  - Valuation
  - Undisclosed fees and expenses, and misallocated expenses
  - Conflicts of interest

Q & A

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