



2017 BOSTON INVESTMENT MANAGEMENT CONFERENCE

Developments in SEC Enforcement and Examinations

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AGENDA

- SEC Transition Issues
- SEC Enforcement Priorities and Trends for 2017
 - Broken Windows Theory
 - Initial Coin Offerings (ICOs)
 - Disgorgement Priorities and Kokesh
 - Insider Trading
 - Fiduciary Duties
 - Cybersecurity Developments
- SEC Examination Priorities and Guidance

SEC TRANSITION ISSUES

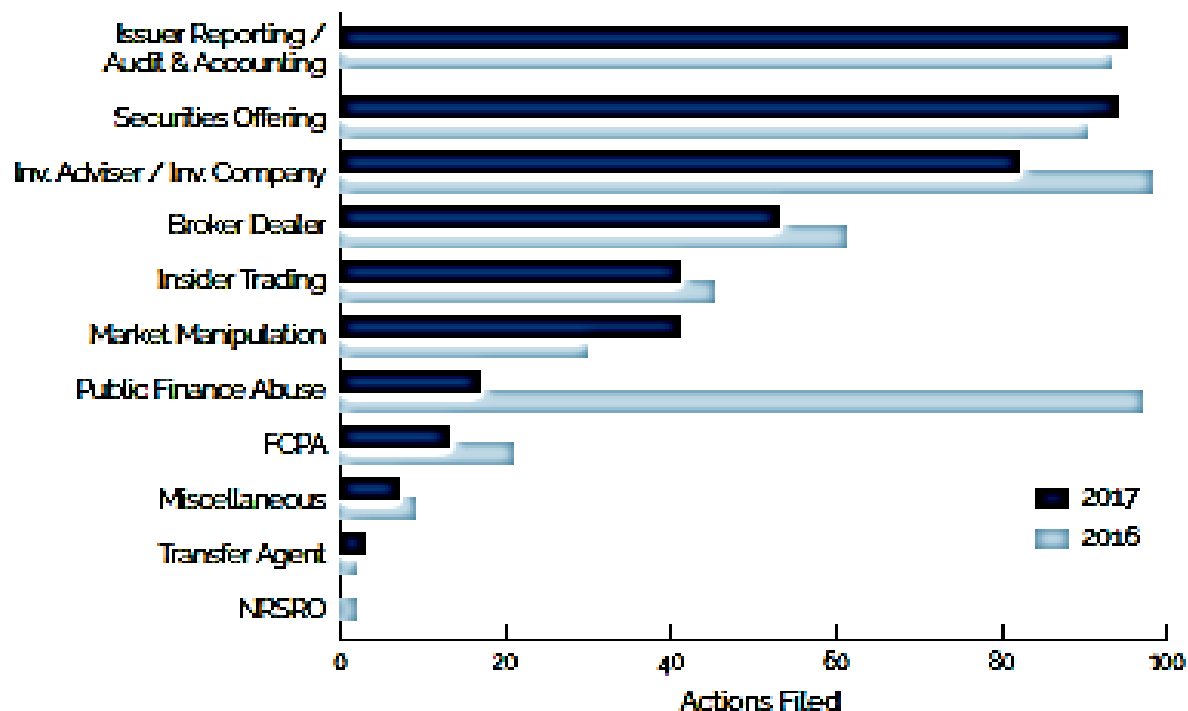
- New SEC leadership faces challenges
 - New Chairman: Jay Clayton
 - New Enforcement Co-Director: Steven Peiken
 - Two Commission seats remain unfilled
 - Terms of the remaining commissioners expiring soon
 - Stein in 2017 and Piwowar in 2018
- Day-to-day business of enforcement and examination continue with:
 - Less resources
 - Frozen budget
 - Smaller headcount
- Two new Enforcement specialized units: Retail and Cyber

ENFORCEMENT STATISTICS

- Is SEC Enforcement slowing down?
- 754 enforcement actions during the 2017 Fiscal Year
 - 446 primary or standalone enforcement actions
 - 196 follow-on proceedings
 - 112 delinquent filings against public companies
 - Compare to 868 total actions in 2016
- \$3.8 billion in disgorgement and penalties over the 2017 Fiscal Year
 - 7% drop (\$4.08 billion in 2016)
- Distributed a record \$1.21 billion to harmed investors

*Source - <https://www.sec.gov/files/enforcement-annual-report-2017.pdf>

ENFORCEMENT STATISTICS BY CATEGORY



* Source - <https://www.sec.gov/files/enforcement-annual-report-2017.pdf>

HOT ENFORCEMENT TOPICS IN 2017

- End of Broken Windows?
- Preference for litigated administrative proceedings on the wane?
- Whistleblowers protections: employment agreements scrutinized for anti-retaliation and “pre-taliation” language
- Focus on individual culpability rather than corporate liability
- Fiduciary duties of advisers and conflicts of interest
- Back to neither admit nor deny?
- Less delegated authority
- Cooperation credit – is it worth it?

INITIAL COIN OFFERINGS (ICOs)

- No Action Letter: July 25, 2017
 - Decentralized Autonomous Organization (DAO) Report
 - First public statement regarding ICOs
- Found some “coins” or “tokens” for sale are actually securities and can be regulated
- Case by case approach to ICOs
- Focus on celebrity endorsements of ICOs
- Chairman Clayton:
 - “I have yet to see an ICO that doesn’t have a sufficient number of hallmarks of a security”

S.O.L AND DISGORGEMENT: KOKESH

- Kokesh v. SEC, 581 U.S. ____ (2017)
 - Unanimous decision that disgorgement is a penalty (not an equitable remedy)
 - Subject to five year limitation period
 - Some question whether SEC can seek disgorgement at all
 - \$15 billion lawsuit against SEC

- Impact
 - Benefits of self-reporting must be scrutinized
 - Cooperation and tolling agreements more important than ever
 - Factor in settlement discussions
 - Resources issue for staff

INSIDER TRADING – “PERSONAL BENEFIT”

- Recent History
 - United States v. Newman, 773 F.3d 438 (2d Cir. 2014)
 - Prosecutors must prove tipper received a personal benefit based on “meaningful close personal relationship” and potential pecuniary gain
 - United States v. Salman, 580 U. S. ____ (2016)
 - Personal benefit from relative or friend, regardless of any pecuniary gain
- United States v. Martoma, No. 14-3599 (2d Cir. 2017)
 - Second Circuit reversed course on “personal benefit” requirement
- New Tipper/Tippee Standard
 - An insider or tipper personally benefits from the disclosure of inside information whenever the information was disclosed with the expectation that the recipient would trade on it

INSIDER TRADING

- Securities and Exchange Commission v. O'Neill et al, Case No. 1:14-cv-13381
 - Trader was tipped off about a bank acquisition by his golf pal who was a bank employee
 - Convicted by DOJ in 2016
 - Bray, trader, found guilty by jury
 - Sentenced to 2 years in prison
 - O'Neill, bank employee, pled guilty
 - Received one year probation
 - Judge order payment of nearly \$375,000 in disgorgements

FIDUCIARY DUTIES OF ADVISERS

- In the Matter of F-Squared Investments, Inc., Adm. Proc. No. 3-16325
 - Agreed to pay \$35 million settlement
 - Admitted misleading investors through false advertising the performance of an investment product
- SEC v. Present, Civ. Action No. 1:14-cv-14692 (D. Mass)
 - Co-Founder & CEO of F-Squared Investments found guilty of violating federal securities laws
 - Found he intended to defraud investors or was reckless in how he touted the history of his company's flagship investment product

CYBERSECURITY – HACK OF SEC

- On Sept. 20, 2017, SEC announced that its computer system EDGAR had been hacked last year, 2016
 - EDGAR system receives 1.7 million corporate and securities filing a year
- Chairman Clayton claimed that hacking did not “result in systemic risk”
- But, SEC acknowledged the hacking “may have provided the basis for illicit gain through trading”

CYBERSECURITY – FORMATION OF SEC CYBER UNIT

- On Sept. 25, 2017, SEC announced creation of a Cyber Unit
- Focus on conduct such as:
 - Seeking market advantage through cyber-related conduct
 - Failure to safeguard against cybersecurity threats
 - Cyber-related disclosure failures
 - Evolution of blockchain technology
- Additional areas include:
 - Electronic market manipulation
 - Hacking-based insider trading
 - Digital token violations
 - Misconduct on the dark web
 - Account instructions and other cyber-related threats

SEC EXAMINATION PRIORITIES

- The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (Feb. 7, 2017)
 - (1) Compliance Rule
 - (2) Inadequacies in Required Filings
 - (3) Custody Rule
 - (4) Code of Ethics Rule
 - (5) Books and Records Rule

2017 OCIE EXAMINATION PRIORITIES

- Office of Compliance Inspections and Examinations (OCIE) announced its intent to focus effort on:
 - Examining matters of importance to retail investors
 - Targeting risks specific to elderly and retiring investors
 - Assessing market-wide risks

- To protect retail investors, OCIE will monitor:
 - Electronically delivered investment advice
 - Wrap fee programs
 - ETFs
 - Registered advisers
 - Recidivists and employers that hire them
 - Analyze multi-branch advisers
 - Instances of conflicts of interest

- To protect senior investors and retirement investments, OCIE will:
 - Continue its ReTIRE initiative to protect investors with retirement accounts,
 - Monitor public pension advisers
 - Identify potential financial exploitation of seniors

SEC EXAMINATION PRIORITIES

- SEC announced a Multi-Branch Adviser Initiative, focusing on:
 - Advisers that offer services from multiple locations, focus on compliance programs and personnel for remote locations
 - Programs under the Compliance Rule, the implementation of policies at both main and branch offices, the supervision structure for branch offices, the empowerment of compliance personnel in branch offices, and the accuracy of branch offices' filings
 - Investment recommendations from branch offices

SEC EXAMINATION PRIORITIES

- Most frequent advertising rule compliance issues among advisers (Sept. 15, 2017)
 - Misleading performance results
 - e.g. failing to deduct advisory fees when discussing performance results
 - Erroneously claiming compliance with performance standards
 - Cherry picking stocks
 - Misleading advertisements
 - Including use of third-party rankings, awards, professional designations, and testimonials
 - Appearing to have appropriate policies and procedures designed to prevent violations of the Advertising Rule

SEC EXAMINATION PRIORITIES – SPOT EXAMS

- SEC staff from the Boston office have recently been conducting unannounced examinations of investment advisers
- Typical questions from OCIE staff:
 - General inquiries about compliance
 - Organization and fund structure charts
 - What prime brokers are used for trades? What other firms were used?
 - Firm committees?
 - Calendar system for tracking interactions?
 - Monitoring and testing is being done to prevent insider trading
 - How frequently does the firm have trade breaks (trade errors) and how are such errors documented?
 - Does the firm follow best practices for trading?
 - What expense allocation processes and procedures are used?

CHIEF COMPLIANCE OFFICER LIABILITY

- Susan M. Diamond, Advisers Act Rel. No. 4619 (Jan. 19, 2017)
 - Private funds adviser allegedly filed Forms ADV with false statements that financial statements were audited and would be distributed
 - COO found liable for overseeing completion of forms containing the false statements
- David I. Osunkwo, Adviser Act Rel. No 4745 (Aug. 15, 2017)
 - Outsourced COO failed to file timely and accurate Forms ADV and amendments; filings overstated AUM and total number of client accounts; allegedly relied on and failed to verify CIO's inaccurate statements
 - Violations of IAA Sections 204 and 207, \$30,000 penalty, and 12 month industry suspension
 - Firms sanctioned for recordkeeping and filing violations

CYBERSECURITY - OBSERVATIONS FROM EXAMINATIONS

- After 2015 cybersecurity exams, OCIE concluded firms generally had enhanced cybersecurity measures and functioned with heightened cybersecurity awareness
- Issue areas:
 - Policies and procedures not tailored
 - System maintenance not conducted enough
- 2017 Recommendations:
 - Detailed cybersecurity-related instructions
 - Maintained inventory and prescriptive schedules and processes for testing data integrity and vulnerabilities
 - Enforced controls to access systems and data
 - Mandatory employee training
 - Engaged senior management



Questions

