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2017 WASHINGTON D.C. INVESTMENT MANAGEMENT CONFERENCE

Hot Topics in Enforcement

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OVERVIEW OF PRESENTATION

- SEC Priorities and Trends
- Selected SEC Enforcement Actions Involving Investment Advisers
- SEC Cybersecurity Developments
- FINRA Enforcement Developments
- What's Ahead for 2018?

SEC Priorities and Trends

SEC TRANSITION ISSUES

- SEC leadership is new and not operating at full strength
  - New Chairman Clayton and SEC Enforcement Co-Director Steven Peikin appointed
  - Two open Commission seats with nominations pending Senate
  - Terms of the remaining Commissioners expiring soon
    - Stein in 2017 & Piwowar in 2018
- Themes of jobs growth, capital formation, & avoiding controversy
- Day-to-Day business of enforcement and examinations continue
  - A shifting of examination staff has taken place
  - Investment adviser examinations are rising

HOT ENFORCEMENT TOPICS IN 2017

- Plain vanilla fraud, Ponzi schemes, insider trading and fewer "broken windows" cases
- Approval of Enforcement Division Co-Head required for initiation of Formal Orders of Investigation, reversing 2009 delegation to lower senior staff
- Supreme Court ruling that 5-year Statute of Limitations applies to disgorgement actions (*SEC v. Kokesh*)
- Cooperation credit still seen and touted as a factor in settlements

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HOT ENFORCEMENT TOPICS IN 2017

- Preference for litigated administrative proceedings on the wane?
- Whistleblowers still rewarded and employment agreements scrutinized for anti-retaliation and “pre-taliation” language
- Fewer settled actions involving admissions
- Fiduciary duties of advisers and conflicts of interest remain key
- Clayton’s focus on individual culpability rather than corporate liability

HOT ENFORCEMENT TOPICS IN 2017

- CCO Liability
- Insider trading (and related supervision liability)
- Fiduciary duties of advisers and conflicts of interest
  - Cherry-picking favorable trades and expenses
  - Distribution-in-Guise
  - Share class selection
  - Disclosure of Conflicts associated with 12b-1 fees
  - Undisclosed fees and expenses
  - Pay-to-Play
- Valuation

Selected SEC Enforcement Actions Involving Investment Advisers

CHIEF COMPLIANCE OFFICER (CCO) LIABILITY

- The SEC's position is unchanged; no new pronouncements and few actions
- Prior Speeches (by Andrew "Buddy" Donoghue and Andrew Ceresney) contained common themes:
  - SEC is not targeting CCOs.
  - CCOs who perform their responsibilities "diligently" need not fear enforcement
- SEC actions against CCOs tend to involve compliance officers who:
  - Affirmatively participated in the underlying misconduct,
  - Helped mislead regulators,
  - Wear multiple hats including as CCO while engaging in misconduct, or
  - Had clear responsibility to implement compliance programs and wholly failed to carry out that responsibility

CHERRY PICKING

- **SEC v. Strategic Capital Management and Michael J. Breton, Lit. Rel. No. 23867 (June 23, 2017)**
  - Adviser placed trades through master brokerage account and owner allegedly allocated profitable trades to himself and unprofitable trades to clients; trades were made on earnings announcement dates, allocations were made afterward
  - Violations of '34 Act Section 10(b) and Rule 10b-5 and IAA Sections 206(1) and (2), owner banned from industry, monetary sanctions to be determined; prison and penalty in corresponding criminal case
- **Howarth Financial Services and Gary S. Howarth, Advisers Act Rel. No. 4768 (Sept. 12, 2017)**
  - Adviser and owner purchased securities through omnibus account, then allegedly delayed allocation until after determining intraday performance; owner also allegedly sold client securities and waited to see if price increased or decreased, allocating losses to clients and allocating profitable repurchases to himself
  - Violations of '34 Act Section 10(b) and Rule 10b-5 and IAA Sections 206(1) and (2), owner banned from industry, $160,000 penalty, $38,172 in disgorgement

DISTRIBUTION-IN-GUISE

- **Calvert Investment Distributors Inc. and Calvert Investment Management, Inc., Admin. Proc. File No. 3-17016 (May 2, 2017)**
  - Adviser and broker-dealer affiliate negligently caused its advised open-end investment companies to pay nearly $13 million for distribution and marketing of fund shares outside of a Rule 12b-1 plan. As a result, funds' prospectuses contained material misstatements regarding distribution-related services, and also, funds incurred expenses for sub-transfer agent services beyond applicable expense limits
  - Violation of Advisers Act Section 206(2) and Investment Company Act Sections 12(b) and 34(b)
  - SEC issued cease and desist order and imposed disgorgement and interest of over $21.6 million, plus a reduced penalty of $1 million
  - SEC reduced the monetary penalty due to the funds' self-reporting of the improper fee payments, significant cooperation, and prompt remediation through shareholder distribution

DISTRIBUTION-IN-GUISE (CONT.)

- **William Blair & Company, Admin. Proc. File No. 3-17960 (May 1, 2017)**
  - Adviser and broker-dealer affiliate negligently used mutual fund assets to pay for distribution and marketing of fund shares outside of a written, board-approved Rule 12b-1 plan, and sub-TA services in excess of board-approved limits; payments totaled approximately $1.25 million and rendered disclosures concerning payments for distribution and sub-TA services inaccurate
  - Findings that William Blair failed to fully disclose to the funds' board that it (and not a third-party service provider) would retain a fee for providing shareholder administration services to the funds under its shareholder administration services agreement
  - SEC found William Blair to have violated Advisers Act Section 206(2) and Investment Company Act Section 34(b), and to have caused the funds to violate Investment Company Act Section 12(b) and Rule 12b-1
  - SEC imposed cease and desist order and $4.5 million penalty, taking into consideration credit for remediation and cooperation
  - After being informed by OCIE that it would conduct an examination into payments to financial intermediaries, William Blair self-investigated and detected the violations, and remediated by promptly notifying the fund Board, reimbursing the funds with interest, and supplementing its practices of providing oversight of payments to financial intermediaries

SHARE CLASS CONFLICTS

- **Credit Suisse Securities (USA) LLC, Advisers Act Rel. No. 4678 (Apr. 4, 2017); Sanford Michael Katz, Advisers Act Rel. No. 4679 (Apr. 4, 2017)**
  - Credit Suisse adviser representatives purchased Class A mutual fund shares for advisory clients who were eligible to purchase less expensive share classes; Class A shares had marketing and distribution fees imposed on shareholders; the 12b-1 fees were paid out of fund assets and included in its expense ratio, and Credit Suisse used a portion of those received funds to pay its investment advisers; 12b-1 fees reduced the value of clients' mutual fund investments and increased the gain to Credit Suisse and its investment adviser representatives
  - Credit Suisse allegedly did not disclose that other share classes lacked 12b-1 fees; general disclosure of potential receipt of 12b-1 fees for Class A was inadequate to inform clients of conflict of interest presented by its adviser representatives without a simultaneous disclosure of the less expensive share classes
  - Firm violated Advisers Act Sections 206(2), 206(4), and 207
  - SEC issued cease and desist order and imposed a $3.275 million penalty and $2 million in disgorgement

SHARE CLASS CONFLICTS (CONT.)

- **Envoy Advisory, Inc., Advisers Act Rel. No. 4764 (Sept. 8, 2017)**
  - Adviser firm recommended Class A mutual fund shares when less expensive share classes available; firm received approximately $24,000 in 12b-1 fees; firm's disclosures did not adequately inform clients of conflict of interest created by its recommendation to purchase Class A shares
  - Firm violated Advisers Act Sections 206(2), 206(4), and 207
  - SEC issued cease and desist order and ordered disgorgement of approximately $24,000
  - SEC took note of the firm's cooperation and remedial efforts, including engaging a compliance consultant

FAILURE TO DISCLOSE FEE OVERCHARGE

- **Barclays Capital Inc., Advisers Act Rel. No. 4705 (May 10, 2017)**
  - Barclays allegedly improperly charged nearly $50 million in advisory fees from September 2010 through December 2015. Barclays falsely claimed it was performing certain due diligence in exchange for fees
  - Barclays also allegedly recommended that certain retirement plan and charitable organization brokerage customers buy more expensive mutual fund share classes despite the availability of less expensive class shares; without disclosing the conflict of interest, Barclays received greater compensation from customers' purchases of more expensive class shares; Barclays did not inform customers that purchase of more expensive class shares would diminish overall investment returns
  - Barclays violated Advisers Act Sections 206(2), 206(4), and 207 and Securities Act Sections 17(a)(2) and (3)
  - SEC issued cease and desist order and imposed $30 million penalty and $50 million in disgorgement

FAILURE TO DISCLOSE CONFLICTS (CONT.)

- **John W. Rafal, Admin. Proc. File No. 3-17760 (Jan. 9 2017); Peter Hershman, Esq., Admin. Proc. File No. 3-17761 (Jan. 9 2017); Essex Financial Services, Inc., Admin. Proc. File No. 3-17762 (Jan. 9, 2017)**
  - Adviser's President and CEO **admitted** to fraudulently circumvented rule regarding payments for client solicitations by paying attorney for client referral without notifying client of arrangement and resulting conflict of interest
  - President sent emails to other clients, falsely claiming that he was not being investigated for a securities violation. He also made false statements in testimony to the SEC regarding solicitation arrangement. He was barred from the industry and ordered to pay $275,000 fine and disgorgement of $275,000
  - Attorney barred from the industry and ordered to pay $37,500 penalty and disgorgement of $49 million
  - SEC considered adviser's remedial measures of increasing compliance department staffing, reporting solicitation arrangement, promptly removing President from his position and subjecting him to internal investigation, and ultimately discharging him. Adviser also promptly informed the SEC of President's false emails and compelled him to issue retractions. SEC ordered adviser ordered to pay disgorgement of $170,000

NEGLIGENT OVERCHARGING

- **Citigroup Global Markets, Inc., Advisers Act Rel. No. 4626 (Jan. 26, 2017)**
  - Between 2000 and 2015, CGMI overcharged approximately $18 million in advisory fees. Overcharging occurred due to procedural flaw relating to how fee rates were entered into computer system. CGMI also failed to maintain and preserve certain books and records regarding advisory contracts
  - SEC issued cease and desist order and imposed $14.3 million penalty and $3.2 million in disgorgement.
- **Morgan Stanley Smith Barney, LLC, Advisers Act Rel. No. 4607 (Jan. 13, 2017)**
  - Between 2002 and 2016, MSSB inadvertently overcharged approximately $16 MM in advisory fees primarily due to numerous errors in its billing systems. MSSB also failed to maintain and preserve certain books and records regarding advisory contracts
  - SEC issued cease and desist order and imposed $13 million penalty

PAY-TO-PLAY VIOLATIONS

- **See e.g., NGN Capital LLC, Advisers Act Rel. No. 4612 (January 17, 2017)**
- SEC reached settlements with 10 investment advisory firms in January 2017 for violations of the Advisers Act Rule 206 (4)-5
- Rule 206(4)-5 prohibits investment advisers from providing investment advisory services for compensation to a government client (or to an investment vehicle in which a government entity invests) for two years after the adviser or certain of its executives or employees makes a campaign contribution to certain elected officials or candidates who can influence the selection of certain investment advisers
- Sanctions ranged from $35,000 to $100,000 in penalties together with cease and desist orders
- States and other instrumentalities may also impose requirements to register as lobbyists, prohibit the use of placement agents and contingent compensation, and restrict gifts and entertainment and political contributions

VALUATION – THE "DIVA OF DISTRESSED INVESTING" TRIAL CONCLUDES

- **Lynn Tilton, Patriarch Partners, et al.**,
  Admin Proc. File No. 3-16462 (Mar. 30, 2015)
  - Lynn Tilton of Patriarch Partners, the Adviser to Zohar Funds, allegedly failed to properly value distressed loans in funds' portfolios (CLOs) in accordance with disclosed valuation policies. The SEC alleged that improper valuation resulted in over $200 million in management fees to adviser
  - Publicly, Tilton has used this case to challenge the due process of administrative proceedings before the SEC. Substantively, however, the case concerns valuation
  - In an Initial Decision released on September 27, 2017, an SEC ALJ dismissed the charges concerning Tilton's operation of the Zohar Funds. The ALJ concluded that the alleged violations that Tilton overvalued loan portfolio companies in a quest for higher management fees were "unproven" by the SEC
  - Among other things, ALJ found that the financial statements disclosed the subjective and uncertain nature of the fair valuation techniques, that GAAP violations without fraudulent intent are not proof of securities fraud violations, and that the "total mix" of information available to the investors was such that there was no omission to state a material fact or misrepresentation of a material fact

TRIAL OF FORMER F-SQUARED CEO CONCLUDES WITH SEC WIN

SEC v. Present, D. Mass No. 14-cv-14692

- On October 6, 2017, after four week trial, a jury found former CEO and founder of F-Squared to have committed fraud in connection with false and misleading marketing of the AlphaSector strategy for trading ETFs
- In 2014, investment manager F-Squared Investments settled SEC action by paying a $35 million penalty and admitting that it had inflated performance data for its strategy for trading ETFs, by advertising seven years of successful performance data that, in actuality was based on back-testing
- F-Squared proceeding spawned 13 separate enforcement actions against investment advisers to other funds for relying on F-Squared advertising in their own marketing activities and not conducting their own due diligence


Cybersecurity

CYBERSECURITY

Risk Alert: Observations from Cybersecurity Examinations (August 8, 207)

- Results of OCIE's Cybersecurity 2 Initiative in which the staff examined the cybersecurity procedures of 75 firms
- Concluded generally that firms had enhanced cybersecurity measures and functioned with heightened cybersecurity awareness, although NEP staff noted areas in which cybersecurity protocols may be augmented
- NEP staff encouraged all firms to establish and maintain robust cybersecurity policies. First, firms should maintain a complete inventory of data and information regarding each service provider and vendor. Second, firms should adopt comprehensive cybersecurity-related instructions that cover penetration tests, security monitoring, system auditing, access rights, and reporting of breaches. Third, firms should consistently test for data integrity and vulnerabilities. In addition, firms should disseminate "acceptable use" policies to employees and strictly enforce access controls. Finally, firms should make information security training mandatory for its employees, monitor attendance, and take appropriate punitive action against noncompliance

Hack of SEC

- On Sept. 20, 2017, SEC announced that its computer system EDGAR had been hacked last year. SEC acknowledged the hacking "may have provided the basis for illicit gain through trading"

Formation of SEC Cyber Unit

- On Sept. 25, 2017, SEC announced creation of a Cyber Unit that will focus on targeting hacking, misconduct using the dark web, and intrusions into retail brokerage accounts


Digital Currency Enforcement

SCRUTINY OF INITIAL COIN OFFERINGS

- **Report of Investigation: The DAO, Exchange Act Rel. No. 81207 (July 25, 2017)**
  - Decentralized Autonomous Organization ("DAO"), a "virtual" organization, distributed ledger tokens. DAO was created by Slock.it, a German for-profit entity, which uses assets acquired through the sale of its DAO Tokens to fund projects. DAO Tokens could be purchased with virtual currency, and in return, buyers would receive limited voting and ownership rights
  - SEC investigated whether DAO Tokens qualified as "investment contracts." SEC issued an investigative report that contained its findings on the matter
  - Employing the *Howey* test as adopted by the Supreme Court, SEC concluded that the DAO Tokens constituted securities. SEC concluded more generally that the securities laws apply to virtual organizations or capital raising entities that make use of distributed ledger technology. Therefore, entities or individuals who participate in an unregistered offer and sale of virtual currencies or digital tokens may be subject to Securities Act Section 5 liability, depending on the facts and circumstances
  - SEC declined to bring enforcement action or to make formal findings of violations in the investigative report
  - Takeaways:
    - (1) The sponsors and intermediaries in token offerings should consult with securities counsel regarding compliance with the federal securities laws
    - (2) Potential purchasers of digital tokens should consult with securities counsel prior to resale

FRAUD IN THE ICO CONTEXT

- **SEC v. Recoin Group Foundation, LLC et al.**, 1:17-cv-05725 (Sept. 29, 2017)
  - In an enforcement action filed in the U.S. District Court for the Eastern District of New York, the SEC charged an individual and two companies with jointly defrauding investors in two initial coin offerings (ICOs). Maksim Zaslavskiy and his companies REcoin Group Foundation and DRC World Inc. sold investors digital tokens, purportedly backed by real estate and diamonds, in two separate ICOs. The SEC alleges that neither the digital tokens nor the alleged backing of real estate and diamonds existed, and as such, Zaslavskiy made false statements in connection with the offering
  - This action represents the first fraud charges issued by the SEC involving ICOs

FINRA ENFORCEMENT

FINRA LEADERSHIP TRANSITION AND NEW INITIATIVE

- June 2016—Robert W. Cook appointed President and Chief Executive Officer; succeeded Richard G. Ketchum, who served as Chairman and CEO since 2009
- January 2017—Robert Cook, on the heels of his listening tour, launched FINRA360, an ongoing, comprehensive self-evaluation and organizational improvement initiative
- July 2017—William H. Heyman elected as FINRA Chairman
- July 2017—FINRA promoted Susan Schroeder to Executive Vice President and Head of Enforcement
- As part of FINRA360 initiative, FINRA consolidated its two enforcement groups—Market Regulation's surveillance and examination programs, and Enforcement which handles cases referred from other regulatory oversight divisions including Member Regulation, Corporate Financing, the Office of Fraud Detection and Market Intelligence, and Advertising Regulation

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FINRA 2017 REGULATORY EXAMINATIONS PRIORITIES

- High-risk and Recidivist Brokers; Office Inspections
- Sales Practices
  - Senior Investors
  - Product Suitability and Concentration
  - Excessive and Short-term Trading of Long-term Products
  - Outside Business Activities and Private Securities Transactions
  - Social Media and Electronic Communications Retention and Supervision
- Financial Risks
  - Liquidity Risk
  - Risk Management Practices
  - FINRA Rule 4210, which became effective 12/15/2016, established margin requirements for covered agency transactions

FINRA 2017 REGULATORY EXAMINATIONS PRIORITIES (CONT.)

- Operational Risks
  - Cybersecurity
  - Supervisory Controls Testing
  - Customer Protection/Segregation of Client Assets
  - Regulation SHO—Close Out and Easy to Borrow
  - Anti-Money Laundering and Suspicious Activity Monitoring
  - Municipal Advisor Registration
- Market Integrity
  - Manipulation
  - Best Execution
  - Audit Trail Reporting Early Remediation Initiative and Expansion
  - Tick Size Pilot
  - Market Access Rule
  - Trading Examinations
  - Fixed-Income Securities Surveillance Program

VOLATILITY-LINKED EXCHANGE TRADED PRODUCTS (ETPs)

- On October 16, 2017, FINRA issued a press release announcing that a member firm (two affiliates) agreed to pay more than $3.4 million in restitution to affected customers for unsuitable recommendations of volatility-linked ETPs and related supervisory deficiencies
- FINRA alleged that, between July 1, 2010 and May 1, 2012, certain firm representatives mistakenly believed ETPs could be used as a long-term hedge on their customers' equity positions in the event of a market downturn; in FINRA's view, ETPs are generally short-term trading products that degrade over time and should not be used as part of a long-term buy-and-hold investment strategy
- In May 2012, the member firm took remedial action to correct its supervisory deficiencies, prior to detection by FINRA, and provided substantial assistance to FINRA's investigation
- On the same day as FINRA's press release FINRA issued Regulatory Notice 17-32 as a reminder to firms of their sales practice obligations relating to ETPs

MORGAN STANLEY SMITH BARNEY LLC
FINRA MATTER NO. 2016048805501 (AWC 9/25/2017)

- FINRA fined Morgan Stanley $3.25 million and required the firm to pay $9.79 million in restitution to more than 3,000 affected customers for failing to supervise its representatives' short-term trades of unit investment trusts (UITs)
- From January 2012 through June 2015, hundreds of Morgan Stanley representatives executed short-term UIT rollovers, including UITs rolled over more than 100 days before maturity, in thousands of customer accounts
- Morgan Stanley failed to supervise its representatives' sales of UITs in several respects: i) provided insufficient guidance to supervisors regarding how they should review UIT transactions to detect unsuitable short-term trading of UITs, including short-term rollovers; ii) failed to implement an adequate supervisory system to detect short-term UIT rollovers; and iii) failed to conduct training for its representatives specific to UITs
- Takeaway: consistent with FINRA's 2017 priorities, firm received significant fine even though given credit for initiating its own investigation prior to intervention by regulator and providing substantial assistance to FINRA

FINRA DEPARTMENT OF ENFORCEMENT v. MATTHEW NEMER
DISCIPLINARY PROCEEDING NO. 20160519253-01 (OHO SEPT. 27, 2017)

- Post-Complaint, FINRA's Office of Hearing Officers accepted an offer of settlement between Enforcement and Mr. Nemer, a former senior equity research analyst with a member firm; Mr. Nemer published five research reports on a company with which he was actively engaged in pursuing employment (one report was published after he had negotiated and accepted a formal employment offer which included the grant of future interests in the company)
- Found that Mr. Nemer knew that his employer at the time required disclosures of conflicts of interest but that he took affirmative steps to prevent his employer from discovering his employment discussions
- Suspended two years and fined $20,000 for violations of NASD/FINRA rules related to disclosing a financial interest and material conflicts of interest in research reports, and publishing misleading research reports

CETERA ADVISOR NETWORKS LLC (AWC MAY 3, 2017)
MUTUAL FUND SHARE CLASS WAIVER

- Cetera agreed to a remediation plan in which it returned $1,911,080 (with interest) to 722 customer accounts for its failure to apply available sales charge waivers when these accounts (charitable organizations and retirement plans) purchased mutual fund shares from July 1, 2009 to January 1, 2017
- Customer accounts purchased Class A shares in certain funds with a front-end sales charge or Class B or C shares with back-end sales charges and higher ongoing fees and expenses when the customers were eligible to purchase Class A shares without a front-end sales charge
- Charged with NASD/FINRA rules related to supervision for its failure to (i) maintain adequate written supervisory procedures to assist advisors in making the waiver determination; (ii) adequately notify and train its advisors regarding the availability of the waivers; and (iii) adopt adequate controls to detect instances in which waivers were not provided to eligible customers

MARKET ACCESS RULE SETTLEMENTS (FINRA PRESS RELEASE DATED JULY 27, 2017)

- FINRA, Bats, The NASDAQ Stock Market LLC, NYSE, and their affiliated Exchanges (collectively, “Exchanges”) censured four firms, and fined them a total of $4.75 million for violations of various provisions of Rule 15c3-5 of the Securities Exchange Act of 1934 (known as the Market Access Rule)
- Between May and July 2017:
  - Deutsche Bank was fined a total of $2.5 million
  - Citigroup was fined a total of $1 million
  - J.P. Morgan was fined a total of $800,000
  - Interactive Brokers was fined a total of $450,000
- Principally alleged that the firms lacked supervisory controls that could have prevented the entry of erroneous or duplicative orders and the entry of orders that exceeded pre-set credit thresholds

DEPARTMENT OF ENFORCEMENT v. RED RIVER SECURITIES, LLC
DISCIPLINARY PROCEEDING NO. 20130353442-01 (OHO FEB. 9, 2017)

- A FINRA hearing panel expelled Plano, TX-based broker-dealer Red River Securities, barred its CEO, and ordered the firm and the CEO to jointly and severally pay $24.6 million in restitution to customers for fraudulent sales in five oil and gas joint ventures
- The joint venture interests (general partnership interests) were deemed securities because, among other things, the investors could not exercise ultimate control, as a majority, over the joint ventures' business activities
- Alleged that Respondents engaged in a pattern of misrepresentations and omissions that spanned nearly four years and involved sales in the risky joint ventures
- The hearing panel dismissed Enforcement's allegations that the firm sold interests in two of the joint venture offerings in violation of the general solicitation prohibition for the private placement of securities under Regulation D, one alleged misrepresentation charge, several alleged suitability violations by the firm, and all suitability allegations against the CEO

WHAT'S AHEAD FOR 2018

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