

The logo for K&L GATES is displayed in white, uppercase letters on a dark blue rectangular background. The background of the entire slide features a complex financial visualization with orange and blue tones, including a candlestick chart, a line graph, and a world map composed of dots.

K&L GATES

2018 INVESTMENT MANAGEMENT CONFERENCE
New York, October 30, 2018

Examination and Enforcement Priorities

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OVERVIEW

- Direction of the SEC
- Examination Priorities
- FINRA Enforcement Priorities
- Cybersecurity Developments
- Cryptocurrency / Blockchain Developments





DIRECTION OF THE SEC



DESPITE ALL THE NOISE, THE SEC HAS NOT CHANGED SIGNIFICANTLY DURING THE TRUMP ADMINISTRATION

The SEC is structured and designed to be non-partisan

- Consists of five presidentially appointed commissioners (including the Chairman of the Commission who is the SEC's chief executive)—by law no more than three can be from the same political party
- Chairman Jay Clayton is an Independent with Wall Street experience

CHANGES UNDER CHAIRMAN CLAYTON

- Shift away from broken windows and admissions cases
- A more conciliatory approach to enforcement
- Focus on capital formation issues
- Focus on ICOs and the role of gatekeepers
- Focus on retail frauds and regulatory concerns



CHAIRMAN CLAYTON'S GUIDING PRINCIPLES

- Apply the three tenets of the SEC's mission equally
- Focus on the long-term interests of the main street investor
- Remain true to the SEC's disclosure-based regulatory regime
- Remain conscious that regulatory actions drive change which can have lasting effects
- The SEC must evolve as the markets evolve
- Retrospectively review rules after they are adopted to ensure they are functioning as intended
- Ensure that the cost of compliance is considered in proposing and adopting rules
- The SEC must coordinate with numerous agencies and authorities whose jurisdictions overlap or are related to the SEC's



MORE RECENT DEVELOPMENTS

- On September 13, 2018, Chairman Clayton took the position that SEC Staff statements are non-binding views that create no enforceable rights or obligations on the Commission
- Also in late September, over a dozen Congress members wrote to Chairman Clayton, asking the SEC to clarify how it views cryptocurrencies and other digital assets



The background features a dark blue and black color palette with glowing digital elements. On the left, there's a grid of light blue dots forming a map-like shape. To the right, a bar chart with orange bars is visible. The bottom half of the image is a solid dark blue band containing the title. Below the band, there are vertical lines with colored circles (orange, purple, white) and a grid of blue dots, suggesting a data visualization or network structure.

EXAMINATION PRIORITIES

2018 SEC EXAMINATION PRIORITIES

- OCIE's annual priorities letter articulates five themes:
 - Matters of importance to retail investors, including disclosure of investing costs, electronic investment advice, wrap fee programs, senior investors and retirement accounts and products, mutual funds and ETFs; and crypto issues
 - Compliance and risks in critical market infrastructure
 - FINRA and the MSRB
 - Cybersecurity
 - Anti-Money Laundering Programs



SEC EXAMINATION PRIORITIES AND FACTS

- 15% of registered advisers were examined in fiscal year 2017, up from 8% just five years ago
- OCIE's Private Funds Unit remains active
 - Private fund managers should remain diligent
- Exams are risk-based (routine), sweep, or for cause
 - OCIE is increasingly relying on data analytics to select exam candidates
- Visiting never-before-examined advisers remains a priority
 - Chair White commented in 2013 that 40% of advisers had never been examined
- We have observed more truncated exam request lists recently



NOTABLE SEC RISK ALERTS

- Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 12, 2018)
 - Areas cited include: fee-billing based on incorrect account valuations; billing fees in advance or with improper frequency; applying incorrect fee rates; omitting rebates and applying discounts incorrectly; disclosure issues; and expense allocations

- Most Frequent Best Execution Issues Cited in Adviser Exams (July 11, 2018)
 - Areas cited include: not performing best execution reviews; not considering relevant factors during best execution reviews; not seeking comparisons from other brokers; disclosure issues; soft dollar issues; and weak policies and procedures



FINRA 2018 REGULATORY AND EXAMINATION PRIORITIES

- Fraud
- High-Risk Firms and Brokers
- Operational and Financial Risks
 - Business Continuity Planning
 - Technology Governance
 - Short Sales
- Sales Practice Risks
 - Initial Coin Offerings and Cryptocurrencies
 - Use of Margin
- Market Integrity
 - Options
 - Alternative Trading System (ATS) Surveillance
 - Compliance Report Cards
- New Rules
 - Financial Exploitation of Specified Adults – FINRA Rule 2165
 - Consolidated Registration Rules – FINRA Rules 1210-1240 (SIE, PFO, POO)





ENFORCEMENT PRIORITIES

SEC ENFORCEMENT PRIORITIES

- In last year's Enforcement Division Annual Report, Co-Directors Avakian and Peikin articulated five principles:
 - Focus on the Main Street investor
 - Focus on individual accountability
 - Keep pace with technological change
 - Manifested in the focus on ICOs
 - Impose sanctions that most effectively further enforcement goals
 - Constantly assess the allocation of our resources



SEC ENFORCEMENT CONDITIONS

- Budget constraints and a hiring freeze are affecting investigations
- The Whistleblower Office continues to provide significant awards
- Drawbacks to formal order delegation have changed investigations
 - Recipients of informal requests should not assume that the matter is not serious
- Commissioner Peirce opined that enforcement should be limited
- Nevertheless, actions against advisers remains active



ADVISER ENFORCEMENT OVERVIEW

- Share class selection
- Conflicts of interest (compensation and recommendations)
- Undisclosed fee acceleration provisions
- Trade allocation / cherry picking
- Allocation of investment opportunities
- Custody violations
- Valuation
- Advertising violations
- Insider trading
- Wrap fees / trading away
- Cybersecurity



SELECTED ENFORCEMENT ACTIONS (CONT.)

Capital Analysts, LLC,

Advisers Act Rel. No. 5009 (Sept. 14, 2018)

- The adviser settled claims that it invested clients in share classes that paid 12b-1 fees when lower-cost share classes were available without disclosing that an affiliated broker-dealer was receiving these 12b-1 fees. The adviser also purportedly failed to disclose that it had an agreement with a third-party clearing broker to share the shareholder service fee paid to the clearing broker when the adviser invested its clients into certain no-transaction fee mutual funds.
- Relief included remediation under which new clients were invested in the lowest share class, and existing clients were converted to the lowest share class. Disgorgement of \$936,000 was ordered for the 12b-1 violation. Disgorgement of \$691,000 was ordered for the clearing broker violation. A penalty of \$300,000 was ordered.



SELECTED ENFORCEMENT ACTIONS (CONT.)

Arlington Capital Management, Inc. et al.,
Advisers Act Rel. No. 4885 (Sept. 14, 2018)

- The adviser settled claims that it advertised performance results using back-tested hypotheticals of its computer model, including times where the model would be adjusted and the performance was reported as if the new version had previously been in effect.
- The SEC noted remediation of revising advertisement policies and procedures, hiring a new CCO, hiring a compliance consultant, and implementing the consultant's suggestions. The adviser and CCO were censured, the adviser incurred a \$125,000 penalty, and the CCO incurred a \$75,000 penalty.



SELECTED ENFORCEMENT ACTIONS (CONT.)

Lockwood Advisors Inc,
Advisers Act Rel. No. 4885 (Aug. 14, 2018)

- The adviser settled claims that it failed to adopt and implement policies and procedures in connection with its assessment, oversight, and disclosure of the costs incurred by third-party portfolio managers, who were part of a wrap program, when they directed trades to brokers who were not part of the program which resulted in additional costs to clients.
- The SEC considered remedial steps taken, and ordered a \$200,000 penalty.



DEMONSTRATION OF PRIORITIES IN FINRA ENFORCEMENT

- February 5, 2018 Wedbush Securities Inc. fined \$1.5 Million for Customer Protection, Net Capital Rule Violations and Related Failures
- March 28, 2018 Aegis Capital Corp. fined \$550,000 for Anti-Money Laundering and Supervision Rule Violations
- April 12, 2018 FINRA, BOX, Cboe, IEX, NASDAQ and NYSE fined Instinet, LLC \$1.75 million for Market Access Rule Violations
- May 8, 2018 Fifth Third Securities, Inc., fined \$6 Million for Cost and Fee Disclosure Failures and Unsuitable Recommendations Related to Variable Annuity Exchanges
- May 16, 2018 Industrial and Commercial Bank of China Financial Services LLC (ICBCFS) fined \$5.3 Million for AML Compliance Deficiencies and Other Violations
- August 20, 2018 Interactive Brokers LLC fined \$5.5 Million for Regulation SHO Violations and Supervisory Failures



DEMONSTRATION OF PRIORITIES IN FINRA ENFORCEMENT (CONT.)

September 11, 2018

First Disciplinary Action by FINRA Involving Cryptocurrencies

- FINRA charged Timothy Tilton Ayre of Agawam, Massachusetts, with securities fraud and the unlawful distribution of an unregistered cryptocurrency security called HempCoin.
- FINRA alleged that, from January 2013 through October 2016, Ayre attempted to lure public investment in a worthless public company, Rocky Mountain Ayre, Inc. (RMTN) by issuing and selling HempCoin – which he publicized as “the first minable coin backed by marketable securities” – and by making fraudulent, positive statements about RMTN’s business and finances.



CFTC: ENERGIZED ENFORCEMENT

- Rise of the Whistleblower Program
 - Active promotion of the program
 - Five awards in 2018 (only four from 2014 - 2017)
- Landmarks:
 - \$30 million award in July
 - \$70,000 award to foreign resident in July
 - \$45 million (three awards) in August
- Volume of tips and reports increasing
- Importance of global systems for compliance, internal reporting channels, and investigations



CFTC: AREAS OF FOCUS

- Focusing on Marketplace Misconduct
 - New Task Forces
 - Insider Trading
 - EOX Holdings / Gizienski: CFTC complaint alleges trader exercised discretionary authority over a friend's account while brokering block trades for other customers. Firm waived company policies without implementing controls.
 - Manipulation
 - Lansing: \$6.5 million penalties for sending "false or misleading signal to the market"
- Individual Liability: 70% of cases





CYBERSECURITY DEVELOPMENTS



SEC'S CYBER UNIT


- Formed in September 2017, the Unit's priorities are:
 - Market manipulation schemes involving false information spread through electronic and social media
 - Hacking to obtain material nonpublic information
 - Violations involving distributed ledger technology and ICOs
 - Misconduct perpetrated using the dark web
 - Intrusions into retail brokerage accounts
 - Cyber-related threats to trading platforms and other critical market infrastructure
- Cases to date have included ICO actions, an adviser's data breach, and a crypto-based broker-dealer violation (below)




DATA BREACH ACTIONS

- Altaba Inc., f/d/b/a Yahoo! Inc., Securities Act Rel. No. 10485 (Apr. 24, 2018)
 - Settled order for failure to disclose data breach to investors and an acquirer
 - Framed as a disclosure controls failure; \$35 million penalty
 - Preceded by SEC's Statement and Guidance on Public Company Cybersecurity Disclosures, Exchange Act Rel. No. 82756 (Feb. 21, 2018)
- Voya Financial Advisors, Inc., Advisers Act Rel. No. 5048 (Sept. 26, 2018)
 - Settled order finding failures to adopt policies and procedures reasonably designed to protect customer records and information (Regulation S-P), and to detect identity theft (Regulation S-ID)
 - Despite noting remediation, SEC imposed a \$1 million penalty





CRYPTOCURRENCY / BLOCKCHAIN DEVELOPMENTS



FRAUDULENT OFFERING

SEC v. BlockVest et al.,
18-cv-2287 (S.D. Cal. Oct. 11, 2018)

- Emergency action to halt planned ICO and ongoing pre-ICO sales
- Company is alleged to have falsely claimed that its ICO and its affiliates received regulatory approval from various agencies, including the SEC and the "Blockchain Exchange Commission"
- Case brought by the Cyber Unit
- Other ICO-related antifraud actions include AriseBank (Jan. 30, 2018), Centra Tech (Apr. 20, 2018), and Titanium Blockchain Infrastructure Services (May 29, 2018)



REGISTRATION FAILURES

- Crypto Asset Management, LP et al., Advisers Act Rel. No. 5004 (Sept. 11, 2018)
 - Settled order involving hedge fund manager that purportedly touted the “first regulated cryptoasset fund in the United States;” raised \$3.6 million from 44 investors
 - Found that manager failed to register as an investment company; \$200,000 penalty
- TokenLot, LLC et al., Exchange Act Rel. No. 84075 (Sept. 11, 2018)
 - Settled order against firm and its owners for allegedly touting a “superstore” through which investors could purchase digital tokens during ICOs and engage in secondary trading
 - SEC charged entity and its owners with failing to register as a broker-dealer
 - SEC ordered \$471,000 in disgorgement, each owner paid \$45,000 and agreed to a penny stock bar and an investment company prohibition



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