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2018 SAN FRANCISCO INVESTMENT MANAGEMENT CONFERENCE

SEC Examination and Enforcement Priorities

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OVERVIEW

- Direction of the Agency
- Examination Priorities
- Enforcement Priorities and Selected Actions
- Cybersecurity Developments
- Cryptocurrency / Blockchain Developments

DIRECTION OF THE AGENCY

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 tenants 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

EXAMINATION PRIORITIES

2018 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

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

RISK ALERTS

Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 12, 2018)

- Encourages advisers to review practices, policies and procedures to ensure compliance given frequently found deficiencies regarding:
  - 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
  - Expense allocations

RISK ALERTS (CONT.)

Most Frequent Best Execution Issues Cited in Adviser Exams
(July 11, 2018)

- Encourages advisers to review practices, policies and procedures to ensure compliance given frequently found deficiencies, including:
  - Not performing best execution reviews
  - Not considering relevant factors during best execution reviews
  - Not seeking comparisons from other brokers
  - Disclosure issues
  - Soft dollar issues
  - Weak policies and procedures

ENFORCEMENT PRIORITIES AND SELECTED ACTIONS

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

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

TPG Capital Advisors, LLC,
Advisers Act Rel. No. 4830 (Dec. 21, 2017)

- The adviser settled claims that it terminated certain monitoring agreements and accelerated the payment of future monitoring fees without disclosing to the fund and its limited partners that it may accelerate future monitoring fees upon termination. Notably, the adviser disclosed that it may receive monitoring fees and the amount that had been accelerated following the acceleration.
- Although the SEC noted cooperation, it ordered $9.5 million in disgorgement, and a $3 million penalty.

SELECTED ENFORCEMENT ACTIONS

Aisling Capital, LLC,
Advisers Act Rel. No. 4951 (June 29, 2018)

- A venture capital fund adviser settled claims that it failed to offset consulting fees against management fees paid by certain funds it advised, pursuant to percentages set forth in the funds' private offering memorandum and limited partnership agreement, resulting in over $750,000 in incorrect management fees.
- The SEC considered remedial acts, and ordered a $200,000 penalty.

SELECTED ENFORCEMENT ACTIONS (CONT.)

Potomac Asset Management Co. et al,
Advisers Act Rel. No. 4766 (Sept. 11, 2017)

- In this settled administrative proceeding, the SEC claimed that fees and expenses were improperly allocated to two private equity fund clients. The SEC also claimed that the adviser used fund assets to pay adviser-related expenses.
- The SEC cited substantial remedial efforts, and the Order imposed a censure and a $300,000 penalty.

SELECTED ENFORCEMENT ACTIONS (CONT.)

Platinum Equity Advisors, LLC,
Advisers Act Rel. No. 4772 (Sept. 21, 2017)

- The adviser settled claims that it allocated broken deal expenses among funds in excess of disclosures in private placement memoranda, including expenses that would have been allocated to co-investors.
- The Order imposed $1.9 million in disgorgement, and a $1.5 million penalty.

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.

CYBERSECURITY DEVELOPMENTS

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)

ISSUER DATA BREACH

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
- Members of issuer's senior management and legal department were informed of the breach, but purportedly failed to "properly assess the scope, business impact, or legal implications of the breach"
- 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)

ADVISER DATA BREACH

Voya Financial Advisors, Inc.,
Advisers Act Rel. No. 5048 (Sept. 26, 2018)

- Firm settled claims that it failed to adopt policies and procedures reasonably designed to protect customer records and information (Regulation S-P), and to detect identity theft (Regulation S-ID)
- Firm's purportedly reset web portal passwords in response to callers who impersonated contractors, despite the fact that some of the numbers had been previously flagged as potentially fraudulent
- Intruders gained access to customer information
- Firm purportedly did not update its Identity Theft Prevention Program in response to evolving threats
- 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)

INVESTMENT COMPANY REGISTRATION

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”
- Fund raised $3.6 million from 44 investors
- Order finds that manager failed to register as an investment company
- $200,000 penalty
- Case brought by the Asset Management Unit

BROKER-DEALER REGISTRATION

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
- Case brought by the Cyber Unit

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