K&L GATES

Examination, Enforcement and Litigation Trends: SEC, CFTC, NFA, FCA and New Market Abuse Regime

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SEC Examinations

EXAMINATION TRENDS: FROM OCIE'S MOUTH TO YOUR EARS

"We collect information on everyone. We analyze information on everyone. I think people assume, if they're not the 9%, the other 91% are out there doing things off the radar screen. But the SEC has gotten very proficient through hiring and staffing and resourcing of financial engineers…"

— Drew Bowden, Former Director, OCIE

Source: *Exams Not the Only Scrutiny, OCIE Official Warns*, Compliance Reporter, October 31, 2012

EXAMINATION TRENDS: OBSERVATIONS

- **45%** of respondents have undergone an SEC Exam
- **50%** of private equity managers that registered as a result of Dodd-Frank have had an SEC Exam
- **28%** of hedge fund managers that registered as a result of Dodd-Frank have had an SEC Exam

Source: *2015 Alternative Fund Manager Compliance Survey*, ACA Compliance Group, August 2015

CONFLICTS, CONFLICTS, CONFLICTS

- In her February 26, 2015 remarks to the 17th Annual Investment Advisers Compliance Conference, Julie Riewe stated that, in nearly every matter in the Asset Management Unit, the unit is exploring whether the adviser discharged its fiduciary obligation to identify conflicts and (1) either eliminate them or (2) mitigate them and disclose them to boards or investors
- She said, “Over and over again we see advisers failing to properly identify and then address their conflicts”

2016 EXAMINATION PRIORITIES: PRIVATE FUND ADVISERS

- Conflicts:
  - Fees and expenses
  - Valuation
  - Trade allocation
  - Use of affiliates
- Side-by-side management of accounts with performance fees vs. accounts without performance fees
- Compliance and controls
- Never before examined advisers
- Private placements – Rule 506(c)
- Excessive trading
- Product promotion/performance advertising
- Recidivist representatives and their employers
- Cybersecurity

PRIVATE FUNDS UNIT

- Role of Private Funds Unit within OCIE
- Relationship with Asset Management Unit within the Division of Enforcement
- 2016 OCIE exams of private fund managers:
  - Hot button issues
  - Sweep exams
  - Conflicts
  - Recidivist practices

PRIVATE FUNDS UNIT *(continued)*

- Tips for making an examination run efficiently
- Examination don’ts
- How has examination program changed as a result of:
  - Data analytics for illegal activity detection
  - Whistleblower program

Overview of Key 2015 – 2016 Investment Adviser Enforcement Cases

CHAIR WHITE ON ENFORCEMENT

"Vigorous and comprehensive enforcement protects investors and reassures them that our financial markets operate with integrity and transparency, and the Commission continues that enforcement approach by bringing innovative cases holding executives and companies accountable for their wrongdoing, sending clear warnings to would-be violators"

Source: *SEC Announces Enforcement Results for FY 2015*, SEC Press Release, 2015-245 (October 22, 2015)

RECEIPT OF UNAUTHORIZED OR INADEQUATELY DISCLOSED FEES

- *In re Blackstone Management Partners LLC et al.*, Investment Advisers Act of 1940 ("IAA") Rel. No. 4219 (Oct. 7, 2015):
  - $39 million in disgorgement and civil money penalties settlement by investment adviser to private equity funds because (1) there was inadequate disclosure of "accelerated monitoring fees" and (2) the adviser negotiated fees for legal services for which the adviser received a greater discount than did the funds
    - Key Takeaway: Full transparency of fees and conflicts of interest is critical

FAILURE TO DISCLOSE CONFLICTS OF INTEREST

- *In re BlackRock Advisors LLC and Bartholomew Battista*, IAA Rel. No. 4065 (Apr. 20, 2015):
  - In the first SEC case to charge a violation of Rule 38a-1 under the Investment Company Act (requiring the disclosure of "each material compliance matter" to the board), the Commission charged that an adviser to registered funds, private funds, and separately managed accounts should have disclosed to the registered fund's board that one of the adviser's portfolio managers had founded a company that formed a joint venture with a publicly owned company in which the fund had a significant interest. The Commission also charged the chief compliance officer with causing certain violations, which led to a dissent by Commissioner Daniel M. Gallagher. The adviser paid $12 million to settle the matter
    - Key Takeaway: Conflicts of interest created by outside business activities must either be eliminated or be disclosed to the board and advisory clients

FAILURE TO DISCLOSE CONFLICTS OF INTEREST *(continued)*

- *In re Guggenheim Partners Investment Management LLC*, IAA Rel. No. 4163 (Aug. 10, 2015):
  - In an action alleging that an adviser to institutional clients, high-net-worth clients, and private funds failed to disclose a $50 million loan that a senior executive of the adviser had received from an advisory client, the adviser settled by paying a $20 million penalty. The Commission alleged that the adviser did not disclose the loan to the compliance department or clients
    - Key Takeaway: Advisers must be vigilant in disclosing conflicts

FAILURE TO DISCLOSE CONFLICTS OF INTEREST *(continued)*

- In the Matter of JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC, IAA Rel. 4295 (Dec. 18, 2015):
  - Broker-dealer and bank preferred to invest client assets in the firm's proprietary investment products without disclosing the preference
  - This included more expensive share classes of proprietary mutual funds and third-party hedge funds where the manager made payments to a J.P. Morgan affiliate
  - $127.5 million in disgorgement, $11.815 million in prejudgment interest and $127.5 million penalty
    - Key Takeaways: Review Form ADV disclosures of conflicts carefully, especially with respect to referrals to proprietary products

INADEQUATE PROCEDURES TO PROTECT AGAINST INSIDER TRADING

- *In re Steven A. Cohen*, Investment Advisers Act Rel. 4307 (Jan. 8, 2016):
- The Commission charged that the CEO of SAC Capital failed to reasonably supervise a portfolio manager who liquidated a substantial position based on his receipt of material nonpublic negative information about the results of clinical drug trials. The Commission charged that Cohen failed to follow up on red flags suggesting that the portfolio manager might have received material nonpublic information
- SAC Capital and certain related entities were previously fined $900 million and required to forfeit an additional $284 million
- The Commission suspended Cohen from acting in a supervisory capacity for two years

INADEQUATE PROCEDURES TO PROTECT AGAINST INSIDER TRADING *(CONTINUED)*

- *In Re Federated Global Investment Management Corp.*, IAA Rel. 4401 (May 27, 2016):
- The Commission charged that Federated failed to have adequate procedures to prevent the misuse of material nonpublic information because its procedures did not apply to an outside consultant who served on a number of boards of public companies in which Federated's funds invested
- The Commission did not allege the consultant misused material nonpublic information
- The Commission fined Federated $1.5 million
  - Key Takeaway: The Commission continues to be highly focused on supervision of persons who may come into possession of material nonpublic information

VIOLATION OF BROKER-DEALER REGISTRATION REQUIREMENTS

- *In re Blackstreet Capital Management, LLC et al.*, Securities Exchange Act Rel. 77959 (June 1, 2016):
- The Commission charged that a private equity fund advisory firm should have registered as a broker-dealer because it charged transaction-based fees and was engaged in the purchase or sale of securities, soliciting transactions, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing transactions. It also found that it engaged in a number of other violations
- Respondents were ordered to pay $3.1 million in disgorgement, penalties and interest
  - Key Takeaway: This is one of several SEC cases over the past few years charging private equity firms with violating broker-dealer registration requirements. The law in this area is unsettled, but transaction-based compensation poses a clear risk

SEC Cases Against Chief Compliance Officers (“CCOs”)

CCO CASES

- IAA Rule 206(4)-7 requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Act and to appoint a chief compliance officer responsible for "administering" the policies and procedures
- *In re BlackRock Advisors, LLC*, IAA Rel. No. 4065 (Apr. 20, 2015):
  - Charged CCO with causing compliance-related violations related to outside business activities because he allegedly "knew or should have known" that the violations were not reported to the funds' boards in violation of Rule 38a-1(a)(4)(iii)(B)
  - The order states that, as CCO, he was "responsible for the design and implementation of [the firm's] written policies and procedures," and "did not recommend written policies and procedures to assess and monitor [certain] outside activities and to disclose conflicts of interest to the funds' boards and to advisory clients"
  - The CCO was fined $60,000 and ordered to cease and desist from violating IAA 206(4), Rule 206(4)-7, and Investment Company Act Rule 38a-1

CCO CASES *(continued)*

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CCO CASES *(continued)*

- *In re SFX Financial Advisory Management Enterprises, Inc.*, IAA Rel. No. 4116 (June 15, 2015):
  - In a case involving misappropriation of client assets, the Commission charged that the CCO failed to "effectively implement" a compliance policy requirement to review "cash flows in client accounts" and thereby "caused" the firm's violation of IAA Sections 206(4) and 206(4)-7
  - The compliance officer paid a fine of $25,000 and was ordered to cease and desist from violations of IAA Sections 206(4) and 207 and Rule 206(4)-7
- On June 18, 2015, Commissioner Gallagher issued a statement on why he dissented from those two decisions. He stated that CCOs are responsible for "administering" compliance policies and procedures but that responsibility for "implementation" rests with the adviser itself
- On June 29, 2015, Commissioner Luis A. Aguilar responded, stating that CCOs who do their jobs "competently, diligently, and in good faith" should not fear the SEC. He stated that between 2009 and 2014, the number of IAA cases brought against CCOs ranged from 6%-19%

CCO CASES *(continued)*

- On October 24, 2015, Andrew ("Buddy") Donohue, Chair Mary Jo White's Chief of Staff, addressed the liability of chief compliance officers:
  - He repeated that the Commission is not "targeting" CCOs
  - He quoted earlier statements by Chair White that compliance officers who perform their responsibilities "diligently" need not fear enforcement action
  - He stated that SEC actions against compliance officers tend to involve compliance officers who:
    - Affirmatively participated in the underlying misconduct,
    - Helped mislead regulators, or
    - Had clear responsibility to implement compliance programs and "wholly failed to carry out that responsibility"
- Given the degree to which hindsight informs enforcement actions, the fact that the SEC says it is not "targeting" CCOs or charging CCOs who performed their responsibilities "diligently" may provide cold comfort
- Issues with outsourced CCOs

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Lessons Learned

LESSONS LEARNED

- How do these enforcement cases affect fund formation and documentation?
  - Creation and updating of fund documents:
    - Conflicts resolution
    - Fee allocations and expenses
    - Disclosure requirements
  - Role of and use of advisory committees and independent client representatives to resolve conflicts
  - Fund governance (outside directors)
  - Obtaining investor consent

LESSONS LEARNED *(continued)*

- How do these enforcement cases affect …
  - Construction and review of compliance policies and procedures
  - Annual reviews
  - Data security and privacy

NFA Examinations

NFA EXAMINATIONS

- Examinations are risk-based
  - Customer complaints
  - Business background of principals
  - Promotional materials, disclosure documents, financial statements and other regulatory filings
  - Referrals from other regulators/members
  - Time since last exam
- Now NFA has staff in London!

NFA EXAMINATIONS: HOT BUTTONS

- Governance/separation of duties
- Administrators/custodians – selections, due diligence, ongoing monitoring, conflicts
- Counterparty and concentration risk
- Liquidity policies – portfolio repositioning, stress testings and sources of liquidity
- Performance reporting and disclosure/sales practices
- Handling of pool assets
- Financial reporting and valuation
- Principals, APs and branch offices
- Bylaw 1101

CFTC

INSIDER TRADING

- Arya Motazedi – December 2, 2015
- First insider trading prosecution under CFTC Regulation 180.1 – anti-manipulation authority granted under Dodd-Frank
- Energy trader placed orders for his own accounts ahead of his employer's orders
- Fined $100,000, banned from trading, $216,956 in reimbursement

Market Abuse

MARKET ABUSE REGULATION ("MAR")

- Implementation date across the EU was 3 July 2016
- Most EU countries (except the UK and Denmark) also implemented the Directive on criminal sanctions for Market Abuse ("CSMAD")
- Part of the rationale for MAR is to facilitate regulator enforcement of market abuse breaches
- Notably harsher sanctions regime

HOW WILL FCA ENFORCEMENT BENEFIT FROM MAR?

- New market soundings regime
  - Compliant “market sounding” not within “unlawful disclosure of inside information” offence
  - Comprehensive record keeping and retention (for at least 5 years) required on the part of disclosing market participants (“DMPs”) and market sounding recipients (“MSRs”)
  - DMP and MSR to reach independent views on whether information is inside information and to document their assessments

HOW WILL FCA ENFORCEMENT BENEFIT FROM MAR? *(continued)*

- New market soundings regime (cont.)
  - MSRs to keep a list of persons working for them who are in possession of information from market soundings (i.e., a form of insider list)
  - MSRs who consider they have inside information to identify all issuers and financial instruments to which that information relates
  - Where market soundings are conducted by telephone and the DMP has access to recorded telephone lines, these must be used

HOW WILL FCA ENFORCEMENT BENEFIT FROM MAR? *(continued)*

- New market soundings regime (cont.)
  - DMP must keep a record of persons who receive the market sounding
  - DMP to keep records even when it considers inside information is not being imparted
  - Equipment not provided by the DMP not to be used for market soundings
  - DMP required to notify MSR when information ceases to be inside information

HOW WILL FCA ENFORCEMENT BENEFIT FROM MAR? *(continued)*

- New detection obligation
  - Applicable to venue operators who also have a prevention obligation
  - Importantly, applicable to the buy-side ("persons professionally arranging or executing transactions" is understood per ESMA Q&A to extend this far, as well as to proprietary trading firms)

HOW WILL FCA ENFORCEMENT BENEFIT FROM MAR? *(continued)*

- New detection obligation (cont.)
  - Uncertain exactly how far buy-side firms need to go in detecting as “appropriate and proportionate” systems are required with an “appropriate” level of human analysis
  - IT vendors are offering products
  - Some reasonable level of STORs (suspicious transaction and order reports) will be expected by regulators

MAR – A HARSHER SANCTIONS REGIME?

- Criminal sanctions under CSMAD everywhere except UK and Denmark
- CSMAD requires that serious cases of market abuse be treated as criminal offences
  - Under CSMAD, 4 year minimum for maximum jail term for insider dealing or market manipulation

MAR – A HARSHER SANCTIONS REGIME? *(continued)*

- Under MAR, minimum administrative sanctions regime (to foster a more unified EU approach)
  - Maximum administrative pecuniary sanctions of at least three times the amount of the profits gained or lost through the infringement
  - Maximum fine of > €5 million for natural persons for insider dealing/market manipulation
  - Maximum fine of > €15 million for legal persons or 15% of annual turnover for insider dealing/market manipulation
  - Infringement of detection obligations must carry fine of at least €1 million

MAR – A HARSHER SANCTION REGIME?
(continued)

- But, MAR administrative sanctions regime does not need to be followed if Member State applies criminal sanctions to the relevant breaches
- In his 2014 Mansion House speech, George Osborne said that the UK will be introducing new domestic criminal offences for market abuse in place of “EU rules we do not think suitable or sufficient for our needs”

MAR – A HARSHER SANCTION REGIME?
(continued)

- When the UK Government rejected CSMAD they said “we need to address the flexibility of when to apply a criminal penalty and when an administrative penalty needs to be retained…that must be determined on a case-by-case basis”

FCA

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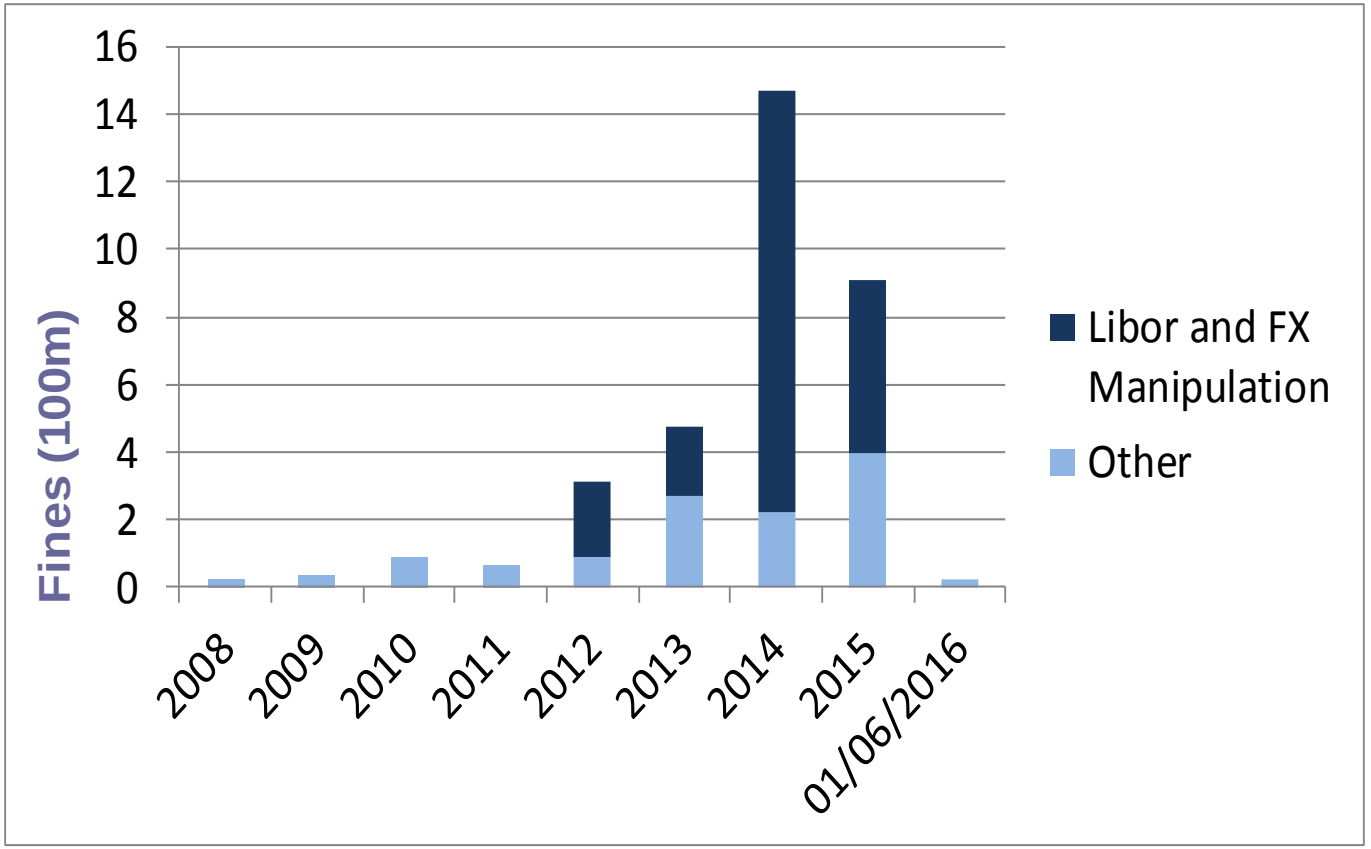
PREDICTIONS FROM 2014/15

- LIBOR/FX
- Individuals/Senior Management
- Higher Fines
- Conflicts of Interest
- Market abuse systems and control
- Friends with United States

LIBOR/FX

- No more fines for financial institutions relating to LIBOR/FX
- Regulators changing tack on LIBOR – “reckless” rather than “dishonest” behaviour
- Lack of enforcement in FX
- End of criminal investigation into FX

LIBOR/FX *(continued)*



INDIVIDUALS/SENIOR MANAGEMENT

- Bruno Iksil
  - FCA's Regulatory Decisions Committee ("RDC") dismissed allegations of misconduct arising from the "London Whale" trading in 2012
- Achilles Macris
  - FCA issued a Final Notice and imposed a fine of £792,000 in relation to failure to disclose information arising from the "London Whale" trading in 2012
  - Principle 4 – dealing with the regulators in an open and cooperative way

INDIVIDUALS/SENIOR MANAGEMENT *(continued)*

- Peter Johnson
  - Former compliance officer of an investment management firm
  - FCA published the Final Notice in May 2016, publicly censured Mr Johnson and prohibited him for performing any function in relation to regulated activities

INDIVIDUALS/SENIOR MANAGEMENT *(continued)*

- Senior Managers and Certification Regime
  - Currently applies to:
    - Banks and PRA-regulated investment firms
    - Building societies
    - Credit unions
  - From 2018 the regime will also apply to:
    - Insurers
    - Investment firms (including stockbrokers, asset managers, financial advisers)

MARKET ABUSE

- Operation Tabernula
  - FCA prosecuted 5 individuals – 2 convicted and 3 acquitted
  - Investment banker sentenced to 4.5 years in prison – the longest sentence ever handed down for insider dealing
- 3 other individuals have been charged with insider dealing offences but no trial date has been set

FRIENDS WITH UNITED STATES

- Narvinder Sarao – “flash crash trader”
- Connelly and Black – former LIBOR traders
- Sweett Group PLC prosecution under section 7 of the Bribery Act 2010
- Standard Bank’s Deferred Prosecution Agreement

FCA BUSINESS PLAN 2016/17

- Financial Crime
  - Financial Crime Annual Data Return – Anti-Money Laundering
  - Whistleblowing
- Supervising the major UK FICC benchmarks
- Extending the Senior Managers and Certification Regime to asset managers, hedge funds and broker-deals

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