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SEC's Recent Actions Against Two Investment Advisers Raise Important Lessons for All Investment Advisers

By Kelley A. Howes

Recently announced cases against two registered investment advisers and certain of their executives serve as timely reminders of where the SEC is focusing its attention. Although the SEC's actions are based on alleged intentional violations or disregard of certain regulations, they include important lessons for law-abiding registered investment advisers. Advisers should be aware of the SEC's focus areas and ensure that the annual review of their compliance program addresses policies related to, among other things:

- their trading policies and, specifically, whether they are conducting any undisclosed principal trading;
- whether they have custody of client assets and, if so, the need to comply with the custody rule;
- whether their compliance policies and program adequately and specifically address their business structures.

BACKGROUND

The SEC charged two investment advisers and certain of their executives with engaging in thousands of principal transactions through an affiliated brokerage firm without informing their clients. One of the firms and its chief compliance officer (CCO) were also charged with violations of the custody rule.

Executives at the two advisory firms collectively owned a brokerage firm through which the advisers initiated and executed principal trades without making the required disclosures to their clients or obtaining the clients' prior consent. The executives were paid a total of more than $2 million in connection with the offending trades.

CHARGES RELATED TO PRINCIPAL TRANSACTIONS

Principal transactions create conflicts of interest between investment advisers and their clients. Advisers are required to disclose the conflict and their financial interests to their clients in writing and clients must consent to the transactions, in writing, before the trades are executed. The SEC alleged that the affiliated broker purchased mortgage-backed bonds into its inventory account and then transferred the bonds to the advisers' client accounts. The broker charged the advisers' clients a sales credit for the trades, a portion of which was paid in turn to the principals, according to the SEC's complaint. From the beginning of 2009 until late 2011, the SEC said, the two investment advisers engaged in more than 4,000 undisclosed principal trades and the executives were collectively paid more than $2 million from related sales credits.

CHARGES RELATED TO THE CUSTODY RULE

The SEC also charged one of the investment advisers with violation of Rule 206(4)-2 under the Investment Advisers Act (the “custody rule”) in connection with a private fund to which it provides advisory services. During the relevant period, the custody rule required an investment adviser to a private fund to obtain an annual surprise examination or to distribute audited annual financial statements to its investors. The SEC claims that the adviser elected to distribute audited financial statements to the investors in the private fund, but it failed to:

- distribute audited financial statements by the deadline set forth in the custody rule;
- engage a PCAOB-registered auditor to conduct the audit of the private fund; and
- comply with GAAP requirements for disclosures about securities held at fair value.

The SEC also alleges that the owner of the investment adviser and its CCO were aware of the requirements of the custody rule and knew at the time that the audit and distribution of the financial statements were not consistent with the rule. According to the SEC, however, the two executives did not remedy the issues until after an SEC examination that revealed the deficiencies.

CHARGES RELATED TO THE COMPLIANCE PROGRAM AND CODE OF ETHICS.

The investment adviser was also charged with failing to adopt and implement written compliance procedures and a written code of ethics as required by Rule 206(4)-7 and Rule 204A-1, respectively, under the Investment Advisers Act. The SEC said that the adviser relied on an “off-the-shelf” compliance manual without tailoring the manual to its own business. Moreover, although the CCO identified the need to update the manual, he took no meaningful action to do so.

The SEC also alleges that the CCO told SEC examination staff that he performed an annual review of the adviser’s compliance program, as required by Rule 206(4)-7, in February 2011. In reality, the SEC says, metadata for the annual compliance review memorandum indicates that it was created after the staff notified the adviser of an impending in-person examination and just three days before the examination staff was scheduled to begin its field work.

The SEC also notes that the CCO, who previously worked as a broker-dealer and investment adviser examiner in the State of California and with FINRA, is the owner of a separate compliance consulting firm. The SEC claims that the CCO did not maintain a permanent office at the adviser and dedicated an average of only nine hours a month to his work for the adviser.

These two actions have not been settled and will be heard in front of an SEC Administrative Law Judge.

A TIMELY REMINDER

The SEC has been clear that it is focused on investment advisers’ compliance with their regulatory obligations, particularly in areas such as:

- conflicts of interest;
- principal transactions;

- the custody rule; and
- the need to adopt and maintain compliance programs designed to prevent violations of the federal securities laws.

These two actions are particularly timely examples of the SEC staff putting its money where its mouth is. As we approach the end of the year, many registered investment advisers will start to plan for the annual review of their compliance programs required under Rule 206(4)-7. Advisers should consider consulting experienced counsel to ensure that such programs are appropriately drafted and maintained in light of their particular business and the SEC's focus areas.

Such consultations could be money well spent. As these cases demonstrate, the alternative could be responding to an enforcement matter, and that is not a good use of time or money for any advisory business.

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