

The logo for K&L GATES is displayed in white, bold, sans-serif capital letters on a dark blue rectangular background. The background of the entire slide features a complex financial data visualization with a world map, various line and bar charts, and numerical data points in shades of blue and white.

K&L GATES

2019 SEATTLE INVESTMENT MANAGEMENT CONFERENCE

SEC Examination and Enforcement Priorities

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OVERVIEW

- SEC State of Play
- Examination Priorities
- Enforcement Priorities and Selected Actions





SEC STATE OF PLAY



DIRECTION OF THE AGENCY (CONT.)

- SEC is vigorously policing fraud
 - Chairman Clayton announced in April 2019 nearly \$800 million was returned to harmed investors over past year
- Chairman Clayton expects recent victory in *Lorenzo v. SEC* to have “significant impact” on SEC’s ability to enforce securities laws by targeting disseminators of misstatements



ENFORCEMENT

- Enforcement Division is not pursuing cases against advisers as aggressively as broken windows approach, but still active
 - Focus on advisers' conflicts of interest (e.g., revenue sharing agreements, undisclosed commissions, expense avoidance practices)
 - Focus also on suitability of complex investment recommendations
- General focus on widespread problem of affinity fraud (e.g., offering frauds, Ponzi schemes, market manipulation schemes)





EXAMINATION PRIORITIES



2019 EXAMINATION PRIORITIES

- OCIE's annual priorities statement articulates six themes:
 - Main Street Investors (including seniors and those saving for retirement)
 - Exam focus areas include: fees and expenses (including disclosure of investing costs), conflicts of interest, senior investors and retirement accounts/products, and portfolio management processes
 - Registrants Responsible for Critical Market Infrastructure (clearing agencies)
 - FINRA and the MSRB
 - Digital Assets (crypto, coins, and tokens)
 - Cybersecurity
 - Anti-Money Laundering Programs



EXAMINATION PRIORITIES AND FACTS

- 3,150 examinations were completed in FY18 (10% increase from FY17)
- 17% of registered advisers were examined in FY18 (compared to 15% in FY17, and only 8% about five years ago)
- In 2018, number of registered advisers grew by 5%, assets increased to \$84 trillion, 35% of registered advisers managed private funds, and more than 50% of registered advisers retained custody of client assets
- OCIE's Private Funds Unit remains active



EXAMINATION PRIORITIES AND FACTS

- Exams are risk-based (routine), sweep, or for cause
 - OCIE is increasingly leveraging data analytics and technology to select exam candidates
- Use of correspondence exams is increasing
 - More newly registered advisers are being examined
 - Correspondence exams can evolve into onsite exams
- Examiners are spending less time onsite during exams (however, supplemental requests and other correspondence by examiners are increasing)
- Importance of and need to be transparent, and organized, with examiners



EXAMINATION PRIORITIES AND FACTS

- OCIE's deficiency letter review project has identified the 'Top 10' list of adviser deficiencies:
 - Custody
 - Compliance program rule
 - Regulatory filings
 - Code of Ethics
 - Books and records
 - Best execution
 - Cash solicitation rule
 - Advisory fees and expenses
 - Advertising
 - Conflicts of interest



EXAMINATION PRIORITIES AND FACTS

- Percentage of investment advisers, investment companies and broker-dealers examined during the year

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018 Plan	FY 2018 Actual
Investment advisers	9%	10%	10%	11%	15%	15%	17%
Investment companies	11%	10%	15%	17%	11%	11%	15%
Broker-dealers	46%	49%	51%	50%	48%	48%	48%

Source: U.S. SEC FY 2018 Annual Performance Report



EXAMINATION PRIORITIES AND FACTS

- Percentage of exams that identify deficiencies, the percentage that result in a “significant finding” and the percentage referred to the Division of Enforcement

Fiscal Year	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018 Actual
Percentage that identify deficiencies	80%	76%	77%	72%	72%	69%
Percentage that result in a “significant finding”	35%	30%	31%	27%	20%	20%
Percentage referred to the Division of Enforcement	13%	12%	11%	9%	7%	6%

Source: U.S. SEC FY 2018 Annual Performance Report



NATIONAL EXAM PROGRAM: RISK ALERTS

- Investment Adviser Compliance Issues Related to the Cash Solicitation Rule (Oct. 31, 2018)
- Observations from Investment Adviser Examinations Relating to Electronic Messaging (Dec. 14, 2018)
- Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies (Apr. 16, 2019)
- Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features (May 23, 2019)
- Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019)
- Investment Adviser Principal and Agency Cross Trading Compliance Issues (Sept. 4, 2019)



RISK ALERT (1 OF 6)

Investment Adviser Compliance Issues Related to the Cash Solicitation Rule (Oct. 31, 2018)

- Encourages advisers to review the adequacy and effectiveness of their solicitation agreements and client acknowledgements
- Frequently found deficiencies include:
 - Inadequate disclosures and missing terms in solicitor disclosure documents (e.g., nature of relationship to the adviser, compensation arrangements, and additional costs to the client)
 - Advisers failing to timely receive client acknowledgements
 - Payments of cash fees to solicitors without any solicitation agreements (or agreements lacking required provisions)
 - No bona fide efforts by advisers to ascertain solicitor compliance



RISK ALERT (2 OF 6)

Observations from Investment Adviser Examinations Relating to Electronic Messaging (Dec. 14, 2018)

- Focuses on advisers' compliance with the Books and Records Rule for electronic communications, such as use of personal devices, social media and texting/IM
- Practices that can assist advisers in meeting their record and retention obligations include:
 - Permitting or prohibiting certain forms of electronic communication
 - Monitoring social media, emails and websites that employees use for business purposes, and retain/archive such communications
 - Load security apps or other software on employee devices



RISK ALERT (3 OF 6)

Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies (Apr. 16, 2019)

- Encourages advisers to review their policies and procedures, and their implementation, to ensure the security and confidentiality of client records
- Frequently found deficiencies include:
 - Not properly configuring personal devices to safeguard personally identifiable information (PII) stored on those devices
 - Not requiring outside vendors to keep clients' PII confidential
 - Inadequately training employees on handling client information
 - Disseminating client login credentials to unauthorized personnel
 - Failing to remove former employee access rights after their departures



RISK ALERT (4 OF 6)

Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features (May 23, 2019)

- Focuses on risks with electronic storage of client records in the cloud and on other network storage solutions, such as:
 - Misconfigured security settings on network storage solutions
 - Inadequate oversight of vendor-provided network storage solutions
 - Insufficient data classification in advisers' policies and procedures
- Encourages firms to actively oversee vendors used for network or cloud storage
 - Non-industry specific example: Capital One data breach of 106 million card customers and applicants on Amazon's cloud (July 30, 2019)



RISK ALERT (5 OF 6)

Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019)

- In effort to protect retail investors, SEC conducted Supervision Initiative that focused on advisers':
 - Policies and procedures addressing activities by employees with disciplinary histories
 - Disclosures, including those relating to previously-disciplined employees
 - Conflicts of interests, particularly those regarding compensation arrangements and account management
- Nearly all examined advisers received deficiency letters, and frequently found deficiencies include:
 - No policies and procedures addressing risks associated with hiring/employing individuals with disciplinary histories; overreliance on such persons to self-report their histories
 - Undisclosed compensation arrangements, and other fees charged for services not delivered
 - Insufficient annual compliance program reviews (e.g., documentation, risk assessments)



RISK ALERT (6 OF 6)

Investment Adviser Principal and Agency Cross Trading Compliance Issues (Sept. 4, 2019)

- Encourages advisers to review their policies and procedures, and their implementation, regarding principal trades and agency cross transactions
- Frequently found deficiencies and weaknesses include advisers:
 - Not recognizing trades as being principal trades, not making sufficient disclosures to clients about conflicts of interest and transaction terms, not obtaining the required consents, or obtaining client consent after completing principal trades
 - Failing to obtain appropriate prior client consent for each principal trade
 - For affiliated private funds, not recognizing that >25% ownership interests lead to principal trades (and not obtaining effective consent from private funds before completing principal trades)
 - Engaging in agency cross transactions while affirmatively stating to clients they would not, and not being able to produce documentation in compliance with written consent, confirmation and disclosure requirements of Rule 206(3)-2





ENFORCEMENT PRIORITIES AND SELECTED ACTIONS



ENFORCEMENT PRIORITIES

- Continued focus on the Enforcement Division's five previously articulated principles:
 - Focus on the Main Street investor
 - Retail-focused investigations returned \$794 million to harmed investors
 - Retail Strategy Task Force
 - Share Class Selection Disclosure (SCSD) Initiative announced in FY18
 - Focus on individual accountability
 - In FY18, individuals charged in more than 70% of stand alone enforcement actions
 - Keep pace with technological change
 - Digital assets and ICO misconduct
 - Impose remedies that most effectively further enforcement goals
 - Constantly assess the allocation of resources
 - Shift toward emerging risks, such as cyber threats, ICOs and SCSD



ENFORCEMENT PRIORITIES AND FACTS

- Leadership changes: in 2019, several experienced Enforcement Division lawyers advanced to senior leadership roles
- Hiring has resumed since freeze lifted, but not yet at prior staffing levels
- Chairman Clayton announced in July 2019 that practice on settlement offers with waiver requests is changing (returning to historical practice prior to change during last administration)
- Significant awards to whistleblowers continue



ENFORCEMENT PRIORITIES AND FACTS

- Co-Director Stephanie Avakian stated in March 2019 “priorities have not shifted much”
- Focused attention on violations that have potential for damage even when there is not a fraud charge
- Adviser themes and 2019 pipeline:
 - Misappropriation
 - Cherry-picking (with increased data-driven initiatives)
 - Undisclosed compensation
 - Mark-ups on products
 - “Double-dipping”
 - High-risk compliance issues, including custody and cross transactions
 - Misrepresentations of services provided and historical performance



ENFORCEMENT PRIORITIES AND FACTS

- Recent remarks by senior leadership reflect views toward Enforcement
 - Commissioner Jackson noted insider trading law has not been reviewed in-depth in a long time; time to think through existing regulations
 - Commissioner Peirce highlighted downsides when staff-level guidance is not made public; transparency is essential to maintaining trust
 - Charu Chandrasekhar (head, Retail Strategy Task Force) stated his group very focused on affinity fraud
 - Kurt Gottschall (regional director, Denver Regional Office) reiterated focus on conflicts of interest
 - Focus areas include revenue sharing agreements with clearing firms, undisclosed commissions, and expense avoidance practices
- Actions against advisers remain active!



Breakdown of Classification of Stand Alone Enforcement Actions

	FY 2018		FY 2017	
	Actions	Pct	Actions	Pct
Securities Offering	121	25%	94	21%
Investment Advisers / Inv. Company	108	22%	82	18%
Issuer Reporting & Disclosure	79	16%	95	21%
Broker Dealer	63	13%	53	12%
Insider Trading	51	10%	41	9%
Market Manipulation	32	7%	41	9%
Public Finance Abuse	15	3%	17	4%
FCPA	13	3%	13	3%
Miscellaneous	3	1%	7	2%
NRSRO	2	0%	0	0%
Transfer Agent	2	0%	3	1%
SRO or Exchange	1	0%	0	0%
Total	490	100%	446	100%

Source: U.S. SEC FY 2018 Division of Enforcement Annual Report, Appendix



ADVISER ENFORCEMENT OVERVIEW

- Expense Allocations
- Agency/Principal Transactions
- Custody
- Conflicts of Interest
- Advertising
- Robo-Advisers
- Disclosures
- Cryptocurrency & Digital Assets
- Best Execution



SELECTED ENFORCEMENT ACTIONS: EXPENSE ALLOCATIONS

- **Corinthian Capital (May 6, 2019)** *Administrative Proceeding File No. 3-19159*
 - The PE adviser settled claims that it failed to apply a \$1.2 million fee offset to its fund, used fund assets to fund advisory operations, and caused the fund to overpay \$600,000 in organizational expenses.
 - The SEC ordered the adviser and its principals to collectively pay \$140,000 in penalty.
- **Lightyear Capital (Dec. 26, 2018)** *Administrative Proceeding File No. 3-18958*
 - The PE adviser settled claims that it failed to properly allocate expenses to employee co-investment funds, and to properly offset management fees in connection with undisclosed fee-sharing agreements with certain co-investors.
 - The SEC noted cooperation, and it ordered the adviser to pay \$400,000 in penalty.
- **Yucaipa (Dec. 13, 2018)** *Administrative Proceeding File No. 3-18930*
 - The PE adviser settled claims that it allocated unpermitted personnel expenses to its funds, failed to appropriately allocate expenses among clients, and misallocated expenses to clients that should have been borne by the adviser or a principal.
 - The SEC noted cooperation and remedial efforts, and it ordered the adviser to pay nearly \$2 million in disgorgement and \$1 million in penalty.



SELECTED ENFORCEMENT ACTIONS: CUSTODY

■ Hudson Housing Capital (Sept. 25, 2018)

Administrative Proceeding File No. 3-18837

- The private fund adviser, which registered with the SEC in 2012, settled claims that it failed to distribute annual audited financial statements to investors in numerous private investment funds in each fiscal year from 2012 through 2017.
- For 32 funds, the adviser failed to timely distribute the financials at least three times, and, for 6 funds, it never distributed them. (During the time period, the adviser managed between 68 and 79 funds.)
- The SEC noted cooperation and remedial efforts, and it ordered the adviser to pay \$65,000 in penalty.



SELECTED ENFORCEMENT ACTIONS: CONFLICTS OF INTEREST

■ **Commonwealth Equity Services (Aug. 1, 2019)**

Civil Action No. 1:19-cv-11655

- The SEC recently charged the Massachusetts-based registered investment adviser and broker-dealer with failing to disclose material conflicts of interest related to revenue sharing that it received for client investments.
- The complaint alleges that Commonwealth received over \$100 million from National Financial Services, an affiliate of Fidelity Investments, related to investments in certain share classes of "no transaction fee" and "transaction fee" mutual funds.
- The SEC seeks a permanent injunction, disgorgement plus interest, a penalty, and any other relief the court deems proper.



SELECTED ENFORCEMENT ACTIONS: DISCLOSURES

- **The Robare Group (April 30, 2019)** *Civil Action No. 16-1453*
 - The D.C. Court of Appeals upheld a SEC decision that the word *may* in a conflicts of interest disclosure related to revenue sharing is not sufficient when the firm is in fact receiving such compensation.
 - The adviser from 2002 to 2013 received nearly \$400,000 from Fidelity, which performed execution, custody, and clearing services. In its Form ADV, the adviser stated it *may* receive selling compensation as a result of the facilitation of certain securities transactions on behalf of clients. The disclosure did not describe the revenue sharing agreement in effect with Fidelity, through which the adviser received payments of shareholder servicing fees when clients invested in certain funds.
 - The Court found the adviser's conduct to be negligent, but not "willful." This runs in conflict with the SEC's historical position on what constitutes "willful" conduct (and may potentially impact its charging decisions in months and years to come).



SELECTED ENFORCEMENT ACTIONS: ADVERTISING

■ **Sterling Global Strategies (Dec. 20, 2018)**

Administrative Proceeding File No. 3-18948

- The adviser settled claims that it made material misstatements and omissions while advertising back-tested performance of its Sterling Tactical Rotation Index. The calculations contained material errors and deviated from the pricing methodology utilized, which inflated the advertised performance by approximately 41.2% for the period from 2000 to 2010. The adviser also failed to disclose that the back-tested performance was based in part on investment in a commodity index that was not available during the back-tested period.
- The SEC ordered the adviser to pay \$175,000 in penalty.



SELECTED ENFORCEMENT ACTIONS: BEST EXECUTION

■ Lefavi Wealth Management (Sept. 3, 2019)

Administrative Proceeding File No. 3-19411

- The adviser settled claims that it (i) did not seek best execution when recommending and investing client assets in certain alternative investments with embedded commissions, (ii) failed to disclose it could have invested those client assets in the same alternative investments at lower share prices, and (iii) failed to disclose its investment adviser representatives' conflicts of interest related to receiving additional compensation for those investments. Client assets were invested at a share price reflecting a 7% commission.
- The SEC ordered the adviser to pay nearly \$1 million in disgorgement and \$150,000 in penalty.



SELECTED ENFORCEMENT ACTIONS: ROBO-ADVISERS

■ **Wealthfront Advisers (Dec. 21, 2018)**

Administrative Proceeding File No. 3-18949

- The adviser settled claims that it (i) falsely stated its proprietary tax loss harvesting program monitored all client accounts to avoid transactions that might trigger a wash sale, while the program did in fact permit such wash sales with rebalancing or client-directed transactions, (ii) retweeted client tweets on Twitter, which constituted client testimonials, without the related required disclosures, and (iii) paid bloggers for new client referrals based on amounts of assets initially deposited.
- The SEC ordered the adviser to pay \$250,000 in penalty.



SELECTED ENFORCEMENT ACTIONS: CRYPTOCURRENCY AND DIGITAL ASSETS

- **Kik Interactive (June 4, 2019)** *Civil Action No. 19-cv-5244*
 - The SEC recently charged the private Canadian company for conducting an illegal \$100 million securities offering of digital “Kin” tokens without registering the offer and sale as required by U.S. securities laws. More than \$55 million was raised from U.S. investors.
 - Kin tokens traded at about half the value that public investors paid in the offering, yet Kik allegedly told investors that the rising demand would drive up the value of Kin. Kik also allegedly claimed that it would keep three trillion Kin tokens, the Kin tokens would immediately trade on secondary markets, and Kik would profit alongside investors from the increased demand that it would foster.
 - The SEC seeks a permanent injunction, disgorgement plus interest, and a penalty.



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