
**8 December 2016**

***Practice Groups:***

***Global Government Solutions***

***Government Enforcement***

***Securities Enforcement***

# The Year In Review

# SEC Enforcement Actions Against Investment Advisers

***By Jon Eisenberg***

The Securities and Exchange Commission's enforcement program is highly focused on investment advisers for an obvious reason: they manage more than $67 trillion in assets for approximately 30 million clients.[1] In addition, because the SEC examines a far smaller percentage of investment advisers than broker-dealers, and there is no self-regulatory organization, like the Financial Industry Regulatory Authority, that also regulates investment advisers, enforcement plays a prominent role in sending a message to the investment management industry about the areas of concern to the Commission.

In recent years, it has not been unusual for the SEC to bring more than a hundred cases against investment advisers in a single year.[2] In the SEC's most recent fiscal year, which ended on September 30, 2016, almost one in every five enforcement actions was against an investment adviser. An entire unit in the SEC's Division of Enforcement is focused on bringing cases against investment advisers; advisers are subject to routine and for-cause examinations by the SEC examination staff; and the Commission now has access to voluminous data regarding their activities and sophisticated technology to analyze that data. Moreover, because investment advisers are fiduciaries, the standards for establishing liability are modest: in an SEC enforcement action, intentional, knowing or reckless misconduct is not usually necessary to prove a violation of the Investment Advisers Act.

We discuss the Commission's 2016 enforcement actions against investment advisers under the categories listed below, which are similar but not identical to the categories we used in articles reviewing the Commission's enforcement programs in 2014 and 2015:[3]

1. Conflicts of Interest
2. Fees and Allocations of Expenses
3. Trade Allocations
4. Best Execution
5. Principal Trades and Agency Cross Trades

---

[1] *See* Investment Advisers Act Release No. 4439 at 5 (June 28, 2016).

[2] For the Commission's fiscal year ended September 30, 2016, it brought 160 actions involving investment advisers or investment companies, including 98 independent or standalone actions involving investment advisers or investment companies. *See* SEC Press Release, "SEC Announces Enforcement Results for FY 2016," (Oct. 11, 2016). These were the most enforcement cases brought against investment advisers in a single year.

[3] *See* Jon Eisenberg, "8 Types of SEC Investment Adviser Actions in 2015," Law360 (Jan. 5, 2016); "8 More Types of SEC Investment Adviser Actions in 2015," Law360 (Jan. 6, 2016); "2014 SEC and FINRA Enforcement Actions Against Broker-Dealers and Investment Advisers," Harvard Law School Forum on Corporate Governance and Financial Regulation," (Dec. 24, 2014).

6. Insider Trading
7. Valuation of Securities
8. Disclosures Related to Performance, Assets under Management, and the Adviser's Background
9. Failure to Disclose Changes in Investment Strategy
10. Disclosures to the SEC and to Issuers Rather than to Clients
11. Failure to Register as an Investment Adviser or Broker-Dealer
12. Misappropriation
13. Custody Violations
14. Safeguarding Client Information
15. Business Continuity
16. Foreign Corrupt Practices Act Violations
17. Firm Procedures and Individual Supervision

At the end of each section, we provide one or more key "takeaways." After the section on procedures and supervision, we include a checklist of questions that advisers may wish to ask about their own practices in light of these actions. Finally, we conclude with a few brief observations about the enforcement program and an educated guess about the program under a new administration.

## 1. CONFLICTS OF INTEREST

Like most industries, the asset management industry has conflicts of interest. For example, investment advisers or their affiliates may receive revenue share, 12b-1 fees, and other compensation from mutual funds that they recommend. They might benefit by selling one type of variable annuity over another or one type of variable annuity rider over another. They might receive "soft dollars" from the broker-dealers to whom they direct order flow. They might receive compensation from the custodians they use to hold client assets. They might receive more compensation from some clients than from others. They might advise clients to invest in funds managed by an affiliate of the adviser.

Conflicts are not prohibited under the Investment Advisers Act, but they arouse the SEC's interest.[4] To the extent that material conflicts are not eliminated, they must be disclosed. More than a half century ago, the Supreme Court stated that the Investment Advisers Act reflects a congressional intent "to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice

[4] In contrast, the Department of Labor recently adopted a rule that, absent an exemption, prohibits fiduciaries to employee benefit plans and individual retirement accounts from receiving compensation that varies based on their investment advice or from receiving compensation from third parties in connection with that advice. *See* Department of Labor Employee Benefits Security Administration, "Fact Sheet: Department of Labor Finalizes Rule to Address Conflicts of Interest in Retirement Advice, Saving Middle Class Families Billions of Dollars Every Year," https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/dol-final-rule-to-address-conflicts-of-interest. Unlike the SEC, the Department of Labor does not view disclosure as an adequate response to conflicts of interest. It remains to be seen whether the Department of Labor rule, which has not yet gone into effect, will survive a new administration.

which was not disinterested."[5] While the Investment Advisers Act and the SEC label such failures to disclose "fraud," it need not be fraud in the commonly-understood sense. To establish liability, the Commission need not show intentional, knowing, or reckless deception, and it need not show that any investor was harmed or that the respondent benefitted from the alleged disclosure violation. Negligence is enough. On the other hand, some of the Commission's conflict-of-interest enforcement actions do involve intentional failures to disclose obvious conflicts.

We briefly summarize the Commission's 2016 conflict-of-interest cases below.

a. Failure to Disclose an Adviser's Current or Past Ownership Interest in Investments or Service Providers that the Adviser Recommends

The Commission required an investment adviser and its owner/founder to disgorge $2.7 million because the adviser recommended the purchase of investments in three private funds without accurately disclosing that the owner of the funds had agreed to acquire the adviser after it raised $20 million for the funds.[6] The Commission also revoked the registration of the investment adviser and imposed an industry bar on the owner.

The Commission found that the former president and majority owner of a registered investment adviser, without adequate disclosure, directed clients' AAA-rated Treasury and agency bond purchase transactions to a broker-dealer that he had once owned and that he had sold to a friend and former co-worker.[7] The Commission stated that the adviser failed to disclose that the new owner of the broker-dealer used the revenues earned on those trades to buy the broker-dealer from the adviser's owner. The Commission imposed an industry bar, required disgorgement of more than $1 million (minus an amount already paid in state court litigation), and imposed a penalty of $75,000.

In other actions involving advisers' failures to disclose conflicts of interest, the Commission found that:

- an investment adviser failed to disclose that it was investing client assets in an affiliated mutual fund in which principals of the adviser had a substantial interest;[8]
- an investment adviser failed to disclose that private offshore investment companies which it recommended were under common beneficial ownership with the investment adviser;[9]
- an investment adviser to two unregistered investment companies caused the funds to engage in conflicted non-arms-length transactions with entities that the adviser owned without disclosing that fact.[10]

The Commission also found that an adviser that disclosed the existence of controlled affiliates failed to disclose that he used those affiliates to divert several hundred thousand dollars of profits to himself.[11]

---

[5] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963).
[6] Investment Advisers Act Release No. 4400 (May 27, 2016).
[7] Investment Advisers Act Release No. 4463 (July 27, 2016).
[8] Investment Advisers Act Release No. 4537 (Sept. 28, 2016).
[9] Investment Advisers Act Release No. 4399 (May 27, 2016).
[10] Investment Advisers Act Release No. 4423 (June 15, 2016).
[11] Investment Advisers Act Release No. 4567 (Nov. 10, 2016).

# The Year In Review
# SEC Enforcement Actions Against Investment Advisers

b. Failure to Disclose Additional Compensation or Other Benefits Received by the Adviser for Making Particular Investments

The Commission held that an investment adviser failed to disclose that it received soft dollars (benefits provided by a broker-dealer other than trade executions) for four distinct purposes not covered by the safe harbor for soft dollars under the Securities Exchange Act.[12] In particular, the adviser used soft dollar payments to pay: i) an employee's salary and bonus for operating the soft dollar program; ii) a former spouse of a principal of the adviser in connection with a marital settlement agreement; iii) rent to a company that the principal owned; and iv) the costs of a timeshare that the principal maintained to visit his family and entertain guests. For these and other violations, it revoked the firm's investment adviser registration, barred the principal from the securities industry, and required the adviser to pay disgorgement and a large civil money penalty.

An SEC administrative law judge found that two individuals at an investment adviser that advised a fund received soft dollar payments that were purportedly for research services but, in fact, were for their personal benefit unrelated to research.[13] The order, which followed a default judgment entered against them in an SEC injunctive action, barred them from the securities industry.

In other actions involving advisers' failures to disclose conflicts of interest, the Commission found that:

- the owner of an investment adviser failed to disclose that each time a client of his purchased certain offshore hedge funds that he recommended, the fund manager deducted a sales charge from their investment and paid it to a foreign bank account that the owner controlled; in addition, he received, without disclosure, half of the management and performance fees that the funds charged on his clients' investments.[14] The Commission imposed an industry bar and $3.4 million in disgorgement offset by the amounts paid in an arbitration settlement;
- an investment adviser to a pooled investment vehicle failed to disclose that he expected promoters of a company in which he recommended investments to help find the adviser clients in return for the investments;[15]
- an investment adviser failed to adequately disclose that it received compensation from its custodian;[16]
- an investment adviser failed to disclose a $3 million forgivable loan from a broker-dealer that it used to provide clearing and custody services;[17]
- an investment adviser, in recommending that clients sell shares of a managed futures fund and buy shares of another fund, failed to disclose that he had lost the ability to earn commissions on the fund that was being sold and had gained the ability to earn commissions on the fund that he was recommending;[18] and

[12] Investment Advisers Act Release No. 4431 (June 17, 2016).
[13] Initial Decision Release No. 1079 (Nov. 9, 2016).
[14] Investment Advises Act Release No. 4543 (Sept. 30, 2016).
[15] Investment Advisers Release No. 4323 (Jan. 28, 2016).
[16] Investment Advisers Act Release No. 4566 (Nov. 7, 2016).
[17] Investment Advisers Act Release No. 4455 (July 18, 2016).
[18] Investment Advisers Act Release No. 4557 (Oct. 20, 2016).

- an investment adviser representative failed to disclose that he stood to receive extra incentive compensation, in the form of warrants, for recommending that clients buy certain debentures, and also failed to disclose that he was the primary fundraiser for the issuer of the warrants.[19]

In cases being litigated, the Commission accused an investment adviser of persuading its clients to invest in a company that provided undisclosed kickbacks to the adviser; [20] accused another investment adviser of increasing his compensation from a hedge fund by appointing himself to be a sub-adviser for a fee, without disclosing the fee and the related conflict of interest to investors;[21] and accused an investment adviser that offered investments in itself (through royalty units) of failing to explain that the adviser had discretion to use their funds to pay itself more compensation rather than greater returns to investors.[22]

c. Undisclosed Conflicts Involving Advisers to Municipalities

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among many other provisions, the Act included provisions for the registration and regulation of municipal advisers, imposed upon municipal advisers and their associated persons a fiduciary duty to their municipal entity clients, and prohibited them from engaging in conduct inconsistent with their fiduciary duty.

In 2016, the Commission brought its first enforcement case alleging that an investment adviser to a municipality violated its fiduciary duty.[23] In that case, the firm served as an adviser to a client on municipal bond offerings and arranged for the offerings to be underwritten by a broker-dealer where the individuals advising the municipality also worked as registered representatives. The Commission stated that they failed to inform their client of their relationship to the underwriter and the financial benefit they obtained from serving in dual roles. In announcing the settlement, the SEC's Director of Enforcement stated that the adviser had deprived the city "of the opportunity to seek unbiased advice," and that "[a] municipal adviser's first duty should be to its municipal client, not its own bottom line." The adviser paid disgorgement of $290,000 and a civil money penalty of $85,000. Three individuals paid fines ranging from $17,500 to $25,000 and agreed to additional sanctions ranging from a six-month suspension from acting in a supervisory capacity to a bar from the financial services industry for a minimum of two years.

The Commission also brought its first enforcement action under the municipal adviser antifraud provisions of the Dodd-Frank Act.[24] In that case, a consulting firm had relationships with both municipalities that hired municipal advisers and with municipal advisers seeking to be hired. The Commission found that in five instances, the consultant improperly provided one municipal adviser confidential information about the hiring process, including advance notice of the draft interview questions and the specifics of some of the competitors' proposals. In announcing the settlement, the Chief of the SEC Enforcement Division's Public Finance Abuse Unit said, "Municipal entities should be able to trust that their selection of a municipal adviser is untainted by any breach of fiduciary duty." The

[19] Initial Decision Release No. 973 (Mar. 2, 2016).

[20] SEC Complaint in SEC v. Ikenna Ikokwu, et al., Case No. 1:16-cv-01950 (D.D.C., filed Sept. 30, 2016).

[21] SEC Complaint in SEC v. Thomas Conrad, Jr., et al., Case No. 1:16-cv-0572-LMM (N.D. Ga., filed July 15, 2016).

[22] Investment Advisers Act Release No. 4389 (May 19, 2016).

[23] Investment Advisers Act Release No. 4352 (Mar. 15, 2016).

[24] Securities Exchange Act Release No. 78053 (June 13, 2016) and Securities Exchange Act Release No. 78054 (June 13, 2016).

Commission imposed a $100,000 penalty on the municipal adviser and penalties of $30,000 and $20,000 on two of its principals. It also imposed a $30,000 fine on the consultant, and imposed a $20,000 penalty and a bar from acting as a municipal adviser on the consultant's president.

*TAKEAWAY: CONFLICTS NEED NOT BE ELIMINATED BUT THEY MUST BE DISCLOSED.*

## 2. FEES AND ALLOCATIONS OF EXPENSES

Fees and expense allocations are conflicts of interest that merit their own special treatment. Of course, advisers are entitled to be paid for their services and some expenses may properly be allocated to clients. The problems generally arise when multiple sources of fees are not adequately disclosed or when the expense allocations are not adequately disclosed. The SEC's Division of Enforcement has been focused on fees and expense allocations in the last few years, especially in connection with investment advisers to private equity funds.[25] Cases in this area can be expensive to resolve because the Commission often takes the position that fees or expense allocations that were not adequately disclosed have to be disgorged even if there is little reason to believe that customers would have gone elsewhere if the disclosures had been more fulsome.

a. Fees and Expense Allocations Involving Advisers to Private Equity Funds

In 2016 the SEC brought a settled administrative action against four affiliated private equity fund advisers that resulted in a settlement involving $37.5 million in disgorgement, a $12.5 million civil money penalty, and $2.7 million in interest.[26] The Commission found that when a portfolio company was going to be sold or the subject of an initial public offering, the investment adviser, without adequate disclosure to investors, would accelerate the payment of future monitoring fees that the portfolio companies would have paid to the adviser in the absence of a sale or IPO. The Commission stated: "Although [the adviser] disclosed that it may receive monitoring fees from portfolio companies held by the funds it advised, and disclosed the amount of monitoring fees that had been accelerated following the acceleration, [the adviser] failed adequately to disclose to its funds, and to the funds' limited partners prior to their commitment of capital, that it may accelerate future monitoring fees upon termination of the monitoring agreements. Because of its conflict of interest as the recipient of the accelerated monitoring fees, [the adviser] could not effectively consent to this practice on behalf of the funds it advised." In the same case, the Commission found that a senior partner of the adviser improperly charged personal items and services to the funds and the funds' portfolio companies, and that the adviser failed reasonably to supervise the partner to prevent those violations.

The Commission brought a settled administrative action against a private equity fund adviser for failure to adequately disclose its fee allocation practices. [27] The Commission's order

[25] *See* Andrew Ceresney, Director, Division of Enforcement, "Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement," (May 12, 2016); Investment Advisers Act Release No. 4219 (Oct. 7, 2015); Investment Advisers Act Release No. 131 (June 29, 2015); Investment Advisers Act Release No. 3927 (Sept. 22, 2014); Investment Advisers Act Release No. 4258 (Nov. 5, 2015); Investment Advisers Act Release No. 4253 (Nov. 3, 2015); and Investment Advisers Act Release No. 4276 (Nov. 23, 2015).

[26] Investment Advisers Act Release No. 4493 (Aug. 23, 2016).

[27] Investment Advisers Act Release No. 4494 (Aug. 24, 2016).

stated that the adviser provided investment advisory services to a number of private equity funds, co-investment vehicles, and separately managed accounts, as well as to portfolio companies in which its clients invested. The fees from portfolio companies included break-up, origination, commitment, broken-deal, topped bid, cancellation, monitoring, closing, financial advisory, investment banking, director and other transaction fees. Under the limited partnership agreement, fees payable by the funds were to be reduced by 50-80% of fees paid by the portfolio companies. The problem arose because the limited partnership agreement did not specify how the offset would be allocated among different funds invested in the same portfolio companies. The Commission concluded that the allocation methodology chosen benefitted the adviser more than an alternative methodology. The order stated that the adviser had voluntarily reimbursed the funds $10.4 million plus $1.4 million in interest. While noting its cooperation and voluntary remedial efforts, the Commission also imposed a $2.3 million fine.

The Commission brought a settled administrative action against a private equity fund adviser that, in the case of one investment, caused the funds to invest in a separately-managed pooled investment vehicle that would later deploy capital for ultimate investments in companies in the energy sector.[28] Because this investment was not made directly in a portfolio company, the private equity fund incurred extra expenses in connection with paying a separate firm that provided investment advice to the pooled investment vehicle. In addition, the Commission found that the funds paid 100% of the premiums for an insurance policy that covered certain risks not entirely arising from the adviser's management of the funds, and that the adviser negotiated a legal fee discount for itself without negotiating a comparable discount for the funds. The order stated that following the SEC staff's examination, the adviser voluntarily reimbursed the funds $7.4 million in connection for the additional fees incurred in connection with the managed pool investment, $733,000 in connection with the payment of insurance premiums, and $179,000 in connection with the failure to negotiate a legal fee discount. After noting the firm's cooperation and voluntary remedial efforts, the Commission imposed an additional $3.5 million fine.

The Commission brought a settled administrative action against a private equity fund adviser for charging "operating partner oversight fees" that the fund's governing documents did not expressly authorize and that were not disclosed to the fund's limited partners until after the fees were received, and for using fund assets to make political and charitable contributions and to pay for entertainment expenses even though the funds' governing documents did not expressly authorize the use of fund assets for these purposes.[29] The Commission also found that the adviser did not adequately track or maintain records of whether entertainment expenses were for business or personal use. For these and other violations, the adviser and its principal were ordered to pay disgorgement of $2.3 million, prejudgment interest of $284,000, and a civil money penalty of $500,000.

b. Fees and Expense Allocations Involving Advisers to Other Types of Funds

The SEC brought a settled action against an investment adviser to a managed futures fund that it found had charged fees based on the notional trading value of assets (the total amount invested including leverage) even though its registration statement stated that the fees would be based on the net asset value. [30] The Commission required the adviser to disgorge $5.4

[28] Investment Advisers Act Release No. 4529 (Sept. 14, 2016).
[29] Investment Advisers Act Release No. 4411 (June 1, 2016).
[30] Investment Advisers Act Release No. 4315 (Jan. 19, 2016).

million, pay prejudgment interest of nearly $600,000, and pay a civil money penalty of $400,000.

The Commission filed a complaint against an investment adviser (and its owner) to two hedge funds.[31] In that case, the adviser received an incentive fee calculated as a share of the monthly realized profits earned in the funds' accounts. The Commission alleged that the adviser exploited the fact that unrealized losses were not factored into the fee calculation and each month caused the Funds to make certain trades that had the purpose and effect of realizing a large gain in the current month while effectively guaranteeing a large loss would be realized in the future. The Commission is seeking an injunction, disgorgement, and a civil money penalty.

The Commission filed an administrative action alleging that an investment adviser to a mutual fund falsely told clients who invested in the fund that he would not "double-dip" by charging them both advisory fees (which were based on a percentage of assets under management in the client's account) and fund management fees (which were based on a percentage of assets under management in the fund) for the portions of their accounts invested in the fund.[32] The Commission alleged that, contrary to these representations, the adviser did not apply any credit to the quarterly advisory fees that he deducted from his clients' accounts. The matter is in litigation.

c. Wrap Fees and Other Advisory Fees

In wrap fee programs, clients pay an annual fee that is intended to cover the cost of multiple services "wrapped" together, such as portfolio management, trade execution, and custody. In 2016, the Commission brought several cases charging that advisers did not accurately disclose how the wrap fees would be calculated:

- The Commission filed a settled action finding that an investment adviser for separately managed client accounts represented to clients participating in a wrap fee program that when they were charged a commission in connection with the purchase of interests in certain alternative investment products, the wrap account advisory fee would not be assessed on the value of such interests.[33] The Commission, however, identified a number of instances in which the adviser charged clients both the commission and an advisory fee in connection with the purchase of interests in alternative investment products  The order stated that the adviser had reimbursed clients $34,640 in overcharges, and it ordered it to pay a civil money penalty of $100,000.
- The Commission filed a settled action against an investment adviser that served as a sub-adviser to clients in various wrap fee programs and that often placed trades (in order to obtain better executions, it claimed) with brokers not covered by the wrap fees.[34] The Commission stated that the adviser should have disclosed that it had substantially increased the amount of trades it was directing to brokers not covered by the wrap fee program. After stating that it had taken into account the sub-adviser's remedial actions and cooperation, the Commission imposed a $300,000 civil money penalty.

[31] SEC Complaint in SEC v. Hope Advisers, LLC, Case No. 1:16-cv-01752-LMM (N.D. Ga, filed May 31, 2016).
[32] Investment Advisers Act Release No. 4545 (Oct. 4, 2016).
[33] Investment Advisers Act Release No. 4441 (June 28, 2016).
[34] Investment Advisers Act Release No. 4453 (July 14, 2016).

## The Year In Review
## SEC Enforcement Actions Against Investment Advisers

- The Commission brought two settled actions against investment advisers that lacked information on how frequently sub-advisers traded away for clients in wrap fee programs, and thus required clients to pay commissions in addition to the wrap fee. [35] Although the firms disclosed that a sub-adviser could trade away and that the commissions associated with such transactions would be in addition to the wrap fee, they did not obtain information regarding the amount of commissions charged for these transactions. One firm agreed to pay a $600,000 civil money penalty and the other agreed to pay a $250,000 civil money penalty.
- The Commission brought a settled administrative proceeding against an investment adviser providing discretionary money management services to high net worth individuals and institutional clients.[36] The investment adviser entered into advisory agreements requiring the advisory fee to be calculated as a percentage of the portfolio gross assets per annum. The Commission found that for 25 clients the calculation of the assets under management did not appropriately reflect the immediate application of the proceeds from sales to reduce margin balances. The Commission required the adviser to disgorge $125,000 in advisory fees, to pay prejudgment interest of $7,600, and to pay a civil money penalty of $100,000. While this was not technically a "wrap fee" case, it illustrates the importance of accurately calculating the assets under management when applying a fee based on those assets.

d. Fee Suitability

Many investment advisers are dually registered as broker-dealers, and clients may be charged either an investment advisory fee based on the total value of the assets in their account or a commission based on each transaction. Although there are many factors that go into which type of arrangement a client might prefer, clients who trade frequently might pay lower fees by being charged a fee based on assets under management, while clients who trade infrequently might pay lower fees if they only pay transaction-based commissions. The SEC expects firms to monitor whether clients are in a fee structure that makes sense for them.

The Commission filed a settled administrative proceeding against three affiliated investment advisers based, in part, on their failure to monitor investment advisory accounts to determine whether they were better served by paying a wrap fee based on assets under management or commissions based on individual transactions.[37] The Commission stated that the firms were required to monitor advisory accounts quarterly for inactivity or "reverse churning" (as required by their compliance policies), which the Commission defined as "the practice where a client is charged a wrap fee that covers all advisory services and trading costs even though the client trades infrequently." The Commission stated, "A wrap fee account may not be in the best interest of a client with minimal or no trading activity as compared to a non-wrap fee account or brokerage account where the client would otherwise pay trading costs as incurred but a lower fee…." For that and other violations involving the selection of mutual fund share classes that were more expensive than other available share classes, the Commission imposed a $7.5 million civil money penalty.

[35] Investment Advisers Act Release No. 4525 (Sept. 8, 2016) and Investment Advisers Act Release No. 4526 (Sept. 8, 2016).

[36] Investment Advisers Act Release No. 4348 (Mar. 2, 2016).

[37] Investment Advisers Act Release No. 4351 (Mar. 14, 2016).

*TAKEAWAY: ALL FEES, REGARDLESS OF THEIR SOURCE, SHOULD BE CLEARLY DISCLOSED, AS SHOULD THE PROCESS FOR ALLOCATING EXPENSES; IN ADDITION, THERE SHOULD BE A PROCESS IN PLACE TO MONITOR FEE SUITABILITY.*

## 3. TRADE ALLOCATION PRACTICES

Another conflict of interest that merits its own treatment is trade allocations. An investment adviser may aggregate trades for multiple clients in a single omnibus account, and then allocate those trades later in the day. While aggregating and then later allocating trades is permissible, such arrangements involve the potential for abuse.

a. "Cherry Picking"

"Cherry picking is a practice in which securities professionals allocate profitable trades to a preferred account (like their own) and less profitable or unprofitable trades to a non-preferred account (like a customer's)."[38] In recent years, the Commission has brought more cherry picking cases than in the past because it has more data and better tools to detect suspicious trade allocations.

The Commission issued a decision on an appeal from an administrative law judge decision de-registering an investment adviser and barring its principal because it cherry picked profitable transactions for favored accounts.[39] In that case, the investment adviser managed both client accounts and hedge funds. The Commission found that it systematically allocated the most profitable trades to six favored accounts, including four hedge funds that it managed, at the expense of three disfavored client accounts, including the accounts of an elderly widow's trust and non-profit organization. On an annualized basis, the favored accounts had positive first-day returns 35% of the time and the disfavored accounts had negative first-day returns 96% of the time. The Commission's expert testified that the probability that the observed allocation arose by chance was approximately one in a "quadrillion," which is one in ten multiplied by itself 15 times. The Commission revoked the firm's registration as an investment adviser, barred the principal from the securities industry, ordered disgorgement of $1.4 million, prejudgment interest of $201,000, and civil money penalties of $6.6 million against the firm and $1.3 million against the individual.

In smaller "cherry picking" cases, the Commission:

- brought a settled administrative action finding that two investment advisers, which had discretionary authority over client accounts, purchased blocks of securities in an omnibus account that included both proprietary and client accounts and did not allocate the securities purchased until after they had an opportunity to observe the securities' intra-day performance.[40] The Commission stated that respondents allocated a greater proportion of the profitable trades to favored accounts and a greater proportion of the unprofitable trades to disfavored accounts, and that the probability of observing such an uneven allocation by chance was less than one in one million. The Commission ordered

[38] Securities Exchange Act Release No. 77396 (Mar. 17, 2016).

[39] Investment Advises Act Release No. 4431 (June 17, 2016).

[40] Investment Advises Act Release No. 4433 (June 22, 2016).

disgorgement of $130,450 and a civil money penalty of $150,000 and barred the individual respondent from the securities industry;

- brought a settled administrative action finding that an investment adviser representative realized $109,000 in ill-gotten gains by "disproportionately allocat[ing] profitable trades to proprietary accounts and unprofitable trade to client accounts."[41] It barred the respondent from the securities industry, ordered him to pay disgorgement of $109,000, interest of $5,000, and a civil money penalty of $75,000;
- brought an administrative proceeding against an investment adviser to individual investors and a mutual fund in which it alleged that the adviser executed day trades through two omnibus accounts and then allocated those trades only after he knew the profitability of the trades. The Commission alleged that he disproportionately allocated profitable trades to his own accounts and unprofitable trades to his client accounts, with one particular client bearing the bulk of the losses. During one period, the investment adviser earned first-day returns in the omnibus account of $220,000, while the disfavored client suffered first-day losses of $1.4 million. The matter is in litigation; and
- brought an administrative proceeding against an investment adviser and sole owner/principal for "unfairly and systematically allocat[ing] profitable trades to a set of accounts while other accounts were harmed by the allocation of unprofitable trades."[42] The Commission alleged that the adviser allocated a disproportionate number of profitable trades and options trades to at least six favored accounts that included a lifelong family friend, a cousin, and certain long-term clients, while allocating unprofitable trades to disfavored client accounts. The matter is in litigation.

b. Allocation of Limited Investment Opportunities

The Commission also brought a settled administrative action against an investment adviser and its principal with respect to the trading overlap and allocations between their approximately $2 billion hedge fund client and their $100 million dollar private fund, in which the adviser's principal had a much larger interest.[43] The issue here was not cherry picking or advance knowledge of the profitability of the trade before it was allocated, as in the above cases, but the allocation of limited investment opportunities. The Commission's order stated that although the hedge fund was roughly 20 times the size of the smaller fund, respondents routinely allocated at least one-third of new issues to the smaller fund. The order stated that the disclosures did not completely and accurately describe to investors the nature and scope of the overlapping investments. It ordered respondents to pay disgorgement of $1.7 million, pre-judgment interest of $200,000, and a civil money penalty of $200,000.

[41] Investment Advisers Act Release No. 4371 (Apr. 19, 2016).
[42] Investment Adviser Act Release No. 4372 (Apr. 19, 2016).
[43] Investment Advisers Act Release No. 4413 (June 2, 2016).

## The Year In Review
## SEC Enforcement Actions Against Investment Advisers

*TAKEAWAY: TRADE ALLOCATIONS AND ALLOCATIONS OF LIMITED INVESTMENT OPPORTUNITIES THAT FAVOR AN ADVISER OVER A CLIENT OR ONE CLIENT OVER ANOTHER ARE POTENTIALLY PROBLEMATIC. THE SEC HAS BETTER TOOLS THAN IT HAD IN THE PAST TO DETECT PROBLEMATIC TRADE ALLOCATIONS.*

### 4. BEST EXECUTION

Investment advisers have a duty to obtain "best execution" for their clients. Best execution does not require an investment adviser to obtain the absolute lowest price for their customers in securities transactions, but it does require that advisers seek the most favorable terms reasonably available under the circumstances.

a. Share Class Selection

Mutual funds offer a dizzying array of share classes with different fee structures and different levels of compensation paid to investment advisers by the funds. It has been estimated that among 8,000 mutual funds there are roughly 24,000 different share classes, with at least one fund family offering 18 different share classes.[44] Further complicating the selection of share classes is that different fund families offer different fee waivers for different types of clients holding different share classes. All of this can make it difficult for investment advisers to recommend the most favorable share class. In addition, investment advisers have a conflict because they may receive additional compensation when clients buy more expensive share classes. The Commission has brought a number of cases alleging that investment advisers violated their duty of obtaining best execution by recommending share classes that paid them a higher level of compensation and cost their customers more than comparable lower-fee share classes offered by the same fund family.

The Commission filed a settled administrative proceeding against three affiliated investment advisers that it found steered mutual fund clients toward more expensive share classes so that firms could collect more fees.[45] The order stated that the firms invested certain of their clients in share classes that cost clients more than other share classes, and that they chose the more expensive share classes because those share classes paid 12b-1 fees to the adviser. The Commission required the firms to disgorge $2 million in fees that they earned on the higher-priced share classes and to pay a $7.5 million penalty, which covered both the share class violations and violations related to the failure to monitor whether clients in wrap fee programs would have been better off under a commission-based fee structure.

The Commission brought a similar settled administrative proceeding against an investment adviser that caused its clients to invest principally in mutual funds offered by a single family.[46] The fund complex offered two shares classes to investment advisers: a less expensive share class that did not pay 12b-1 fees to advisers and a more expensive share class that did pay 12b-1 fees to advisers. The order stated, "Receipt of 12b-1 fees not only created a conflict of interest that was not adequately disclosed to [the adviser's] clients, but favoring 12b-1 funds over others was inconsistent with [the adviser's] duty of to seek best

[44] See John Waggoner, "Some American Funds Offer Up to 18 Share Classes: Overkill?" Investment News (Mar. 28, 2016).
[45] Investment Advisers Release No. 4351 (Mar. 14, 2016).
[46] Investment Advisers Act Release No. 4314 (Jan. 14, 2016).

execution for its clients." The order described the Commission's position on share class selection and best execution as follows:

> Section 206 of the Advisers Act imposes on investment advisers a fiduciary duty to act for the benefit of their clients. That duty includes, among other things, an obligation to seek best execution for client transactions—i.e., "to seek the most favorable terms reasonably available under the circumstances." The Commission has stated in settled enforcement actions that an investment adviser failed to seek best execution when it caused a client to purchase a more expensive share class when a less expensive class was available. …By not choosing mutual fund share classes with a view to minimizing transaction and ongoing costs, and by failing to disclose that best execution would not be sought for mutual funds with multiple share classes available, [the adviser] failed to seek best execution on behalf of their individual advisory clients.

The Commission ordered respondents to pay $202,000 in disgorgement, $23,000 in interest, and a civil money penalty of $80,000.

b. Broker-Dealer Selection

Best execution issues may also arise in connection with the selection of broker-dealers to execute trades. The Commission held that an investment adviser violated his duty of best execution by directing client bond trades to a broker-dealer branch that he once owned and the proceeds from which were used to make payments to him in connection with the sale of the branch.[47] The Commission stated:

> The duty of best execution requires an investment adviser to "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances." Those circumstances include the "full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager."
>
> [W]e have long held that the "selection of a broker and the determination of the rate to be paid should … never be influenced by the adviser's self-interest in any manner." Where "the adviser is affiliated with or has a relationship with the brokerage firm execution the transaction," the adviser "must make the good faith judgment that such broker is qualified to obtain the best price on the particular transaction and that the commission in respect of such transaction is at least as favorable to the company as that charged by other qualified brokers." In essence, in "a case of self-dealing, the burden of justifying paying a commission rate in excess of the lowest rate available is particularly heavy."

The Commission, pointing to the fact that the adviser did not seek competitive bids for the executions and that dozens of transactions involved commissions that were higher than industry norms, concluded that the adviser violated his duty of best execution and ordered him to disgorge $265,263.60 in excessive commissions, and to pay prejudgment interest and a civil money penalty of $75,000. It also imposed an industry bar.

[47] Investment Advisers Act Release No. 4463 (July 27, 2016).

## The Year In Review
## SEC Enforcement Actions Against Investment Advisers

*TAKEAWAY: THE DUTY OF BEST EXECUTION, REQUIRING ADVISERS TO OBTAIN THE BEST TERMS REASONABLY AVAILABLE UNDER THE CIRCUMSTANCES, APPLIES TO BOTH SHARE CLASS SELECTION AND BROKER-DEALER SELECTION (AMONG OTHER AREAS).*

### 5. PRINCIPAL TRADES AND AGENCY CROSS TRADES

Advisers may represent clients who have an interest in transacting with each other—because one wants to purchase a security and the other wants to sell the same security. If the adviser "crosses" the trades between the two clients, they may save brokerage commissions, avoid a market impact, and reduce other transaction costs. Cross trades, however, also involve a potential for abuse because an adviser to two clients on opposite sides of a transaction is in a position to favor one client over the other. That's especially true if one of the parties to the cross trade is the adviser itself or an affiliate of the adviser.

To protect against that abuse, Section 206(3) of the Investment Advisers Act and Rule 206(3)-2 prohibit agency cross trades unless, among other conditions, the client authorizes the transaction in writing and the adviser discloses in writing the capacities in which it will act and the conflicts that arise. In addition, absent disclosure and consent, Section 206(3) prohibits an investment adviser, acting as a principal for its own account (or the account of an affiliate or controlling person of the adviser), to knowingly buy securities from, or sell securities to, a client. When an investment company is involved, the Investment Company Act also limits cross trades.[48]

The Commission brought a settled administrative action against an investment adviser that engaged in over a hundred cross trades by selling securities from certain advisory client accounts to counter-party broker-dealers on day 1, and then on day 2 repurchasing the same securities from the same broker-dealers for the accounts of certain other advisory clients.[49] The Commission stated that even though the adviser interposed third-party broker-dealers into the sale and waited until the next day to repurchase the securities, these were prohibited cross trades. The Commission imposed a civil money penalty of $250,000 on the adviser.

The Commission also brought a settled administrative action against a small investment adviser that had been repeatedly warned by the Commission staff to revise its procedures for principal trading and had failed to bring them into compliance.[50] The Commission stated that the firm engaged in principal transactions without both disclosing its capacity in writing to clients and without obtaining client consent before the completion of each transaction. The Commission required the firm to retain an independent consultant to review its compliance program and required the firm to pay a civil money penalty of $34,000.

[48] See Sections 17(a)(1) and 17(a)(2) of the Investment Company Act and Rule 17a-7 thereunder.

[49] Investment Advisers Act Release No. 4534 (Sept. 23, 2016). See also Investment Advisers Act Release No. 4441 (June 28, 2016).

[50] Investment Advisers Act Release No. 4542 (Sept. 30, 2016).

*TAKEAWAY: PRINCIPAL TRADES AND AGENCY CROSS TRADES ARE GENERALLY PROHIBITED IN THE ABSENCE OF DISCLOSURE AND PRIOR CLIENT CONSENT; A SALE COUPLED WITH AN AGREEMENT TO REPURCHASE MAY CONSTITUTE A CROSS TRADE.*

## 6. INSIDER TRADING

Like anyone, investment advisers are prohibited from insider trading—trading on the basis of material nonpublic information obtained or used in breach of a duty or tipping such information to others who trade. Indeed, investment advisers to hedge funds have been among the most frequent targets in both civil and criminal insider trading cases.

The line between lawfully trading on material nonpublic information and violating insider trading laws is not always clear. For example, a company insider might provide material nonpublic information to a friend, who shares it with another person, who shares it with another person, who shares it with another person, who shares it with a hedge fund manager, who factors it into his or her trading decisions. Even assuming that the information is material and nonpublic, whether the hedge fund manager has engaged in unlawful trading depends on what he or she knew about how the information came to be shared in the first instance—in particular, did the hedge fund manager know that the insider shared the information for the insider's personal benefit. A prominent Second Circuit judge, at the oral argument in a case which later reversed criminal insider trading convictions of two hedge fund managers, chastised the government for bringing cases based on amorphous standards:

> We sit in the financial capital of the world. And the amorphous theory that you have, that you've tried this case on, gives precious little guidance to all of these institutions, all of these hedge funds out there who are trying to come up with some bright line rules about what can and what cannot be done. And your theory leaves all of these institutions at the mercy of the government, whoever the government chooses to indict….[51]

In a Supreme Court decision issued on December 6, 2016, which affirmed the criminal conviction of an individual who traded on inside information, the Court stated that to establish a defendant's criminal liability as a tippee, the government must prove "that the tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue."[52] The Court also stated that a gift of information to a friend or relative satisfied the personal benefit requirement because it resembled trading by the insider himself followed by a gift of the proceeds.

The Commission filed a complaint in federal district court alleging that the chief executive officer of an investment adviser to multiple hedge funds used his status as one of the largest shareholders of a public company to gain access to an executive of the company and obtain confidential details about the sale of a substantial company asset.[53] The Commission alleged that the executive shared the information because he believed it would be

---

[51] Transcript of Oral Argument in United States v. Newman, 773 F.3d 438 (2d Cir. 2014), cert. denied, 136 S.Ct. 242 (2015), at 49. *See generally*, Jon Eisenberg, "How *United States v. Newman* Changes the Law," Harvard Law School Forum on Corporate Governance and Financial Regulation," (May 3, 2015).

[52] Salman v. United States, No. 15-628, slip op. at 8 (Dec. 6, 2016).

[53] SEC Complaint in SEC v. Leon G. Cooperman and Omega Advisers, Inc., (E.D. Pa., filed Sept. 21, 2016).

maintained in confidence, and that the CEO of the adviser agreed that he would not use the confidential information to trade in the company's securities. The Commission alleged, however, that the CEO and the adviser used this information to acquire securities in the public company before the transaction was announced. The matter is in litigation.

In another case that is in litigation, the SEC charged that a former Food and Drug Administration official, who acted as a hedge fund consultant while working for a trade association, obtained material nonpublic information from his former colleagues at the FDA and shared that information with two hedge fund managers, who used it to make $32 million in profits.[54] The Commission filed complaints against the official and both hedge fund managers. It also alleged that one of the hedge fund manager defendants tipped another hedge fund manager about an impending cut to Medicare reimbursement rates for certain home health services, and that the third hedge fund manager made $300,000 for the hedge funds he managed by trading on that information. The former FDA manager has since settled the suit, and one of the hedge fund manager defendants has since died. The suit is continuing against the two remaining defendants.

*TAKEAWAY: THE LINE BETWEEN PERMISSIBLE AND IMPERMISSIBLE TRADING IS NOT ALWAYS CLEAR. THE LACK OF CLARITY PUTS HEDGE FUND MANAGERS AT PARTICULAR RISK.*

## 7. VALUATION OF SECURITIES

Valuations pose potential conflicts for investment advisers because a higher valuation of assets under management may translate into a higher advisory fee and inflated performance representations. Problems may also arise, however, not because of deliberate misconduct but because many securities are difficult to value and, regardless of conflicts, may lead to valuations that the Commission later challenges.

At the 2016 Investment Company Institute General Meeting, SEC Chair Mary Jo White said with respect to valuation:

> Increasingly, funds have acquired portfolio investments that make it difficult to accurately determine their value, especially in a timely manner each day. Many of these portfolio investments may have legal or contractual restrictions on their sale, others may be complex instruments, and still others may not trade that often. As portfolio strategies and permissible investments for a fund are being developed, it is essential that the accurate pricing of the portfolio holdings and NAV calculations are carefully considered…. I, along with your investors, expect that you will get it right.[55]

The Commission imposed a $20 million fine on a large investment adviser that, the Commission found, overstated the investment performance of one of its first actively managed exchanged-traded funds by pricing odd-lot positions, which it acquired at discounts to round-lot positions, at round-lot prices.[56] The adviser relied on prices provided by a third-

[54] SEC Press Release, "Hedge Fund Managers and Former Government Official Charged in $32 Million Insider Trading Scheme," (June 15, 2016).

[55] Chair Mary Jo White, "Keynote Address Investment Company Institute 2016 General Meeting – 'The Future of Investment Company Regulation,'" (May 20, 2016).

[56] Investment Advisers Act Release No. 4577 (Dec. 1, 2016).

party vendor, but the order stated that the adviser did not have a reasonable basis to believe that the vendor's marks reflected the exit price that the fund would receive for these positions. The order also stated that in monthly and annual reports to investors, the adviser negligently failed to disclose the impact of the "odd-lot" strategy on the fund's performance and that the strategy would not be sustainable as the fund grew in size.

The Commission filed a settled administrative proceeding against an investment adviser for improperly valuing certain mutual fund bond holdings, which led to i) the funds being priced at an incorrect net asset value, ii) inaccurate performance figures, and iii) inflated asset-based fees.[57] The order stated that the improperly valued bonds were complex, illiquid securities that did not have readily available market quotations, and that the firm used a third-party analytical tool to price them. The firm, however, failed to incorporate the prices at which the funds traded the bonds, values assigned by other holders of the bonds, and other market data, and the firm failed to back-test the fair value determinations for the bonds. The Commission stated that after the firm discovered that the tool had led to an inflated value of the bonds, it marked the bonds down and contributed $27 million to the funds as a means of reimbursing investors who had purchased the funds at an inflated price. The Commission, however, concluded that the $27 million was not based on complete transactional data or in accordance with the funds' policies and procedures and that, as a result, some shareholders were undercompensated. The Commission required the firm to make distributions to accountholders based on a different methodology and to pay a $3.9 million civil money penalty.

The Commission filed a settled administrative proceeding against a commodity pool operator and managing owner of a managed futures fund.[58] The adviser invested in highly customized derivatives, including total return swaps and options that were not traded on an open market and that did not have publicly-reported prices. The adviser's Form 10-K and Forms 10-Q stated that the options were reported at "fair value" based on daily valuations provided by a third-party pricing service and "corroborated by weekly counterparty settlement values." The Commission stated this was misleading because the adviser failed to consider certain information that implied a materially different valuation than the valuation used. The Commission also found that the adviser caused a large option position to be transferred from a smaller fund to a larger fund at a price that was higher than the counterparty's indicative settlement valuations. For these and other unrelated violations, the Commission required the adviser to pay $6 million in disgorgement and a $400,000 civil money penalty.

The Commission filed a settled administrative action against an investment adviser to a pooled investment vehicle and its founder, which found that the adviser used unsupported valuations of a penny stock position to make the fund appear more successful than it was, thereby inducing additional investments and delaying investor redemption attempts.[59] For these and other violations, the Commission ordered the adviser to pay $2.9 million in disgorgement and a $75,000 civil money penalty.

The Commission filed complaints against two former portfolio managers to a hedge fund that invested in credit securities.[60] The complaint alleged that they used sham broker quotes to overvalue the securities held by the fund. In particular, the Commission alleged that they told

[57] Investment Advisers Act Release No. 4554 (Oct. 18, 2016).

[58] Investment Advisers Act Release No. 4315 (Jan. 19, 2016).

[59] Investment Advisers Act Release No. 4323 (Jan. 28, 2016).

[60] SEC Complaint in SEC v. Christopher Plaford (S.D.N.Y., filed June 15, 2016).

certain "friendly" outside brokers the specific prices they wanted for the securities held by the fund and directed the outside brokers to send the same prices back to them. In addition, they allegedly purchased one particular security at an above-market price in order to inflate the apparent value of the security in the fund. The matter is in litigation.

*TAKEAWAY: THE COMMISSION WILL CAREFULLY SCRUTINIZE THE METHODOLOGY FIRMS USE TO VALUE DIFFICULT-TO-VALUE SECURITIES.*

## 8. DISCLOSURES RELATED TO PERFORMANCE, ASSETS UNDER MANAGEMENT, AND THE ADVISER'S BACKGROUND

Each year the Commission brings multiple enforcement actions alleging that investment advisers misrepresented their performance, assets under management, and the adviser's background. Each of these categories has in common that the disclosures potentially made the adviser or the recommended investments more attractive to customers than they otherwise would have been. Under Section 206 of the Investment Advisers Act, the Commission need not show that the adviser's disclosure violations were intentional, knowing or reckless. The cases involve a combination of intentional and inadvertent violations.

The Commission announced that it was imposing penalties on 13 investment advisory firms that "accepted and negligently relied upon claims by F-Squared Investments that its AlphaSector strategy for investing in exchange-traded funds had outperformed the S&P Index for several years."[61] In announcing the penalties, the SEC's Director of Enforcement stated, "When an investment adviser echoes another firm's performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact." The fines ranged from $100,000 to $500,000.

The Commission charged that an investment adviser, in connection with its sale of two funds, provided false and misleading performance data to Morningstar in order to obtain a five-star rating, including that its assets were more than 40 times higher than they actually were and that the funds had been in existence for years longer than they had been.[62] It also charged that it created and distributed false and misleading marketing materials, which failed to adequately disclose that results were based on hypothetical rather than actual fund performance, and that it took extensive measures to hide an individual's identity as fund manager given that his background included two felony fraud convictions, a bankruptcy filing, and money judgments and liens against him. Finally, the Commission also charged that the adviser hired a firm to manipulate Internet search results for that individual and to populate the Internet with false and misleading information about him, including that he was a successful fund manager, investor, and philanthropist.

In other cases, the Commission found that:

- an investment adviser overstated its assets under management by at least $1.5 billion in a prominent financial publication, a radio show, and other advertisements and communications; falsely asserted that its returns placed it in the top 1% of firms

[61] SEC Press Release, "Investment Advisers Paying Penalties for Advertising False Performance Claims," (Aug. 25, 2016).

[62] Investment Advisers Act Release No. 4349 (Mar. 8, 2016).

worldwide; and failed to disclose that its performance data were based on a model portfolio rather than actual gains to customers;[63]

- an investment adviser solicited investments in a company through materially misleading private placement memoranda that overstated the assets managed by its subsidiaries, overstated its financial results, and failed to disclose that some of the offering proceeds were being used by the company to pay entities affiliated with the company;[64]
- the owner of an investment adviser concealed his suspension from appearing before the IRS, misstated the risks and profitability of investments made by clients, falsely stated that he was not required to register as an investment adviser, and provided false information about the services provided;[65] and
- an investment adviser for a hedge fund falsely told investors that i) he would monitor the fund on a daily basis, ii) he had invested his own or his children's money in the fund, iii) he would regularly receive information about the Fund, iv) the Fund was his idea, v) a big bank was going to invest in the fund, vi) investors could not lose by investing in the fund, vii) the fund was FDIC insured, viii)the fund's algorithm or trading system would be patented, ix) the Fund was not riskier than their existing investments, and x) the fund would perform better than their previous investments.[66]

The Commission also charged that an investment adviser to multiple private funds solicited millions of dollars of investments in the funds at a time when the adviser knew of, but did not disclose, the funds' calamitous financial condition; [67] and that an investment adviser failed to disclose his disciplinary history, including a broker-dealer industry bar.[68]

*TAKEAWAY: ADVISERS THAT MISREPRESENT THEIR TRACK RECORD, ASSETS UNDER MANAGEMENT, BACKGROUND, OR OTHER FACTS THAT MIGHT INCLINE AN INVESTOR TO USE THEIR SERVICES OR FOLLOW THEIR RECOMMENDATIONS ARE AT A PARTICULARLY HIGH RISK OF ENFORCEMENT ACTIONS.*

## 9. FAILURE TO DISCLOSE CHANGES IN INVESTMENT STRATEGY

An SEC administrative law judge found that two portfolio managers responsible for managing the portfolio of a closed-end investment company departed from the fund's longstanding covered-call investment strategy and caused the fund to employ two new types of derivatives instruments that exposed the fund to a substantial risk of loss and ultimately led to investor losses of $45 million.[69] The Commission stated that the fund was marketed as a covered call fund, that the portfolio managers began to use naked puts and variance swaps to enhance the fund's performance and meet the fund's dividend target, and that they did not disclose the change in strategy and mischaracterized the fund as being "hedged." The Commission imposed industry bars on the portfolio managers (though it granted one a right

[63] Initial Decision Release No. 1033 (July 11, 2016).
[64] Investment Advisers Act Release No. 4460 (July 21, 2016).
[65] Investment Advisers Act Release No. 4367 (Apr. 14, 2016).
[66] Initial Decision Release No. 941 (Jan. 11, 2016).
[67] SEC Complaint in SEC v. Aequitas Management, LLC, et al., Case No. 3:16-cv-00438-PK (filed Mar. 10, 2016).
[68] SEC Complaint in SEC v. Thomas D. Conrad, Jr., et al., Case No. 1:16-cv-02572-LMM (N.D. Ga., filed July 15, 2016).
[69] Investment Advisers Act Release No. 4420 (June 13, 2016).

to reapply after two years), ordered disgorgement of $128,000, and ordered each respondent to pay a civil money penalty of $130,000.

*TAKEAWAY: STRATEGY DRIFT SHOULD BE DISCLOSED.*

## 10. DISCLOSURES TO THE SEC AND TO ISSUERS RATHER THAN TO CLIENTS

Disclosure violations are not limited to disclosures to clients. In 2016, the Commission brought two unusual cases involving disclosures to the Commission itself and disclosures to issuers.

The Commission charged that an investment adviser to registered investment companies and pooled investment vehicles made a misleading statement of a material fact in an exemptive application filed with the Commission.[70] In that case, the investment adviser sought an exemption from the requirement of shareholder approval to amend its sub-advisory agreements. The staff told the adviser that it would not approve the application with a provision requiring the adviser to pay the sub-adviser for terminating it without cause. The adviser then removed that provision but failed to tell the staff that it had entered into a side agreement removing its ability to terminate the sub-adviser. The Commission censured the adviser and ordered it to pay a $75,000 fine.

In perhaps the most unusual disclosure case brought by the Commission in 2016, the Commission charged that the sole owner/CEO of an investment adviser to a hedge fund paid $10,000 to each of more than 60 terminally-ill patients.[71] In return, they agreed to set up jointly-owned brokerage accounts (with the owner/CEO) that the owner/CEO used to purchase fixed-income instruments at discounts to par. The fixed-income securities had “death puts” that, upon the death of one of the owners, allowed the surviving owner to put the security back to the issuer at par plus accrued interest. Since the instruments were purchased at discounts to par, the death put provided a substantial return to “survivors.” As each terminally-ill patient died, the owner/CEO, as the surviving owner of the security, would exercise the death put, eventually collecting more than $100 million in early redemptions from the issuers of the death puts. The Commission alleged that the representations made by the owner/CEO to the issuers of the death puts were false and that the true owner of the death puts was the hedge fund (which would not have been eligible to exercise the death puts). The Commission also alleged that the respondents violated the custody rule by failing to custody the funds and securities under the proper name. The matter is in litigation before an SEC administrative law judge.

[70] Investment Advisers Act Release No. 4513 (Aug. 25, 2016).

[71] Investment Advisers Act Release No. 4485 (Aug. 15, 2016).

## The Year In Review
## SEC Enforcement Actions Against Investment Advisers

*TAKEAWAY: MISREPRESENTATION CASES ARE NOT LIMITED TO MISREPRESENTATIONS TO CLIENTS; MISREPRESENTATIONS TO THE SEC, ISSUERS AND OTHERS MAY PROVIDE A PREDICATE FOR ENFORCEMENT ACTIONS.*

### 11. FAILURE TO REGISTER AS AN INVESTMENT ADVISER OR BROKER-DEALER

The Commission brought cases against investment advisers in 2016 on the grounds that they should have registered as investment advisers, broker-dealers, or both.

The Commission brought a settled administrative proceeding against an Israeli bank and two affiliates that, without registering either as U.S. broker dealers or investment advisers, actively solicited clients in the United States to conduct securities transactions, set up accounts for U.S. clients, and provided cross-border investment advisory services to clients in the United States[72] The bank's relationship managers traveled to the United States to meet with existing and prospective U.S. customers, provide investment advice, and solicit securities transactions. The Commission found that they were required to register as both U.S. broker-dealers and U.S. investment advisers. Respondents were required to disgorge $3.44 million and pay a civil money penalty of $1.5 million. In an earlier action brought by the Department of Justice, respondents entered into a deferred prosecution agreement involving allegations that they aided and assisted in the preparation and presentation of false U.S. income tax returns by their clients. Pursuant to that settlement, the respondents paid approximately $270 million.[73]

The Commission brought a settled administrative proceeding against an investment adviser to a private equity fund alleging that the adviser should have registered as a broker-dealer because it received transaction-based compensation for services in connection with the acquisition and disposition of portfolio companies.[74] The order stated that rather than employing investment banks or broker-dealers to provide brokerage services with respect to the acquisition and disposition of portfolio companies, some of which involved the purchase or sale of securities, the adviser performed these services in-house, "including soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions." For these and other violations, the Commission required the adviser and its principal to disgorge $2.3 million, pay prejudgment interest of $284,000, and pay a civil money penalty of $500,000.

An SEC administrative law judge found that an investment adviser that solicited investors and received transaction-based compensation for the sale of certain bonds was required, but failed, to register as a broker-dealer.[75] The opinion stated that transaction-based compensation is the "hallmark" of being a broker. Further, "Although brokers may be exempt from registering as investment advisers if their advisory activity is 'solely incidental' to their brokerage business, investment advisers are not similarly exempt from registering as brokers

[72] Investment Advisers Act Release No. 4555 (Oct. 18, 2016).

[73] In prior years, the SEC and Department of Justice brought many other cases against foreign entities that solicited U.S. investors to enter into transactions designed to hide assets from U.S. tax authorities. A number of these resulted in very large fines.

[74] Investment Advisers Act Release No. 4411 (June 1, 2016).

[75] Initial Decision Release No. 935 (Jan. 4, 2016).

when, in connection with their advisory business, they act as brokers." The administrative law judge required disgorgement of $15,000 and a civil money penalty of $15,000.

*TAKEAWAY: JUST AS U.S. ADVISERS DOING BUSINESS OUTSIDE THE U.S. MUST COMPLY WITH THE REGISTRATION REQUIREMENTS IN THE COUNTRIES IN WHICH THEY DO BUSINESS, SO TOO NON-U.S. ENTITIES DOING BUSINESS IN THE U.S. MUST COMPLY WITH U.S. REGISTRATION REQUIREMENTS; IN ADDITION, U.S. INVESTMENT ADVISERS THAT RECEIVE TRANSACTION-BASED COMPENSATION WILL OFTEN NEED TO REGISTER AS BROKER-DEALERS.*

## 12. MISAPPROPRIATION

In 2016, the Commission brought more than a dozen cases alleging that investment advisers, their principals or their employees misappropriated funds from their clients—for example, by using the employee's signature authority over accounts to transfer assets into their personal accounts, by charging for services that the clients neither authorized nor received, by "borrowing" money from clients without authorization, or by engaging in Ponzi schemes in which returns for earlier clients were paid with funds provided by new clients. [76] These cases are often accompanied by parallel criminal proceedings and result in substantial prison sentences in addition to industry bars, orders for disgorgement, and civil money penalties. We mention these cases here only to note that they exist.

*TAKEAWAY: ADVISERS SHOULD ANTICIPATE THAT SOME EMPLOYEES MAY SEEK TO TAKE ADVANTAGE OF THEIR POSITIONS AND SHOULD HAVE PROCEDURES IN PLACE THAT ARE REASONABLY DESIGNED TO PREVENT AND DETECT THEFT OR OTHER MISUSE OF CLIENT FUNDS.*

## 13. CUSTODY VIOLATIONS

Investment advisers are expected to protect client assets over which they have custody. They are deemed to have custody if they hold the assets or have the ability to obtain possession of the assets.[77] An adviser who has custody must, among other things, i) maintain client funds in a separate account for each client under that client's name (or in the adviser's name as agent or trustee for the clients), ii) notify each client of the custodian's name and address and the manner in which the assets are maintained, iii) have a reasonable basis for believing that the custodian sends account statements directly to each client at least quarterly, and iv) have an independent public accountant perform a surprise examination of the funds and securities over which custody is maintained at least once each calendar year. The Commission considers compliance with the custody rule to be one of the primary safeguards against misappropriation or misuse of client assets.

[76] *E.g.*, SEC Complaint in SEC v. Onix Capital LLC, et al., Case No. 16-24678 (S.D. Fl., filed Nov. 8, 2016); Litigation Release No. 23654 (Sept. 26, 2016); Investment Advisers Act Release No. 4360 (Mar. 30, 2016); Investment Advisers Act Release No. 4483 (Aug. 15, 2016); Initial Decision Release No. 987 (Mar. 29, 2016); Investment Advisers Act Release No. 4440 (June 28, 2016); Investment Advisers Act Release No. 4361 (Apr. 5, 2016).

[77] 17 C.F.R. § 275.206(4)-2(d)(2).

## The Year In Review
## SEC Enforcement Actions Against Investment Advisers

The Commission brought a settled administrative proceeding against an investment adviser that had an employee who had full signatory authority over certain trust accounts.[78] The Commission stated that because the employee had signatory authority, the adviser had custody over those assets but failed to comply with the custody rule because it did not engage an independent public accountant to conduct a surprise examination of any of those accounts. For these and other violations, it required it to pay $21,000 in disgorgement (for funds that the employee stole) and a $70,000 civil money penalty.

The Commission brought a settled administrative proceeding against the owner/chief compliance officer of an investment adviser that had pooled investment vehicles as clients and that had custody over funds and securities of its advisory clients.[79] The Commission stated that he did not have familiarity with the custody rule and, for a significant period of time, failed to determine which clients securities were subject to the rule, failed to ensure that the securities were maintained by a qualified custodian, and did not adequately obtain a surprise examination of custody of client funds and securities by an independent public accountant. The Commission imposed an industry bar with a right to apply for reentry after one year and a civil money penalty of $45,000.

An SEC administrative law judge, following an offer of settlement, found that an investment adviser to pooled investment vehicles violated the custody rule.[80] Advisers to pooled investment vehicles are permitted to distribute audited financial statements in lieu of complying with the surprise audit requirement. The adviser, however, failed to distribute audited financials for ten funds over a three-year period despite having previously been warned by the SEC staff about its failure to comply with the rule. The Commission imposed a $1 million civil money penalty on the adviser and two of its principals, required the adviser to accept a number of undertakings designed to ensure compliance with the custody rule, required the adviser to pay $15,000 per day for each of the ten funds if it failed to comply with the undertakings as to those ten funds, and suspended the adviser (and two individuals) from acting as investment adviser to any new clients for twelve months.

The Commission filed an administrative proceeding against an investment adviser that sold royalty units granting the purchasers a right to a certain percentage of the adviser's cash receipts, which were paid on a quarterly basis. [81] The Commission stated that the amounts accrued but unpaid were client assets subject to the custody rule, but that the adviser did not treat them as such. The matter is in litigation.

*TAKEAWAY: CUSTODY IS BROADLY DEFINED AND ADVISERS THAT HAVE CUSTODY OF CLIENT ASSETS NEED TO CAREFULLY COMPLY WITH ALL REQUIREMENTS OF THE COMMISSION'S CUSTODY RULE, INCLUDING ANNUAL SURPRISE EXAMINATIONS.*

### 14. SAFEGUARDING CLIENT INFORMATION

Rule 30(a) of Regulation S-P (17 C.F.R. § 248.30(a)), which applies to both investment advisers and broker-dealers, requires firms to adopt written policies and procedures

[78] Investment Advisers Act Release No. 4483 (Aug. 15, 2016).
[79] Investment Advisers Act Release No. 4368 (Apr. 14, 2016).
[80] Investment Advisers Act Release No. 4273 (Nov. 19, 2015).
[81] Investment Advisers Act Release No. 4389 (May 19, 2016).

reasonably designed to: i) ensure the security and confidentiality of customer records and information; ii) protect against any anticipated threats to the security or integrity of customer records and information; and iii) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

The SEC is highly focused on cybersecurity threats. In 2016 SEC Chair Mary Jo White called cybersecurity the "biggest risk facing the financial system."[82] The Division of Investment Management previously issued cybersecurity guidance for investment advisers.[83] The guidance stated that firms may wish to consider the following steps, to the extent that they are relevant, in addressing cybersecurity risk:

- Conduct a periodic assessment of: (1) the nature, sensitivity and location of information that the firm collects, processes and/or stores, and the technology systems it uses; (2) internal and external cybersecurity threats to and vulnerabilities of the firm's information and technology systems; (3) security controls and processes currently in place; (4) the impact should the information or technology systems become compromised; and (5) the effectiveness of the governance structure for the management of cybersecurity risk. An effective assessment would assist in identifying potential cybersecurity threats and vulnerabilities so as to better prioritize and mitigate risk.
- Create a strategy that is designed to prevent, detect and respond to cybersecurity threats. Such a strategy could include: (1) controlling access to various systems and data via management of user credentials, authentication and authorization methods, firewalls and/or perimeter defenses, tiered access to sensitive information and network resources, network segregation, and system hardening; (2) data encryption; (3) protecting against the loss or exfiltration of sensitive data by restricting the use of removable storage media and deploying software that monitors technology systems for unauthorized intrusions, the loss or exfiltration of sensitive data, or other unusual events; (4) data backup and retrieval; and (5) the development of an incident response plan. Routine testing of strategies could also enhance the effectiveness of any strategy.
- Implement the strategy through written policies and procedures and training that provide guidance to officers and employees concerning applicable threats and measures to prevent, detect and respond to such threats, and that monitor compliance with cybersecurity policies and procedures. Firms may also wish to educate investors and clients about how to reduce their exposure to cybersecurity threats concerning their accounts.

Despite the SEC's focus on cybersecurity procedures, it brought only one significant cybersecurity case against an investment adviser in 2016. The Commission brought a settled administrative proceeding against a dually registered investment adviser/broker-dealer, one of whose employees (a client service associate) misappropriated data (names, phone numbers, account numbers, securities holdings) regarding approximately 730,000 customer accounts by accessing information on two of the firm's portals over a multi-year period, and then tried to sell the stolen data.[84] The order stated that the firm's procedures were

[82] See Lisa Lambert and Suzanne Barlyn, "SEC Says Cybersecurity Biggest Risk to Financial System," Reuters (May 18, 2016).
[83] SEC Investment Management Guidance Update No. 2015-02, "Cybersecurity Guidance," (Apr. 2015).
[84] Investment Advisers Act Release No. 4415 (June 8, 2016).

inadequate because they failed to restrict employee access to confidential customer data to persons who had a legitimate business need to know that information and did not monitor and analyze employee access to the use of the portals. The Commission imposed a $1 million civil money penalty.

*TAKEAWAY: EXPECT GREATER SCRUTINY OF THE ADEQUACY OF CYBERSECURITY SAFEGUARDS GOING FORWARD.*

## 15. BUSINESS CONTINUITY

The SEC did not bring any enforcement actions against investment advisers related to business continuity in 2016, but we mention it here because in June 2016 it proposed a rule that would require investment advisers to adopt and implement "written business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption of the investment adviser's operations."[85] The proposed rule is intended to address, among other risks, technological failures with respect to systems and processes (whether proprietary or provided by third-party vendors) and the loss of adviser or client data, or access to the adviser's physical location and facilities. These might be due to, for example, a weather-related emergency or a cyber-attack. We mention it here because in the future failure to adopt and implement reasonable business continuity plans may result in enforcement actions.

*TAKEAWAY: GOING FORWARD, BUSINESS CONTINUITY PLANS ARE LIKELY TO RECEIVE MORE ATTENTION FROM THE ENFORCEMENT DIVISION.*

## 16. FOREIGN CORRUPT PRACTICES ACT VIOLATIONS

The Commission brought only one Foreign Corrupt Practices Act ("FCPA") action against an investment adviser in 2016, but it was one of the SEC's largest FCPA cases ever and (along with a parallel action brought by the Department of Justice) resulted in disgorgement and a fine of $412 million and additional fines against the CEO and CFO.[86] The government found that a hedge fund and its affiliated investment adviser used intermediaries, agents, and business partners to pay bribes to high-level government officials in Africa in order to obtain business from sovereign wealth funds, and that they violated anti-bribery, books and records, and internal controls provisions of the FCPA. The SEC also fined the CEO and the CFO. In announcing the settlement, the chief of the SEC's Enforcement Division's FCPA Unit said, "Firms will be held accountable for their misconduct no matter how they might structure complex transactions or attempt to insulate themselves from the conduct of their employees or agents."

[85] Investment Advisers Release No. 4439 (June 28, 2016).

[86] Investment Advisers Act Release No. 4540 (Sept. 29, 2016).

## The Year In Review
## SEC Enforcement Actions Against Investment Advisers

*TAKEAWAY: CORPORATE BRIBERY CAN LEAD TO EXTREMELY SEVERE SANCTIONS BY BOTH THE SEC AND THE DEPARTMENT OF JUSTICE.*

### 17. FIRM PROCEDURES AND INDIVIDUAL SUPERVISION

SEC Rule 206(4)-7 requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act, to review the adequacy of the policies and procedures at least annually, and to designate an individual (who is a supervised person) responsible for administering the policies and procedures. In addition, Section 204A of the Investment Advisers Act requires every investment adviser to maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information in violation of the securities laws. Finally, Section 203(e)(6) of the Investment Advisers Act authorizes the Commission to bring an action against any person who has failed "reasonably to supervise, with a view to preventing violations…another person who commits such a violation, if such other person is subject to his supervision." The statute provides that a person shall not be deemed to have failed reasonably to supervises if: i) procedures have been established and enforced that would reasonably be expected to prevent and detect the violation, and ii) the supervisor has reasonably discharged the duties and obligations incumbent upon him or her without reason to believe that the procedures were not being followed. Supervisory charges may be brought against a firm or an individual.

a. Procedures Not Reasonably Designed to Prevent Violations

Many of the Commission's actions against investment advisers involve findings that the adviser failed to establish and enforce written policies and procedures reasonably designed to have prevented violations. For example, in 2016 the Commission found that:

- an investment adviser to mutual funds failed to establish policies and procedures reasonably designed to prevent the misuse of material nonpublic information (even though it did not charge any such misuse) in connection with the firm's use of outside consultants;[87]
- an investment adviser that used round-lot prices to value odd-lot positions in certain mortgage-backed securities did not have procedures reasonably designed to prevent valuation issues related to odd-lot pricing because, among other reasons, they failed to provide sufficient guidance to traders about when to elevate significant pricing issues, such as odd-lot pricing, to the adviser's pricing committee or the fund's valuation committee;[88]
- an investment adviser whose employee used his signatory authority over trust accounts failed to establish policies and procedures reasonably designed to prevent employee withdrawals from client accounts;[89]
- an investment adviser that charged unauthorized fees and improperly used fund assets failed to adopt and implement reasonably designed compliance policies and procedures

[87] Investment Advisers Act Release No. 4401 (May 27, 2016).
[88] Investment Advisers Act Release No. 4577 (Dec. 1, 2016).
[89] Investment Advisers Act Release No. 4483 (Aug. 15, 2016).

to prevent violations related to the improper use of fund assets, undisclosed receipt of fees, or conflicts of interest arising from its principal's supervisory role;[90]

- an investment adviser that failed to obtain information regarding how frequently a sub-adviser in a "wrap fee" program "traded away" failed to adopt and implement policies and procedures related to trading commissions charged to advisory clients;[91]
- an investment adviser that overcharged clients in a wrap fee account program and engaged in principal transactions without obtaining prior written consent from clients failed to adopt policies and procedures reasonably designed to ensure that advisory clients' fees were calculated as represented and failed to implement policies and procedures regarding appropriate disclosure to and consent from its clients to transactions effected on a principal basis;[92]
- an investment adviser whose employee stole customer records and information failed to adopt written policies and procedures reasonably designed to protect customer records and information;[93]
- a private equity fund investment adviser that failed to disclose that it charged accelerated monitoring fees failed to adopt and implement written policies and procedures reasonably designed to address the undisclosed receipt of accelerated monitoring fees and failed to implement its policies and procedures concerning employees' reimbursement of expenses;[94]
- a private equity fund investment adviser that allocated certain expenses to the funds without making appropriate disclosures and negotiated a legal fee discount from a law firm for itself but not for the funds failed to adopt and implement policies and procedures reasonably designed to prevent these violations;[95]
- an investment adviser to mutual funds that mis-valued certain bonds failed to properly implement policies and procedures related to valuation and error correction and failed to establish appropriate controls related to its reliance on a third-party analytical tool in fair valuing securities.[96]

b. Failure-to-Supervise Actions Against Individuals

The Commission also brought actions against individuals for failure to supervise. In 2016 enforcement actions, the Commission found that:

- the founder/owner of what had been one of the largest hedge funds in the world failed reasonably to supervise a former portfolio manager who engaged in insider trading.[97] The Commission stated that the portfolio manager provided information to the owner that should have caused him to investigate whether the portfolio manager had access to inside information to support his trading. The Commission's order prohibited the owner

---

[90] Investment Advisers Act Release No. 4411 (June 1, 2016).

[91] Investment Advisers Act Release No. 4525 (Sept. 8, 2016).

[92] Investment Advisers Act Release No. 4441 (June 28, 2016); *See also, e.g.*, Investment Advisers Act Release No. 4534 (Sept. 23, 2016).

[93] Investment Advisers Act Release No. 4415 (June 8, 2016).

[94] Investment Advisers Act Release No. 4493 (Aug. 23, 2016).

[95] Investment Advisers Act Release No. 4529 (Sept. 14, 2016).

[96] Investment Advisers Act Release No. 4554 (Oct. 18, 2016).

[97] Investment Advisers Act Release No. 4307 (Jan. 8, 2016).

from supervising funds that manage outside money until 2018. In a separate proceeding, the employee was sentenced to nine years' imprisonment; his appeal is pending;

- a senior research analyst at an investment adviser that advised multiple hedge funds failed reasonably to supervise a research analyst who obtained material nonpublic information from an insider at a public company.[98] The Commission stated that when the employee shared the information with his supervisor, that should have caused a reasonable supervisor to question whether he had improperly obtained material nonpublic information from a corporate insider. The Commission suspended the supervisor from the securities industry for 12 months, and ordered him to pay a civil money penalty of $130,000. In a separate proceeding, the employee who obtained the information was sentenced to five years' imprisonment;
- the firm's founder/chief compliance officer failed reasonably to supervise an employee who misappropriated approximately $137,000 from trust entities' accounts.[99] The order stated that although he was responsible for the firm's supervisory functions, he did not conduct an adequate review of the employee's withdrawals from the trust account and, instead, primarily relied on the employee's oral representations concerning these activities;
- a regional director failed reasonably to supervise an employee who misappropriated approximately $309,000 in financial planning fees from at least 47 advisory clients.[100]

Although not a supervisory case, the Commission's decision barring the former chief compliance officer of the Stanford Group Company, a dually-registered investment adviser and broker-dealer that engaged in a multi-billion dollar Ponzi scheme, also merits consideration.[101] The compliance officer had an impressive background. He had served almost two decades as a senior regulator with the National Association of Securities Dealers, including as director of its Dallas district office. In a case that was fully litigated, the Commission found that he approved fraudulent marketing materials without conducting adequate due diligence, he failed to conduct a "responsive investigation" after learning that the SEC and others were investigating the firm, he failed to adequately investigate concerns raised by investors, and he drafted reassuring talking points without verifying the information in those talking points. The Commission rejected the defense that he acted in good-faith reliance on firm officials, outside professionals, and regulators. It stated that he "approved material misrepresentations without verifying them or establishing any reasonable or independent basis for relying on verification by others" and that "despite his awareness of ever-increasing red flags, he approved additional misleading statements to placate concerns, prevent redemptions, and encourage further sales." The Commission barred him from the industry and ordered him to disgorge over half the compensation that he received as the firm's chief compliance officer during the relevant period and imposed a civil money penalty of $260,000.

[98] Investment Advisers Act Release No. 4550 (Oct. 13, 2016).
[99] Investment Advisers Act Release No. 4483 (Aug. 15, 2016).
[100] Investment Advisers Act Release No. 4362 (Apr. 5, 2016).
[101] Investment Advisers Act Release No. 4358 (Mar. 24, 2016).

# The Year In Review
# SEC Enforcement Actions Against Investment Advisers

*TAKEAWAY: POLICIES AND PROCEDURES ARE CRITICAL TO AVOIDING SUPERVISORY CHARGES AGAINST BOTH THE FIRM AND INDIVIDUALS; WHENEVER AN INDIVIDUAL VIOLATES THE SECURITIES LAWS, EXPECT THE ENFORCEMENT STAFF TO ASK: DID THE FIRM'S POLICIES REASONABLY ADDRESS THE CONDUCT AT ISSUE, WERE THE POLICIES ENFORCED, AND WHERE WERE THE SUPERVISORS.*

## 18. KEY QUESTIONS FIRMS SHOULD ASK

The above enforcement actions suggest a number of questions that investment advisers should consider in connection with their supervisory and compliance programs. Without attempting to be comprehensive,[102] we suggest the following:

1. Have they identified all material conflicts of interest, including those that might only "unconsciously" affect an investment decision—for example, are all sources of compensation and other benefits identified?
2. Have they decided which conflicts to eliminate, and which to disclose?
3. Are the conflict disclosures accurate and sufficiently detailed—for example, do the disclosures say that a conflict "may" exist when they should say that it "does" exist, or say that a firm "may" be receiving certain types of compensation when it "is" receiving those types of compensation?
4. Have advisers to municipalities taken steps to ensure any conflicts are disclosed to municipalities?
5. Have advisers to private equity funds reviewed whether their compensation from portfolio companies has been adequately disclosed?
6. Do advisers to private equity funds receive discounts from their vendors, including law firms, that are not also provided to their clients? If so, has that been disclosed?
7. Do advisers to private equity funds received accelerated monitoring fees and, if so, have they disclosed that fact?
8. Do the methods for calculating an adviser's fees conform to the descriptions to clients—for example, are the fees based on the notional trading value of assets (including leverage) when the disclosures state that the fees are based on the net asset value?
9. Are charges associated with "trading away" adequately quantified and disclosed to customers in wrap fee programs?
10. Have there been material changes to a wrap fee program and, if so, have the disclosures been updated?
11. Are the fees suitable for clients? How does the adviser address clients who pay an advisory fee but rarely trade, or clients who actively trade but pay commissions rather than advisory fees?

[102] We have not, for example, included issues that investment advisers need to address as a result of the Department of Labor's new fiduciary rule or other issues unrelated to the enforcement actions discussed above.

## The Year In Review
## SEC Enforcement Actions Against Investment Advisers

12. What processes does the adviser have in place to ensure that trade allocations are fair? When trades are placed in omnibus accounts, how quickly and on what basis are they allocated?
13. How does the firm allocate limited investment opportunities among different clients with overlapping investments?
14. How does the firm allocate expenses among clients and between clients and itself? Is the method of allocation adequately disclosed?
15. Do the firm's share class selections reflect what is in the best interests of clients or what is in the best interests of the adviser?
16. How does the firm select broker-dealers and monitor executions to determine whether investors are receiving best execution?
17. Does the firm trade with clients as principal or engage in agency cross trades? If so, what processes are in place to ensure that there is appropriate disclosure and client consent?
18. How does the firm address the unsettled state of the law on insider trading? Does it seek to acquire material nonpublic information and avoid trading only when it would result in a "breach of duty," or does it seek to avoid acquiring material nonpublic information in all circumstances?
19. Do the firm's insider trading procedures extend to persons other than employees—for example, consultants who work for the firm and who may come into possession of material nonpublic information?
20. How does the firm respond to indications that it may have received material nonpublic information?
21. How does the firm value hard to value securities, such as securities that are illiquid and do not have readily-available market quotes? Does its methodology distinguish between odd-lot and round-lot positions? Does the firm adequately disclose the valuation procedures and does it follow the procedures that are disclosed?
22. If the firm discovers that it mis-valued a significant position, how does it approach reimbursing investors who may have been harmed? Does it follow the error-correction disclosures it has made to investors?
23. What steps are in place to ensure that the firm's assets under management and performance history are accurate?
24. Does the firm verify the performance representations made by sub-advisers that it incorporates into its own statements?
25. Has the firm identified past misconduct by its principals or others involved in the investment process?
26. How is the information in the ADV verified?
27. If the firm is in serious financial distress, has that been disclosed to investors from whom it is soliciting business?

28. Has the firm changed its investment strategy from that disclosed to investors? If so, has that change been disclosed?

29. Are the firm's representations to the SEC, including in exemptive applications, are accurate?

30. Does the firm receive transaction-based compensation and, if so, is it registered as a broker-dealer?

31. If the firm is a foreign entity doing business in the U.S., has it complied with U.S. registration requirements? If the firm is a U.S. entity doing business outside the U.S., has it complied with the registration requirements in the countries in which it does business?

32. How does the firm protect against the risk of unethical employees, who may use their positions to misappropriate client assets?

33. How does the firm ensure that employees are providing the services for which they are charging clients?

34. How does the firm ensure that clients have authorized the services for which they are being charged?

35. Has the firm determined whether it has "custody" within the meaning of the SEC's custody rules? If so, does it provide for an annual surprise examination by an independent third party and comply with other aspects of the SEC's custody rule?

36. Has the firm complied with the SEC's cybersecurity advice designed to ensure the confidentiality of customer records and information and protect against unauthorized access to that information?

37. How does the firm respond when information is compromised? Does it disclose it to customers?

38. What procedures are in place to ensure business continuity if there are, for example, technological failures, a major hacking incident, or loss of access to the adviser's physical locations due to a hurricane or other weather-related emergency?

39. What steps does the adviser have in place to ensure that the adviser, its intermediaries, agents, and business partners do not pay bribes to government officials to secure business?

40. When suspicious activity comes to the attention of the firm, to what extent does the firm rely on the explanations of the employee and to what extent does it go beyond those explanations?

## CONCLUSION

The Commission's 2016 enforcement actions against investment advisers show that, at least in this area, history does repeat itself. A comparison of the 2016 cases to those brought in 2014-15 shows that, while a few types of enforcement actions brought in 2014 and 2015 did not show up in 2016,[103] there is a striking overlap from year to year, with a heavy focus on

[103] *See* articles cited in endnote 3 *supra*. Based on our review, it appears that Investments violating a public pension fund's statutory restrictions, disclosures of conflicts to a mutual fund's independent directors, improper use of mutual fund assets to pay for the distribution and marketing of fund shares, delays in compensating clients for errors, inadequate

conflicts of interest, fees and expense allocations, trade allocations, valuation, other disclosure violations, outright theft, and policies and procedures. The cases vary by type of adviser: private equity advisers are particularly at risk for fees and expense allocations because they are compensated by both clients and portfolio companies; hedge fund managers are particularly at risk for insider trading; and advisers to retail accounts are most at risk for failing to disclose conflicts of interest that might, consciously or unconsciously, undermine the objectivity of their advice. But, as the above review shows, all advisers are expected to provide sound investment advice, treat their clients honestly and fairly, perform their services competently, and accurately disclose material facts that might incline a client to choose to use their services or follow their advice.

The primary message from a review of the cases is found not in any particular action but in the breadth of the cases collectively: seventeen different categories of cases; cases against the largest advisers and the smallest advisers; cases against firms, principals, supervisors and individual employees; cases against hedge fund advisers, private equity advisers, municipal advisers, and advisers to retail accounts; cases against persons deliberately abusing their positions of trust and cases against persons acting in complete good faith; cases in which the violations had a large impact on investors and cases in which there was no impact at all; a case in which the government imposed over $400 million in sanctions and cases in which the fines were less than $50,000. The Commission uses enforcement as a tool not only to address the individual merits of particular cases, but to send a message to the rest of the industry about conduct that will lead to enforcement action if the Commission discovers it. That message is that the Commission's expectations are high across the board, and that it will use enforcement to address a wide range of alleged misconduct.

Will the Commission's aggressive enforcement program continue with a new chair and new commissioners under a new administration? It would not be surprising to see significant changes in the enforcement program—for example, there *might* be lower penalties on public companies, fewer "broken-window" type cases, additional process safeguards at the investigation stage, a more receptive forum in which to challenge the merits of staff recommendations, a greater receptivity to arguments against using enforcement as a form of rulemaking, a greater ability to litigate in court rather than administratively, and less controversy about granting waivers from automatic disqualifications that often arise from enforcement actions. The vast majority of cases discussed above, however, would not be affected by these types of changes.

Moreover, it was not that long ago that the Commission was subject to widespread bipartisan attack for not being aggressive enough.[104] It is doubtful that new leadership will want to seriously weaken an enforcement program whose credibility took significant bipartisan hits after i) accounting scandals at some of the largest companies in the United States, including Enron and WorldCom, which led to billions of dollars of losses after those companies filed for

---

compliance resources, pay-to-play violations, and whistleblower retaliation led to enforcement actions against investment advisers in 2014-2015 but not in 2016. That is likely due to the facts that came to the staff's attention in 2016 rather than to any change in approach to these issues.

[104] Between 2007 and 2009, favorable ratings of the SEC in two Harris polls dropped from 71% to 29%, while the percentage of the public rating the SEC's performance as poor rose from 25% to 72%. "By a wide margin," the Harris organization stated, this was "the biggest change in an agency's ratings since these questions were first asked in 2000." Indeed, the SEC's 29% positive rating was a full 15 points worse than even the second lowest rated agency in the survey. A 2015 Harris poll, however, revealed a 20-point rise in the SEC's positive ratings, by far the largest positive change in any agency's ratings. *See* The Harris Poll, "U.S. Mint & FAA Receive Highest Ratings of 17 Government Agencies," (Feb. 26, 2015).

bankruptcy; ii) trillions of dollars of losses from the bursting of the Internet bubble, which led to the Nasdaq market losing nearly 80% of its value; iii) the largest Ponzi scheme in history, which the SEC failed to detect despite abundant red flags that were brought to its attention; and iv) a near global depression following the 2008 financial crisis, in which the SEC was perceived as being particularly ineffective. No one wants a return to the days when Rep. Gary L. Ackerman (D-N.Y.) said: "I want to know who is responsible for protecting the securities investor because I want to tell that person or those people whose job it is that they suck at it." [105]

At this point, no one knows whether the next SEC chair and commissioners will be inclined to moderate some of the harsher aspects of the enforcement program and, if so, whether they will be successful at accomplishing that goal. Richard Breeden, a Republican SEC chair appointed by a Republican president, famously said that he wanted to see defendants in SEC enforcement actions left "naked, homeless and without wheels," hardly a sign of a kinder, gentler SEC under a Republican administration.[106] And there is the risk that if the Commission were to become less active, states such as New York and Massachusetts would step in more aggressively to fill the gap.

Given all of these dynamics, investment advisers are well advised to assume that the enforcement program will continue to generate the same types of cases in the future that it generated in 2016 and before and to address the wide range of issues that led to the enforcement actions discussed above.

[105] *See* Zachary A. Goldfarb, "SEC Broadens Its Probe of Failures in Madoff Case," The Washington Post (Jan. 6, 2009).
[106] *See* Donald C. Langevoort, "On Leaving Corporate Executives 'Naked, Homeless and Without Wheels': Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability," 42 Wake Forest L. Rev. 627 (2007).

# The Year In Review
# SEC Enforcement Actions Against Investment Advisers

**Author:**

**Jon Eisenberg**
jon.eisenberg@klgates.com
+1.202.778.9348

K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha Dubai
Fort Worth Frankfurt Harrisburg Hong Kong Houston London Los Angeles Melbourne Miami Milan Munich Newark New York
Orange County Palo Alto Paris Perth Pittsburgh Portland Raleigh Research Triangle Park San Francisco São Paulo Seattle
Seoul Shanghai Singapore Sydney Taipei Tokyo Warsaw Washington, D.C. Wilmington

K&L Gates comprises approximately 2,000 lawyers globally who practice in fully integrated offices located on five continents. The firm represents leading multinational corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit www.klgates.com.