Robinson+Cole

2019 Investment Adviser Update

Make Sure You Don't Have a "Communication Breakdown"

The rules and regulations governing private equity and hedge fund advisers continue to develop in response to changes in technology, particularly in the areas of social media and cybersecurity. As a result, advisers become subject to an ever-increasing degree of supervision by the Securities and Exchange Commission (SEC) and self-regulatory organizations. This update summarizes some of the most important developments during the past year. We will look at some significant recent regulatory developments, focus on SEC examination priorities, and then review certain recent SEC enforcement actions.

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RECENT REGULATORY DEVELOPMENTS AND GUIDANCE THAT MAY AFFECT AN ADVISER'S COMPLIANCE PROGRAM

The following regulatory developments may affect the compliance programs of certain advisers. Advisers may want to consider reviewing these and other changes in applicable laws, rules, regulations and/or SEC staff guidance to determine whether compliance policies and procedures need to be added or revised.

Guidance Regarding Electronic Communications and Social Media

In a recent Risk Alert,[1] the SEC's Office of Compliance Inspections and Examinations (OCIE) noted that it had conducted a limited-scope examination initiative of Registered Investment Advisers (RIA) designed to obtain an understanding of the various forms of electronic messaging used by advisers and their personnel, the risks presented by evolving forms of electronic communications, and the associated complications in complying with certain provisions of the Advisers Act of 1940, as amended (Advisers Act).[2] Specifically, OCIE noted that a number of changes in the way mobile and personally owned devices are used — including the increasing use of social media, texting and other types of electronic messaging apps and the pervasive use of mobile and personally owned devices for business purposes — pose challenges for advisers in meeting their obligations under Advisers Act Rule 204-2 (the Books and Records Rule) and Advisers Act Rule 206(4)-7 (the Compliance Rule).

During the initiative, the staff observed a range of practices with respect to electronic communications, including advisers not conducting any testing or monitoring to ensure compliance with firm policies and procedures. The Risk Alert lists a number of suggested practices observed and identified by the staff that OCIE believes may assist advisers in meeting their record retention and compliance obligations.
Examples include:

- permitting only those forms of electronic communications that the adviser determines can be used in compliance with the requirements of the Books and Records Rule;

- prohibiting business use of apps and other technologies that can be readily misused by allowing an employee to communicate anonymously, allowing for automatic destruction of messages or preventing third-party viewing or backup;

- adopting and implementing policies and procedures for the monitoring, review and retention of electronic communications if an adviser permits its personnel to use social media, personal email accounts or personal websites for business purposes;

- requiring employee training on the adviser's policies and procedures regarding prohibitions and limitations placed on the use of electronic messaging and electronic apps; and

- soliciting feedback from employees regarding what forms of messaging are requested by clients and service providers so that the adviser can assess the risks involved and how those forms of communication might be incorporated into the adviser's policies.

OCIE also suggested that an adviser that permits use of social media, personal email or personal websites for business purposes consider contracting with software vendors to (i) monitor the social media posts, emails or websites; (ii) archive such business communications to ensure compliance with record retention rules; and (iii) ensure that the adviser has the capability to identify any changes to content and compare postings to a lexicon of key words and phrases.

Advisory Fee and Expense Compliance Issues

A Risk Alert issued in April 2018[3] addresses deficiencies relating to fees and expenses charged by RIAs that were most frequently identified in OCIE exams, which include, among others:

- *Disclosure Issues Involving Advisory Fees*. Staff observed, for example, advisers that did not disclose certain additional fees or markups in addition to advisory fees, such as fee-sharing arrangements with affiliates.

- *Adviser Expense Misallocations*. Staff observed advisers to private and registered funds that misallocated expenses to the funds. For example, certain advisers allocated distribution and marketing expenses, regulatory filing fees and travel expenses to clients instead of to the adviser, in contravention of the applicable advisory agreements, operating agreements or other disclosures.

- *Fee-Billing Based on Incorrect Account Valuations*.

- *Omitting Rebates and Applying Discounts Incorrectly*.

Best Execution Guidance

In a July 2018 Risk Alert,[4] OCIE described many of the most common deficiencies identified by staff in recent adviser examinations in connection with the best execution obligations of advisers. Examples include:

- Not performing best execution reviews. The staff observed advisers that could not demonstrate that they periodically and systematically evaluated the execution performance of broker-dealers used to execute client transactions.

- Not considering materially relevant factors during best execution reviews. The staff observed advisers that did not consider the full range and quality of a broker-dealer's services in directing brokerage and failed to solicit and review input from the firm's traders and portfolio managers.

- Not seeking comparisons with other broker-dealers. The staff observed advisers that used certain broker-dealers without seeking out or considering the quality and costs of services available from other broker-dealers. The staff noted that certain advisers used a single broker-dealer for all clients without seeking comparisons from competing broker-dealers initially and/or on an ongoing basis to assess their chosen broker-dealer's execution performance.

- Failing to adequately disclose the use of soft dollar arrangements. For example, some advisers did not provide adequate disclosure regarding products and services acquired with soft dollars that did not qualify as eligible brokerage and research services under the Securities Exchange Act of 1934 (the Exchange Act) Section 28(e) safe harbor.

Further Guidance Regarding "Inadvertent Custody"

In February 2017, the SEC's Division of Investment Management released a Guidance Update regarding "inadvertent custody" — that is, a situation in which an RIA has authority to transfer client assets from a client's custodial account based on broad authority indicated in the client's agreement with its custodian to which the RIA is not a party (the February 2017 Guidance).[5] The February 2017 Guidance warned that a custodial agreement between a client and its custodian that permits the custodian to accept instructions from an RIA to transfer assets from the custodial account for any purpose other than authorized trading establishes the RIA's custody of such assets.

On June 5, 2018, the SEC staff added two new frequently asked questions (FAQs) to the SEC's FAQs about the Custody Rule that substantially modified the position taken by the staff in the February 2017 Guidance:[6]

- New FAQ II.11 states that an RIA that does not have a copy of a client's custodial agreement — and does not know, or have reason to know, whether the agreement would give the adviser inadvertent custody — need not comply with the Custody Rule with respect to that client's account if inadvertent custody would be the sole basis for custody. The relief is not available, however, where the adviser recommended, requested or required a client to engage the particular custodian. FAQ II.11 does not address the requirements for RIAs that, but for performing due diligence in response to the February 2017 Guidance, would not have known or have had reason to know whether a client's custodial agreement would give the RIA inadvertent custody.

- New FAQ II.12 clarifies SEC treatment of an RIA that has the authority to deduct fees from a client account and/or check-writing authority under the same circumstances presented in FAQ II.11. If pertinent, the RIA may (i) rely on the fee deduction exception (i.e., not obtain a surprise examination for the account) and (ii) complete its Form ADV accordingly (i.e., not report the account as one for which the RIA has custody). The RIA must comply with all other aspects of the Custody Rule. FAQ II.12 also reiterates that an RIA must comply fully with the Custody Rule (including obtaining a surprise examination) with respect to any accounts for which it has check-writing authority.

Some industry participants have noted that language in an endnote to the February 2017 Guidance could be read as raising possible questions regarding whether all transactions must settle on a delivery-versus payment (DVP) basis in order for an adviser to rely on the staff's position that "authorized trading" does not itself constitute custody. Such an interpretation would be problematic for many advisers, as certain types of securities commonly traded in client accounts do not settle on a DVP basis. The new FAQs do not address the issue, and the intent of the language in the February 2017 Guidance remains unclear. Adviser industry groups continue to engage the SEC staff in discussions regarding this issue.

Cash Solicitation Rule Guidance

A Risk Alert issued in October 2018 highlights the topics related to Advisers Act Rule 206(4)-3 (the Cash Solicitation Rule) most frequently associated with deficiencies identified in OCIE exams of RIAs. The compliance deficiencies include, among others:

- *Solicitor disclosure documents*. Some advisers used third-party solicitors that did not provide solicitor disclosure documents to prospective clients or provided solicitor disclosure documents that did not contain all required information.

- *Client acknowledgements*. Some advisers did not receive in a timely manner a signed and dated client acknowledgement of receipt of the adviser brochure and solicitor disclosure document.

- *Solicitation agreements*. Certain advisers paid cash fees to a solicitor without a solicitation agreement in effect or pursuant to an agreement that did not contain certain specific provisions required by the Cash Solicitation Rule.

- *Bona fide efforts to ascertain solicitor compliance*. Staff observed advisers that did not make a bona fide effort to ascertain whether third-party solicitors complied with solicitation agreements and appeared to not have a reasonable basis for believing that the third-party solicitors so complied.

Similar conflicts that technically are not subject to the Cash Solicitation Rule may implicate other provisions of the Advisers Act, such as the anti-fraud provisions of Sections 206(1) and 206(2). For example, OCIE observed advisers that recommended service providers to clients in exchange for client referrals without full and fair disclosure of the conflicts of interest.

SEC EXAMINATION PRIORITIES FOR 2019

On December 20, 2018, OCIE released its report (the 2019 Exam Priorities Report) setting forth its list of examination priorities for 2019 (the Exam Priorities) for various regulated entities, including investment advisers.[7] OCIE announces its exam priorities annually to provide insights into the areas it believes present potentially heightened risk to investors or the integrity of the U.S. capital markets.[8] The Exam Priorities can serve as a roadmap to assist advisers in assessing their policies, procedures and compliance programs; testing for and remediating any suspected deficiencies related to the Exam Priorities; and preparing for OCIE exams. Advisers may want to consider reviewing their current policies, procedures and client disclosures with these priorities in mind. Exempt Reporting Advisors (ERA), as well as RIAs, are subject to SEC examination, although the SEC has indicated that it does not expect to examine ERAs on a routine basis.

The number of investment advisers examined by OCIE has increased significantly in recent years. In fiscal year (FY) 2018, the OCIE National Exam Program examined approximately 17 percent of RIAs, up from 15 percent during FY 2017 and 11 percent during FY 2016. Just five years ago, nine percent of RIAs were examined. Examinations of registered investment companies (RICs) were also up during FY 2018, increasing by approximately 45 percent.[9]

OCIE's current examination priorities, as outlined in the 2019 Exam Priorities Report, reflect both perennial risk areas that have been emphasized in recent years as well as risks associated with developing products and services. The priorities are organized around six themes: (a) retail investors, including seniors and those saving for retirement; (b) compliance issues and risks associated with entities responsible for critical market infrastructure, including clearing agencies, national securities exchanges, the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), transfer agents and other Regulation Systems Compliance and Integrity (Regulation SCI) entities (i.e., entities required to comply with Regulation SCI); (c) select areas and programs of FINRA and MSRB; (d) digital assets, including cryptocurrencies, coins and tokens; (e) cybersecurity; and (f) anti-money-laundering programs of financial institutions that are required by regulations adopted under the Bank Secrecy Act to establish such programs.

Exams are Risk-Based and Data-Driven

OCIE notes in the 2019 Exam Priorities Report that while the Exam Priorities provide a preview of key areas in which OCIE intends to focus its limited resources and will drive many of OCIE's examinations, they do not encompass all of the areas that will be covered in exams. As explained in the 2019 Exam Priorities Report, the scope of any examination is determined through a risk-based approach that includes analysis of the registrant's operations, products offered, and other factors. The 2019 Exam Priorities Report emphasizes that this risk-based approach, both in selecting registered entities to examine and determining the scope of risk areas to examine, "remains flexible in order to cover emerging and exigent risks to investors and the marketplace as they arise." To this end, "OCIE is increasingly leveraging technology and data analytics as well as human capital to fulfill its mission."

Continued Focus on Retail Investors

The Exam Priorities continue OCIE's trend in recent years to prioritize the protection of retail investors, particularly seniors and those saving for retirement. According to the 2019 Exam Priorities Report, in examinations of investment advisers, OCIE will continue to review the services and products offered to these investors, focusing on, among other things, adviser compliance programs, the appropriateness of certain investment recommendations to seniors and the supervision by firms of their investment professionals and other employees.

In furtherance of its commitment to retail investors, OCIE will continue to prioritize the examination of mutual funds and exchange traded funds (ETFs), the activities of their advisers, and the oversight practices of their boards of directors. In the 2019 Exam Priorities Report, OCIE references previous examinations that identified advisers that selected more expensive mutual fund share classes for clients, when lower-cost share classes were available, without adequate disclosure to investors, and notes that in future exams, examiners will continue to evaluate financial incentives for financial professionals that may influence their selection of particular share classes.

With respect to mutual funds and ETFs, examiners also will focus on risks associated with (a) index funds that track custom-built or bespoke indexes; (b) ETFs with little secondary market trading volume and smaller assets under management; (c) funds with higher allocations to certain securitized assets; (d) funds with aberrational underperformance; (e) funds managed by advisers relatively new to managing RICs; and (f) advisers that provide advice to both RICs and private funds with similar investment strategies. OCIE also will continue to focus on investment advisers participating in wrap fee programs, with a continued interest in brokerage practices and the adequacy of disclosures.

Other Relevant Focus Areas

Many of the topics covered in the Exam Priorities, including those discussed primarily in the section on retail investors, are relevant not only to advisers with retail clients but also to advisers that advise other types of clients, including institutional clients and private funds. Focus areas include:

Disclosure of the Costs of Investing. OCIE stresses in the Exam Priorities that the proper disclosure and calculation of fees, expenses and other charges investors pay is critically important. Examiners will review, among other things, whether fees and expenses are calculated and charged in accordance with the disclosures provided to clients and investors and pertinent client agreements.

Conflicts of Interest. Examiners will focus on ensuring that investment advisers are acting in a manner consistent with their fiduciary duty and meeting their contractual obligations to their clients. The Exam Priorities include the following points, among others:

- A financial professional must inform investors of any conflicts of interest that might provide incentives for the professional to recommend certain types of products or services.

- OCIE will examine arrangements in which an investment adviser uses services or products provided by affiliated entities. These arrangements may present conflicts of interest related to, for example, portfolio management practices and compensation arrangements.

- Borrowing funds from clients presents a number of conflicts of interest for an investment adviser. Examiners observing this practice will evaluate whether adequate disclosures, including the potentially poor or failing financial condition of the adviser, are made to the client and the adviser has acted consistently with these disclosures.

Portfolio Management and Trading. OCIE notes in the 2019 Exam Priorities Report that an integral component of investment adviser exams is reviewing portfolio management processes. Examiners will review a firm's practices for executing investment transactions, fairly allocating investment opportunities among clients, ensuring consistency of investments with client objectives, disclosing critical information to clients, and complying with other legal restrictions.

OCIE also will examine portfolio recommendations to assess, among other things, whether an adviser's investment or trading strategies are (a) in the best interests of investors based on their investment objectives and risk tolerance; (b) contrary to, or have drifted from, disclosures to investors; (c) venturing into new, risky investments or products without adequate risk disclosure; and/or (d) appropriately monitored for attendant risks.

Digital Assets. The digital asset market, which includes cryptocurrencies, coins and tokens, has grown rapidly, and the number of investment advisers engaged in this space continues to expand as well. In the 2019 Exam Priorities Report, OCIE references investment adviser examinations that have identified emerging risks related to selling or recommending digital assets, such as concerns related to custody and safekeeping of investor assets, valuation, omitted or misleading disclosures regarding the complexities of the products and technology, and the risks of dramatic price volatility.

According to the Exam Priorities, OCIE will continue to monitor the sale, trading and management of digital assets and, in cases in which the products are securities, examine for regulatory compliance. In particular, OCIE will take steps to identify market participants involved with these products, or that are considering such involvement, and then assess the extent of their activities. For firms actively engaged in the digital asset market, OCIE will conduct examinations focused on, among other things, portfolio management and trading of digital assets, safety of client assets, pricing of client portfolios and compliance and internal controls.

Never-Before-Examined Investment Advisers. OCIE will continue to conduct risk-based examinations of certain investment advisers that have never been examined, including newly registered advisers as well as advisers registered for several years that have not yet been examined. OCIE also will prioritize examinations of certain investment advisers that have not been examined for a number of years and may have substantially grown or changed business models.

Cybersecurity. Cybersecurity remains a top SEC priority, and OCIE will continue to work with firms in all sectors to identify and manage cybersecurity risks. Examinations will focus on, among other things, proper configuration of network storage devices, information security governance generally, and policies and procedures related to retail trading information security. Specific to investment advisers, OCIE will emphasize cybersecurity practices at firms with multiple branch offices, including those that have recently merged with other advisers, and continue to focus on, among other areas, governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response.

RECENT ENFORCEMENT INITIATIVES AND PROCEEDINGS

The following is a summary of several recent enforcement actions of relevance to investment advisers.

Deficient Cybersecurity Procedures and Violations of the Identity Theft "Red Flags" Rule

A dually-registered broker-dealer and investment adviser recently settled SEC charges related to failures in its cybersecurity policies and procedures in connection with a cyberintrusion that compromised the personal information of thousands of customers.[10] Specifically, the SEC charged the firm with violating Rule 30(a) of Regulation S-P (the Safeguards Rule) and failure to develop and implement a written Identity Theft Prevention Program as required by Rule 201 of Regulation S-ID (the Red Flags Rule), which are designed to protect confidential customer information and protect customers from the risk of identity theft. This was the first SEC enforcement action charging violations of the Red Flags Rule.

According to the SEC's order, cyberintruders impersonated firm contractors over a six-day period in 2016 by calling the firm's support line and requesting that the contractors' passwords be reset. The intruders used the new passwords to gain access to the personal information of 5,600 of the firm's customers. The intruders then used the customer information to create new online customer profiles and obtain unauthorized access to account documents for three customers. As of the date of the order, there had been no known unauthorized transfers of funds or securities from customer accounts as a result of the attack.

The Safeguards Rule requires SEC-registered broker-dealers and RIAs to adopt written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information. According to the order, the firm violated the Safeguards Rule because its policies and procedures meant to protect customer information and to prevent and respond to cybersecurity incidents were not reasonably designed to meet these objectives. Among other things, the firm's policies and procedures with respect to resetting contractor representatives' passwords, terminating web sessions for contractor representatives, and identifying higher-risk representatives and customer accounts for additional security measures were not reasonably designed.

The Red Flags Rule requires SEC-registered broker-dealers and RIAs to develop and implement a written Identity Theft Prevention Program that is designed to detect, prevent and mitigate identity theft in connection with the opening of a covered account or any existing covered account. The SEC found that although the firm adopted a written Identity Theft Prevention Program in 2009, the firm violated the Red Flags Rule because it did not review and update the program in response to changes in risks to its customers, nor did it provide adequate training to its employees. In addition, the program did not include reasonable policies and procedures to respond to identity theft red flags, such as those detected by the firm during the 2016 intrusion.

Faulty and Untested Investment Models

The SEC announced settled administrative charges against an RIA and three of its affiliates (the Respondents) for, among other matters, misconduct involving faulty investment models.[11] According to the SEC's order, during the pertinent period the Respondents managed and sold 15 quantitative-model- based mutual funds, variable life insurance investment portfolios, and variable annuity investment portfolios (the registered investment company (RIC) Products), and separately managed account strategies (the SMA Strategies).

The SEC found that the RIA tasked a junior analyst, who had no experience in portfolio management or any formal training in financial modeling, with developing quantitative models for use in managing investment strategies. The RIA ultimately used these models to manage each of the RIC Products and SMA Strategies. The analyst did not follow any formal process to confirm the accuracy of his work, and the RIA failed to provide him with meaningful guidance, training or oversight as he developed the models. The SEC found that the RIA launched the RIC Products and the SMA Strategies without first confirming that the models worked as intended and/or without disclosing any risks associated with using the models.

According to the SEC's order, after using the models for several years, the RIA determined that certain of the models contained material errors. Ultimately, more than 50 errors were discovered, including incorrect calculations, inconsistent formulas and the use of numerical amounts where percentages were intended (such as 1.77 instead of 1.77 percent). The errors affected the models' allocation outputs. As a result, the RIA stopped using, running or relying on those models.

The SEC found that the Respondents failed to disclose to investors in the RIC Products or the SMA Strategies that the models contained errors and were no longer being used. The Respondents also failed to disclose these facts to the boards of the RIC Products as a general matter and, despite the boards' request for such information, during the information-gathering process required by Section 15(c) of the Investment Company Act. Certain of the pertinent investment advisory agreements were subsequently terminated, again without disclosure of the discovery of the errors.

Misleading Marketing Materials

An RIA settled SEC charges arising from alleged material misstatements and omissions by the adviser to certain of its advisory clients concerning hypothetical stock returns associated with the firm's blended research stock ratings.[12] The blended research strategies combine research ratings from the adviser's fundamental analysts and quantitative models to manage portfolios of stocks for client investment.

During the relevant period, the adviser advertised that blending fundamental and quantitative stock ratings over time could yield better returns than either type of rating alone. To illustrate the validity of this claim, the firm advertised the results of a hypothetical portfolio of stocks rated “buy” by both the firm’s fundamental analysts and quantitative models, showing that the hypothetical portfolio had annualized returns from 1995 forward that exceeded the annualized returns of either a hypothetical portfolio of fundamental “buy”-rated stocks or a hypothetical portfolio of quantitative “buy”-rated stocks.

According to the SEC’s order, the advertisements demonstrating the superior returns of the hypothetical portfolio were misleading because the materials failed to disclose that some of the quantitative ratings used to create the hypothetical portfolio were determined using a retroactive, back-tested application of the firm’s quantitative model. In some advertisements, the adviser also falsely claimed that the hypothetical portfolio was based on the firm’s own quantitative stock ratings dating back to the mid-1990s, even though before 2000 the adviser did not generate its own quantitative stock ratings.

The SEC found that the misleading advertisements were due in part to the adviser’s failure to adopt and implement policies and procedures reasonably designed to prevent false and misleading advertisements. Personnel in the group responsible for managing blended research strategies generally knew that the research proof analysis calculated returns dating back to 1995, before the adviser began generating its own quantitative ratings, and also understood that some of the quantitative ratings were back-tested. However, this information was not clearly and consistently communicated to personnel responsible for preparing and reviewing the pertinent advertisements. The adviser’s compliance personnel were unaware that some of the quantitative ratings were back-tested and thus lacked pertinent facts when determining whether the firm’s advertisements complied with the federal securities laws.

Misappropriation of Client Assets

In a settled administrative proceeding,[13] the SEC found that a dually-registered investment adviser and broker-dealer violated the Compliance Rule by failing to have reasonably designed policies and procedures in place to prevent its personnel from misappropriating client funds. According to the SEC’s order, during the pertinent period, the firm permitted its investment adviser representatives and registered representatives (“financial advisers”) to initiate third-party disbursements from client accounts of up to a specified dollar limit per day based on the financial adviser’s attestation on an internal electronic form that he or she had received a verbal request from the client by phone or in person and providing certain details about the request. The SEC found that while the firm’s policies provided for certain reviews prior to issuing the disbursements, such reviews were not reasonably designed to prevent a financial adviser from making false attestations about having received a client request to transfer funds to a third party or to detect such false attestations.

According to the SEC, over a period of nearly a year, a particular financial adviser initiated multiple unauthorized transactions out of accounts of his advisory clients by making false attestations on approximately 90 internal electronic forms to initiate third-party transfers, resulting in his misappropriation of over $5 million. The firm did not detect that any of these transactions were unauthorized for nearly a year, until the defrauded clients contacted the firm with questions about their accounts. The SEC also found that the firm had failed to reasonably supervise the financial adviser.

The SEC noted in the order that the firm has since developed significant enhancements to its policies, procedures, systems and controls relating to preventing or detecting conversion of client advisory and customer brokerage funds by its personnel. The enhanced policies and controls include increased client contact, independent client callbacks on a risk-based and randomly-sampled basis, and new or revised internal surveillance procedures.

Due Diligence and Monitoring Failures

A former RIA settled SEC charges that it negligently failed to perform adequate due diligence and monitoring of certain investments, which ultimately contributed to substantial client losses.[14] According to the SEC's order, the firm advised clients to purchase interests in facilities and other investments containing repurchase agreements ("repos") that eventually proved to be fraudulent, even though the adviser's initial due diligence in connection with the investments had identified concerning information. The adviser continued to offer the repos to clients despite growing concerns about the legitimacy of the investments.

The SEC focused on allegations that the firm's compliance program lacked sufficient resources, finding that the firm failed to reasonably design and implement certain compliance policies and procedures. According to the order, the adviser repeatedly refused to provide the CCO with the compliance resources that he requested, despite specific risk concerns cited by the CCO. The SEC found that the denial of resources "undermined the effectiveness of [the firm's] compliance program resulting in compliance failures." Of key importance, the adviser did not have written policies and procedures regarding initial and ongoing due diligence with respect to its repo program, even after the CCO stated in two consecutive annual risk assessments (which he escalated to the firm's CEO and board of directors) that counterparty risk was a significant risk to the firm.

Separately, the firm's former CEO also agreed to settle charges that he was aware of, but failed to address, resource deficiencies in the firm's compliance program, which contributed substantially to the adviser's compliance failures.[15]

False and Misleading Disclosures by Two Robo-Advisers

The SEC instituted settled proceedings against two robo-advisers for making false statements about investment products and publishing misleading advertising. The proceedings are the SEC's first enforcement actions against robo-advisers, which provide automated, software-based portfolio management services. In the related press release, C. Dabney O'Riordan, Chief of the Enforcement Division's Asset Management Unit, stated: "Technology is rapidly changing the way investment advisers are able to advertise and deliver their services to clients. Regardless of their format, however, all advisers must take seriously their obligations to comply with the securities laws."[16]

In the first proceeding,[17] the SEC found that a robo-adviser made false statements about a tax-loss harvesting strategy that it offered to clients. According to the SEC's order, the robo-adviser also re-tweeted posts that constituted prohibited client testimonials while omitting required disclosures, paid bloggers for client referrals without the required disclosure and documentation, and failed to maintain a compliance program reasonably designed to prevent violations of the securities laws.

In the second proceeding,[18] the SEC found that a robo-adviser disseminated false and misleading marketing materials and performance data. The robo-adviser posted on its website and social media a purported comparison of the investment performance of its clients with those of two robo-adviser competitors. The comparisons were misleading because (i) the robo-adviser included only a small subset of its client accounts and (ii) compared the performance of this subset with rates of return that were not based on the competitors' actual trading models, but instead were an approximation of the competitors' performance based on information available from their websites. The SEC also found that the robo-adviser failed to maintain required performance documentation. In stating that the violations were caused in part by the robo-adviser's ineffective compliance program, the SEC noted that the firm's compliance policies and procedures did not require any officer of the firm to review or approve marketing materials or performance data posted on its digital media platforms.

VIOLATIONS OF THE FOREIGN CORRUPT PRACTICES ACT

The SEC settled an enforcement action involving alleged violations by an investment adviser of the Foreign Corrupt Practices Act arising from bribes paid to Libyan government officials in connection with soliciting business from Libyan stated-owned financial institutions.[19] According to the SEC's order, a former asset management subsidiary of the investment adviser ("the Subsidiary") partnered with a French financial services company to solicit investment business from Libyan state-owned financial institutions. During the pertinent period, the French firm paid a Libyan middleman for supposed "introductory" services. Although employees of the Subsidiary were aware that the intermediary was paying bribes to Libyan government officials in order to secure investments, the employees nevertheless agreed to continue to use the Libyan intermediary. As a result of this scheme, the investment adviser (through the Subsidiary) was awarded business tied to $1 billion of investments from the Libyan financial institutions.

The SEC found that the investment adviser lacked appropriate internal accounting controls with respect to the use of introducing brokers and other intermediaries in emerging markets and, accordingly, violated the internal accounting controls provision of the Exchange Act. According to the order, the advisory firm did not institute in a timely manner appropriate risk-based due diligence and compliance requirements pertaining to the retention and oversight of intermediaries.

FORM PR REPORTING REQUIREMENTS

Most RIAs that advise private funds are required to file Form PF either quarterly or annually; advisers exempt from SEC registration, including ERAs, are not required to file Form PF. Form PF, which is a joint form between the SEC and the Commodities Futures Trading Commission (CFTC) with respect to Sections 1 and 2 of the form, is filed with the SEC via the Private Fund Reporting Depository (PFRD) electronic filing system and is not publicly available.

Given the volume and complexity of the work involved, many private fund advisers face a number of challenges in preparing Form PF, including making decisions regarding (and documenting) assumptions and methodologies, due to the ambiguous or subjective nature of a number of Form PF's instructions, definitions and questions. The SEC staff has provided assistance with respect to these issues and other Form PF questions, both directly in response to private inquiries[20] and in FAQs posted and periodically updated on the SEC's website.[21] According to a December 2018 SEC staff report, the staff regularly contacts individual filers when staff members identify anomalous and possibly erroneous data as well as possibly delinquent or missing filings, and works with these individual filers to determine steps for improving timeliness and accuracy of filings.[22]

When delinquencies persist, the staff has taken further steps to ensure that information is appropriately filed. In June 2018, the SEC announced settlement orders with 13 RIAs that repeatedly failed to file Form. PF.[23] Each adviser was charged a $75,000 penalty. During the course of the SEC investigation, the advisers remediated their failures by making the necessary filings.

Please refer to our 2018 annual investment adviser alert[24] which discusses who is required to file Form PF, the various filing categories for advisers, and the frequency of reporting and filing deadlines.

Finally, please also refer to our newsletter for annual calendar-related filing dates, ongoing and compliance requirements, and additional annual considerations[25] that private fund advisers may wish to consider.

If you have any questions, please contact the author, **Shant Chalian**, or another member of Robinson+Cole's **Investment Management Group**.

For insights on legal issues affecting various industries, please visit our page and subscribe to any of our newsletters or blogs.

[1] SEC Office of Compliance Inspections and Examinations, National Exam Program, Risk Alert, "Observations from Investment Adviser Examinations Related to Electronic Messaging" (December 14, 2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Electronic%20Messaging.pdf.
[2] For purposes of this initiative, "electronic messaging" or "electronic communication" included written business communications conveyed using, for example, text/SMS messaging, instant messaging, personal email and personal or private messaging. OCIE included communications when conducted on the adviser's systems or third-party applications (apps) or platforms or sent using the adviser's computers, mobile devices issued by advisory firms, or personally owned computers or mobile devices used by the adviser's personnel for the adviser's business. The staff indicated in the Risk Alert that email use on advisers' systems was excluded from the review because firms have had decades of experience complying with regulatory requirements with respect to firm email, and it often does not pose similar challenges as other electronic communication methods because it occurs on firm systems rather than on third-party apps or platforms.
[3] SEC Office of Compliance Inspections and Examinations, National Exam Program, Risk Alert, "Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers" (April 12, 2018), https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.
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