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SEC enforcement priorities as a guide for investment adviser policies and procedures

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1. Introduction

During the Obama administration, the Division of Enforcement of the US Securities and Exchange Commission (SEC) prosecuted even minor violations and regularly required admissions of wrongdoing. In the first two years of the Trump administration, the SEC has embraced a more selective approach to enforcement cases, reducing the number of industry-wide sweeps and the number of actions directed at technical violations of the federal securities laws.

It would be a mistake, though, for investment advisers to believe that they will not be the focus of enforcement actions during this administration. In fact, the SEC's leadership has made clear that it intends for every case to send a message, and that individuals will be held responsible. Steven Peikin, co-director of the Enforcement Division, has stated:

> *I view individual accountability as perhaps the most effective general deterrent tool in our arsenal, because it can have a broad effect on corporate culture in a way that immeasurably benefits individual investors, preventing misconduct before it starts.… Of course, our emphasis on individual accountability has costs, because building and prosecuting cases against individuals is inherently resource-intensive.… But we ultimately believe that the cost is worth it; … the deterrent effect of individual accountability has outsized effects on our markets.*[1]

Compliance, therefore, is more than just a matter of proper corporate culture at investment advisers. Effective compliance provides tangible benefits to institutions and their principals. Investment advisers must remain vigilant. During the first two years of the Trump administration, 20% of all SEC enforcement actions were brought against investment advisers. This was the second largest category of enforcement actions, surpassed only by securities

1 Steven Peikin, co-director, Division of Enforcement, Keynote Address to the UJA Federation (15 May 2018), www.sec.gov/news/speech/speech-peikin-051518.

offerings (which increased sharply with the introduction of cryptocurrency offerings involving digital assets).

SEC regulations require investment advisers to put into place policies and procedures that are reasonably designed to prevent violations of the securities laws and SEC rules. Reviewing enforcement trends is a helpful way to test for weak spots in existing policies and procedures, to learn from the pitfalls that have ensnared others, to think critically about the risks inherent in a particular adviser's business model and to be best situated for your next exam.

2. The Enforcement Division's 2018 Annual Report

The Enforcement Division's 2018 Annual Report provides a helpful overview of its current priorities. The Enforcement Division intends to focus on:

- protecting retail investors;
- holding individuals accountable for violations;
- keeping pace with technological changes;
- imposing remedies that most effectively further the SEC's goals; and
- assessing the allocation of Enforcement Division resources.[2]

Recent enforcement actions against advisers are in line with these objectives.

In 2018, the Enforcement Division "brought 821 actions (490 of which were 'stand-alone' actions) and obtained judgments and orders totalling more than $3.9 billion in disgorgement and penalties. Significantly, it also returned $794 million to harmed investors, suspended trading in the securities of 280 companies, and obtained nearly 550 bars and suspensions".[3] The SEC charged individuals in more than 70% of its standalone proceedings in fiscal year 2018, including CEOs, CFOs, accountants, auditors and other gatekeepers. Individuals have also played an outsized role in the non-monetary relief that the SEC has sought in these cases, resulting in suspensions or bars from the industry and undertakings that imposed extraordinary oversight over particular defendants in an effort to prevent future violations.[4]

Working together, the Enforcement Division and the Office of Compliance, Inspections and Examinations (OCIE) delivered a 30% increase in the number of investment adviser examinations it conducted in 2018 over the prior year.

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2 SEC, Division of Enforcement, Annual Report at 2-5 (2018), www.sec.gov/files/enforcement-annual-report-2018.pdf. The division launched the Retail Strategy Task Force, which has used data analytics to detect insufficient disclosures on fees, expenses, and conflicts of interest; market manipulation; and unregistered offerings (*id* at 2, 6). The division also launched its Cyber Unit, which focuses on cyber-related conduct and the growing importance of cryptocurrencies (*id* at 3, 7).

3 *Id* at 5.

4 *Id*. The Annual Report also highlighted fines and other sanctions against two high-profile CEOs in 2018: Theranos CEO Elizabeth Holmes, who was stripped of any ability to benefit from any future liquidation event prior to investors being made whole; and Tesla Inc Chairman and CEO Elon Musk, whose misleading tweets led to enhanced governance practices and oversight (*id* at 17).

OCIE now examines approximately 15% of all investment advisers in any given year.[5] OCIE is also leveraging advanced data analytics tools to make exams more sophisticated in detecting insider trading, 'cherry-picking' schemes and the sale of unsuitable investment products to retail investors. The use of technology has helped to offset the reduction in SEC Enforcement Division staff, which is down 10% from its peak in 2016.[6] Given the resource constraints placed on the Enforcement Division, OCIE has exhibited greater aggressiveness during exams and demanded stronger remedies to conclude exams. With increasing frequency, OCIE includes personnel from the Enforcement Division among the staff conducting the exam. In the current environment, this does not necessarily mean that exams are any more likely to turn into enforcement actions, but it does help the exam team to spot and act on areas that warrant further investigation, with the added risk that an enforcement inquiry could follow.

All indications suggest the SEC will be just as active in the coming year, so investment advisers should take a hard look at their policies and procedures and use them as a proactive tool to cultivate compliance. While investment advisers must understand the recent enforcement priorities – including insider trading, conflicts of interest, accurate solicitation materials and adequate written policies – investment advisers should also develop proactive and adaptable policies and procedures that will withstand the scrutiny of the SEC's future enforcement priorities.

3. Insider trading

Insider trading cases continue to be a staple of the SEC's enforcement programme. Historically, the SEC generally charged individuals with insider trading and not the investment adviser itself. Recent cases demonstrate that the SEC will now charge investment advisers as well for ineffective policies and procedures and inadequate surveillance and documentation.

In a series of significant cases, the SEC and the Department of Justice brought civil and criminal charges against investment advisers who retained former government employees as political intelligence consultants and traded on material non-public information they provided about forthcoming agency decisions. A former US Centers for Medicare and Medicaid Services (CMS) employee opened a political intelligence firm that consulted for a number of investment advisers. He obtained information about upcoming agency decisions from a friend and former colleague who still worked at the agency.

5 Oversight of the US Securities and Exchange Commission, Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs, 115th Cong (26 September 2017) (testimony of Jay Clayton, chairman, SEC), available at www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%209-26-17.pdf.

6 2018 Annual Report at 4.

Some of the investment advisers who received material non-public information traded on it, generating millions of dollars in trading profits.[7]

While the Department of Justice brought criminal charges against the involved partners of the investment adviser, the government employee and the consultant, the more notable action came from the SEC, which brought civil charges against the adviser itself. These charges alleged a failure to establish, maintain and enforce policies and procedures that were reasonably designed to prevent the misuse of material non-public information, and that considered the risks of the adviser's business practices.[8] In particular, the SEC faulted the adviser for engaging political intelligence consultants and other firms as part of the industry research that drove its investment decisions while explicitly excluding research firms from the policies and procedures it had in place regarding expert networks. The SEC also faulted the adviser for ignoring red flags that the information its consultants provided had come from confidential sources, including the consultant's "CMS guys". Several of those communications reached senior executives at the adviser, but no corrective actions followed. The adviser paid $4.6 million to settle the SEC enforcement action.[9]

Likewise, another adviser was charged for failing to enforce insider trading policies and failing to monitor its traders' communications with consultants. The adviser had policies that prohibited its traders from trading on the basis of material non-public information and required its employees to report potential material non-public information to its chief compliance officer. However, according to the SEC, one of the traders obtained and traded on the same confidential information about CMS rate changes, and another trader obtained material non-public information about upcoming generic drug approvals from a former Food and Drug Administration employee he had hired as a consultant. The adviser was censured and forced to withdraw as an adviser, return all investor capital and pay over $10 million in disgorgement and a civil penalty.

In another matter, the SEC alleged that an adviser had failed to adequately supervise an analyst who made highly profitable and well-timed trades, but did not maintain analytical models, research files or written recommendation reports. Although the adviser had policies prohibiting trading or recommending trades following receipt of material non-public information, the adviser allowed the analyst to work from home and did not adequately monitor the analyst's communications with industry contacts. The SEC faulted the analyst's supervisor for unquestioningly accepting and executing the analyst's trading recommendations despite red flags surrounding their timing and profitability.

7 Brendan Pierson, "Ex-Deerfield partners get prison in case over US agency leaks", Reuters (13 September 2018), www.reuters.com/article/us-usa-crime-healthcare-insidertrading/ex-deerfield-partners-get-prison-in-case-over-u-s-agency-leaks-idUSKCN1LT2YG.

8 *In the Matter of Deerfield Mgmt Co*, No 3-18120, Investment Advisers Act Release No 4749 (21 August 2017).

9 *Id* (disgorgement with interest of approximately $800,000 plus a civil penalty of almost $4 million).

The SEC also faulted the chief compliance officer for failing to investigate the analyst's bases for the recommendations. The SEC censured the adviser and imposed disgorgement and a civil penalty totalling over $7.6 million.[10]

These cases establish that investment advisers must go further than merely having adequate policies and procedures prohibiting the use of material non-public information. Advisers must ensure that their policies are tailored to their particular strategies and monitor and surveil their trading activities. Advisers should also educate and train employees on what may constitute material non-public information and ensure that company names are properly added to internal restricted lists in the event of becoming aware of material non-public information. Advisers should maintain documentation to demonstrate the propriety of their conduct in the event of regulatory scrutiny. As these cases make plain, advisers should thoroughly understand where their analysts and traders are sourcing information and appropriately monitor those communications.

4. Conflicts of interest

Over the past two years, the Enforcement Division has devoted considerable resources to policing conflicts of interest between investment advisers and their investors, and to their disclosure of such conflicts. Because conflicts of interest can take on any number of forms, investment advisers must think critically and creatively about their business to identify and explain potential conflicts to investors. OCIE has flagged conflicts of interest as a priority for its examinations in 2019.[11]

The SEC has interpreted investment advisers' obligation to disclose conflicts of interest broadly and scrutinises such conflicts carefully. For example, an investment adviser had a marketing services agreement with a particular custodian, which created an incentive for the adviser to choose that custodian over others in the course of giving investment advice to its clients. Because the adviser failed to disclose that agreement to clients, the SEC censured the adviser, imposed undertakings and required payment of disgorgement and a civil penalty of approximately $250,000.[12]

The SEC has also carefully examined advisers' best execution obligations and brought cases where a series of trades operated to favour certain clients over others. One adviser routinely engaged in cross-trades among client accounts. In certain trades, the adviser favoured purchasing clients by buying at the bid price while simultaneously selling at a small discount from the bid price, rather than using a mid-point calculation or seeking a separate offer-side quotation. In

10 *In the Matter of Artis Capital Mgmt, LP*, No 3-17624, Investment Advisers Act Release No 4550 (13 October 2016) (also suspending and imposing a $130,000 civil penalty on the analyst).
11 OCIE, 2019 Examination Priorities at 6-7, www.sec.gov/files/OCIE%202019%20Priorities.pdf.
12 *In the Matter of Harbour Invs, Inc*, No 3-18760, Exchange Act Release No 84115, Investment Advisers Act Release No 5006 (13 September 2018).

other trades, the adviser arranged purchases of fixed-income securities at above-market prices and then arranged cross-trades at that price without attempting to obtain more favourable pricing in the secondary market. The SEC censured the adviser and imposed a civil penalty of $900,000.[13]

Similarly, a portfolio manager wanted to purchase securities for the accounts of certain clients that other clients had instructed him to sell. He arranged with broker-dealers to temporarily sell at the highest bid and then repurchase the securities at a small mark-up over the sale price, which favoured one client over the other. The SEC imposed a civil penalty of $1 million on the adviser.[14]

Investment advisers owe fiduciary duties to all of their clients and should therefore implement policies and procedures reasonably designed to prevent favouring any one client over another. While these recent cases make clear that cross-trading is an important place to have carefully drawn policies and procedures, investment advisers should also reflect on their particular businesses, identify other areas where potential conflicts may arise and be proactive about addressing the conflicts and ensuring adequate disclosure.

5. Solicitation materials

The SEC has also devoted significant resources to scrutinising investment advisers' statements to potential and current investors to ensure that they provide accurate and adequate disclosure, and that they comport with the advisers' fiduciary duties. Investment advisers may be tempted to overstate valuations or their track record in an effort to retain existing assets and obtain additional investments, but the SEC regularly detects and penalises such misstatements.

Accurate valuation is particularly important in opaque markets. One adviser recently faced civil and criminal charges for allegedly using "imputed mid-point valuations" and receiving inflated quotes for its mortgage-backed securities from a broker in exchange for directing orders to that broker for execution.[15] In another case, an investment adviser was found guilty at trial of fraud and sentenced to 18 months in prison for using sham broker quotes to generate inflated returns and net asset values that generated more than $5.9 million in additional management and performance fees.[16] The SEC also pursued a mismarking scheme that overvalued distressed assets that had no viable market.[17]

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13 *In the Matter of Hamlin Capital Mgmt, LLC*, No 3-18636, Investment Advisers Act Release No 4983 (10 August 2018).

14 *In the Matter of Putnam Inv Mgmt, LLC*, No 3-18844, Investment Advisers Act Release No 5050 (27 September 2018) (the portfolio manager was suspended and ordered to pay a $50,000 civil penalty).

15 *SEC Charges Hedge Fund Adviser with Deceiving Investors by Inflating Fund Performance*, Litigation Release No 24138 (9 May 2018).

16 *In the Matter of Stefan Lumiere*, No 3-18380, Investment Advisers Act Release No 4861 (28 February 2018); Judgment, *United States v Lumiere*, Dkt 112, No 16-cr-483 (SDNY June 16, 2017); *United States v Lumiere*, 249 F Supp 3d 748, 751 (2017).

The SEC also brought charges in 2018 against advisers that improperly represented their track record in promotional materials. For example, an algorithmic adviser misrepresented its track record by advertising the performance of back-tested models rather than its actual historical performance. The SEC censured the adviser and imposed a $125,000 civil penalty.[18]

In several other matters, unrelated advisers signed up with a sub-adviser that overstated its track record by making it appear that it had been in operation since 2001, when it only started in 2008. Each of the advisers settled and paid disgorgement or civil penalties.[19] Thus, investment advisers should carefully vet the accuracy of their marketing and solicitation materials, and should update investors about any material changes.

6. The digital future: cyber and crypto

The Enforcement Division's new Cyber Unit recently completed its first full year. During that time, the Cyber Unit filed 20 standalone enforcement actions and it reportedly has more than 225 active investigations.[20] OCIE has indicated that cybersecurity and digital assets will be among its top priorities in 2019.[21]

The Cyber Unit brought the first enforcement action relating to the Identity Theft Red Flags Rule, which requires investment advisers to develop a written identity theft prevention programme to detect, prevent and mitigate identity theft in covered accounts.[22] Relatedly, the Safeguards Rule requires investment advisers to develop written policies and procedures reasonably designed to keep customer records and information confidential and secure, protect them against anticipated hazards and protect against unauthorised access that could cause substantial harm or inconvenience to customers.[23] In this first case, an investment adviser had written policies pursuant to these regulations, but failed

17 *In the Matter of Steven Ku*, No 3-18474, Investment Advisers Act Release No 4910 (8 May 2018) (investment adviser's CFO paid a $100,000 civil penalty for failure to supervise portfolio managers); SEC, Press Release, *CFO Charged With Failing to Supervise Portfolio Managers* (8 May 2018), www.sec.gov/news/press-release/2018-81 (permanent industry bar for portfolio manager).

18 *In the Matter of Arlington Capital Mgmt, Inc*, No 3-18437, Investment Advisers Act Release No 4885 (16 April 2018).

19 For example, *In the Matter of Institutional Inv Advisors, Inc*, No 3-18303, Securities Act Release No 10443, Investment Advisers Act Release No 4824 (8 December 2017) (civil penalty of $200,000); *In the Matter of Ameriprise Fin Servs, Inc*, No 3-18301, Exchange Act Release No 82244, Investment Advisers Act Release No 4822 (8 December 2017) (disgorgement with interest of $7 million plus a $1.75 million civil penalty); *In the Matter of Horter Inv Mgmt, LLC*, No 3-18302, Investment Advisers Act Release No 4823 (8 December 2017) (disgorgement with interest of more than $500,000 plus a $250,000 civil penalty).

20 In 2018, the SEC filed a first of its kind action against a public company for failing to properly inform investors about a data breach, repeating stale disclosures and thereby fraudulently omitting that it knew a serious breach occurred. *In the Matter of Altaba Inc, f/d/b/a Yahoo! Inc*, No 3-18448, Securities Act Release No 10485, Exchange Act Release No 83096 (24 April 2018). This case is proof that cybersecurity is not just a best practice required by certain investment adviser regulations; it can also be a source of fraud liability when prior disclosures grow stale.

21 OCIE, 2019 Examination Priorities at 11.

22 Rule 201, Regulation S-ID, Securities Exchange Act Release No 69359, Investment Advisers Act Release No 3582, Investment Company Act Release No 30456 (10 April 2013), 78 FR 23638 (19 April 2013) (codified at 17 CFR § 248.201).

23 Rule 30(a), Regulation S-P, 17 CFR § 248.30(a).

to implement and revise them in response to the risks of its business, ultimately allowing individuals who posed as its contractors to reset passwords and obtain personally identifiable information about thousands of its clients. The SEC censured the investment adviser and imposed a civil penalty of $1 million.[24]

The SEC has also concentrated its resources on policing the emergence of distributed ledger technology (also known as blockchain) and the markets that have arisen for digital assets and 'initial coin offerings'. The SEC has tried to balance this new form of capital formation and advances in technology with ensuring proper protections for investors and markets.[25] In one of the earliest actions in this space, a firm that was not registered in any way with the SEC had claimed to be the "first regulated crypto asset fund in the United States". The SEC imposed a $200,000 civil penalty and required rescission of the offering and the return all funds to investors.[26]

The SEC is closely monitoring initial coin offerings and digital assets, and intends to continue to exert the securities laws to their fullest permissible extent in regulating those offerings. In 2019 and beyond, we will likely see additional enforcement actions and settled administrative proceedings through which the SEC will aim to establish and clarify the obligations of participants in these markets.

7. The obligation to develop reasonable policies and procedures

There are several other areas in which investment advisers should have written policies and procedures, both as a matter of best practice and because the SEC is increasingly interpreting existing regulations to require them. In fact, the SEC has recently conducted sweeps and brought enforcement actions directed at making sure investment advisers establish, monitor and enforce the written policies and procedures that SEC rules require.

For example, in 2017, OCIE conducted a sweep of numerous investment advisers to test their policies and procedures for maintaining adequate records of business-related electronic communications. As technology advances, traders no longer communicate exclusively through email and Bloomberg chat. As some of these newer platforms delete messages automatically once read, the investment adviser can be placed at risk for not properly logging and archiving these communications.

Rule 204-2(a)(7) of the Advisers Act requires investment advisers to maintain all communications about investment advice, orders to buy or sell securities, the receipt and distribution of securities or funds and the performance of the

24 *In the Matter of Voya Fin Advisors, Inc*, No 3-18840, Exchange Act Release No 84288, Investment Advisers Act Release No 5048 (26 September 2018).

25 Stephanie Avakian, co-director, Division of Enforcement, *Measuring the Impact of the SEC's Enforcement Program* (20 September 2018), www.sec.gov/news/speech/speech-avakian-092018.

26 *In the Matter of Crypto Asset Mgmt, LP*, No 3-18740, Securities Act Release No 10544, Investment Advisers Act Release No 5004 (11 September 2018).

investments. There is no exception for communications on different platforms.[27] Accordingly, investment advisers should develop and regularly review written policies and procedures regarding the electronic communications that its personnel are permitted to use. Advisers should also train personnel and monitor compliance with Rule 204-2(a)(7).

The SEC also enforces the Foreign Corrupt Practices Act (FCPA), the federal anti-bribery statute. It has two interrelated provisions. First, the FCPA makes it illegal for an issuer to make any payment to a government official for the purpose of influencing official action. Second, the FCPA requires the issuer to maintain accurate books and records and develop adequate internal controls to detect and account for improper payments. In a recent case the SEC required an investment advisory firm to disgorge $200 million to settle charges of corrupt payments and books and records failures. The SEC alleged that the firm ignored red flags and failed to follow its own policies and procedures, which allowed the corrupt transactions to go forward and remain undetected for an extended period.[28] Any investment adviser based in the United States that has dealings in multiple countries should be careful to ensure that it and its business partners remain compliant with the FCPA.

Investment advisers must also keep an eye on their operations to properly update the forms they have filed with the SEC so the disclosures remain accurate. In 2018 the SEC censured several investment advisers that failed to file Form PF when they grew beyond $150 million in private fund assets under management; each was required to pay a civil penalty of $75,000.[29] In another proceeding, a principal was sanctioned for directing one fund to invest in other private funds he managed without updating Form ADV to reflect these proprietary interests.[30] Investment advisers need to be vigilant about keeping all of their disclosures current after any material change and should recognise that stale disclosures in SEC forms are low-hanging fruit for enforcement actions by the SEC.

Policies and procedures are effective only when advisers properly communicate and enforce them. For example, under Section 17(a) of the Investment Company Act, an affiliate cannot sell a security to the investment company absent an exemption order from the SEC. The adviser decided to have one fund sell and have

27 17 CFR § 275.204-2; National Exam Program, OCIE, *Risk Alert: Observations from Investment Adviser Examinations Relating to Electronic Messaging* (14 December 2018), www.sec.gov/ files/ OCIE%20Risk%20 Alert%20-%20Electronic%20Messaging.pdf.

28 *In the Matter of Och-Ziff Capital Mgmt Grp LLC*, No 3-17595, Exchange Act Release No 78989, Investment Advisers Act Release No 4540 (29 September 2016) (also requiring the firm's CEO to disgorge $2.2 million personally).

29 17 CFR § 275.204(b)-1; for example, *In the Matter of Cherokee Inv Partners LLC*, No 3-18516, Investment Advisers Act Release No 4924 (1 June 2018); *In the Matter of Ecosystem Inv Partners LLC*, No 3-18517, Investment Advisers Act Release No 4925 (1 June 2018); *In the Matter of Elm Partners Mgmt LLC*, No 3-18518, Investment Advisers Act Release No 4926 (1 June 2018).

30 *In the Matter of LKL Inv Counsel LLC (a/k/a LKL Invs, LLC)*, No 3-18328, Investment Advisers Act Release No 4836 (3 January 2018).

a related fund buy certain units on the date the units became unrestricted and obtained advice from counsel on the proper way to conduct the trade. However, the traders did not follow the instructions they received, violating Section 17(a) and incurring significant brokerage fees. Even though the adviser had taken many of the appropriate precautions, the SEC imposed a civil penalty of $100,000 for failing to follow through on its own policies.[31] To avoid this problem, advisers should train personnel in a way that effectively communicates which instructions are mandatory rather than illustrative.

Lastly, investment advisers have a duty to supervise their personnel and are expected to have policies and procedures that, as a whole, are reasonably designed to prevent violations of the Advisers Act and its rules. This catchall obligation underscores the important role that policies and procedures are expected to play in compliance, and the value that regular and thoughtful review of policies and procedures can have for investment advisers. Investment advisers have been sanctioned for failing to supervise research analysts who shared the fund's confidential materials, such as offering memoranda, marketing presentations, due diligence questionnaires and analyst research with others who then set up competing funds, particularly when the analysts sent the confidential information to their personal email addresses, in violation of the advisers' policies. Policies and procedures thus should not only implement the investment adviser's obligations under the Advisers Act, but also serve to build a culture of compliance, and must be effectively communicated so personnel understand the purpose behind the rules.

8. Conclusion

Investment advisers should study recent enforcement trends to update their policies and procedures. Strong and regularly tested policies and procedures not only help investment advisers to foresee and avoid potential trouble areas, but also demonstrate an adviser's diligent efforts to fulfil its duties to its investors and its respect for the law. Reviewing enforcement trends provides a useful opportunity to take a fresh look at firm policies and procedures, transforming them from administrative obstacles which the fund must navigate into a culture and practice that makes compliance the natural way that the firm's work gets done.

This chapter 'SEC enforcement priorities as a guide for investment adviser policies and procedures by Charles J Clark, Noah N Gillespie, Craig S Warkol and Peter H White of Schulte Roth & Zabel LLP is from the title Hedge Funds: A Practical Global Handbook to the Law and Regulation, Second Edition*, published by Globe Law and Business*.

31 *In the Matter of Cushing Asset Mgmt, LP*, No 3-18767, Investment Company Act Release No 33226 (14 September 2018).