

The background of the page is a complex, layered image of financial data. It features several overlapping charts: a candlestick chart with red and green bars, a line graph with a blue line showing an upward trend, and a bar chart with blue bars. The charts are set against a dark blue and purple grid background with various numerical values and lines, creating a sense of depth and data analysis.

# **CURRENT DEVELOPMENTS IN SEC EXAMINATIONS & ENFORCEMENT**

A SPECIAL REPORT FOR  
**INVESTMENT ADVISERS**

May 2022

# Morgan Lewis

## CURRENT DEVELOPMENTS IN SEC EXAMINATIONS & ENFORCEMENT: A SPECIAL REPORT FOR INVESTMENT ADVISERS

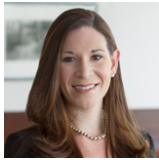
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## CURRENT DEVELOPMENTS IN SEC EXAMINATIONS & ENFORCEMENT: A SPECIAL REPORT FOR INVESTMENT ADVISERS

Morgan Lewis’s securities enforcement and investment management teams highlight expected US Securities and Exchange Commission (SEC or Commission) priorities for investment advisers in 2022 and look back at significant SEC enforcement matters against investment advisers over the last year. If you have a private funds focus, we encourage you to review our [companion piece directed to private fund registered investment advisers](#) (RIAs).

As we pass the one-year anniversary of Chairman Gary Gensler’s tenure at the SEC, it is clear that aggressive policing of investment advisers is and will continue to be a priority. The newly issued 2022 Examination Priorities for the Division of Examinations emphasize the need for resilient compliance programs and a continued focus on “best execution obligations, financial conflicts of interest and related impartiality of advice, and any attendant client disclosures.”<sup>1</sup>

Further, the SEC has set a very aggressive rulemaking agenda in key areas such as environmental, social, and governance (ESG), cybersecurity, digital engagement practices, and cryptocurrency. On the Enforcement side, look for the SEC to continue to devote resources to hot-button enforcement areas related to disclosure, recordkeeping, conflicts of interest, and ESG.

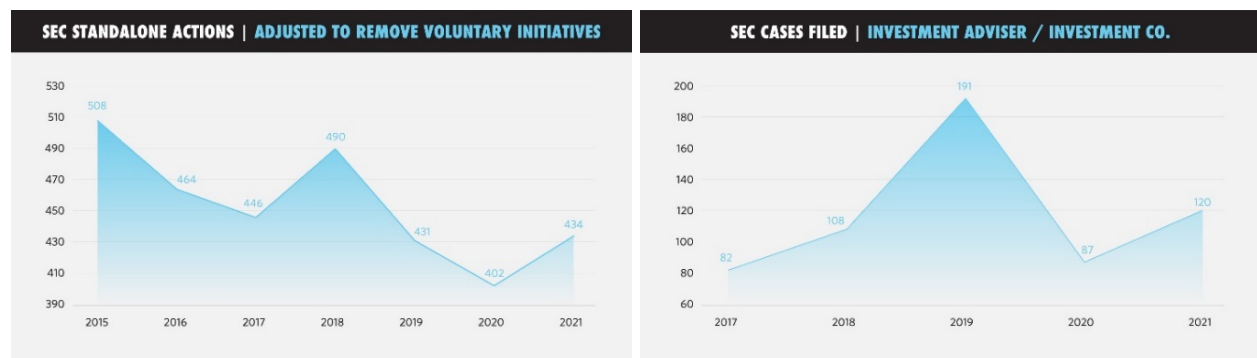
### GENERAL SEC ENFORCEMENT OUTLOOK

#### Speed Traps Ahead, Fines May Be Doubled

It took Gurbir Grewal, the new SEC director of enforcement, little time to remind the defense bar of enforcement analogies from the past, such as “broken windows.” On October 6, 2021, two months into his tenure, Director Grewal announced:

[O]ne thing I know is that if you post a 65 mile-per-hour speed limit and don’t enforce it, people drive 75. Not me, of course, but other people. And they eventually do so with a sense of impunity. And then after a while they will drive 80 or faster, with a growing sense of confidence. As speeds climb higher and higher, you eventually have situations where accidents increase and heightened enforcement follows. But for all of the victims, it’s too late. It’s a stark analogy, but the point is that we are not waiting for accidents to happen.<sup>2</sup>

Translation? Expect this SEC to be more willing to pursue and penalize basic violations — writing more 70 MPH speeding tickets — in areas such as recordkeeping and periodic filing requirements.



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Further, there is an unabashed willingness to engage in regulation by enforcement or, in other words, to take expansive interpretive views on existing statutes, rules, and regulations through enforcement cases in an attempt to affect overall industry conduct. As Chair Gensler recently stated:

A cop on the beat has to balance both the high-impact cases and the everyday fraudsters. A high-impact case pulls many other actors back from the line. This prompts legal alerts, client letters, and bulletins to go out. Compliance departments, lawyers, and accountants change internal procedures as well. Such high-impact cases are important. They change behavior. They send a message to the rest of the market, to participants of various sizes, that certain misconduct will not be permitted. Some market participants may call this “regulation by enforcement.” I just call it “enforcement.”<sup>3</sup>

Necessary to this approach will be a coordinated effort to bring various enforcement tools to bear, and Messrs. Grewal and Gensler have expressed a willingness to do so aggressively.

## Civil Penalties

We expect increased civil penalties in the coming months which may be untethered to past precedent. SEC Commissioner Caroline Crenshaw fired the first salvo in the recent discussion of penalties to promote deterrence, noting, “[W]e can’t look only at the impact the penalty will have on a particular group of investors who own shares in the specific violating entity. . . . We must think about the impact on all investors, and that will help ensure fair and efficient markets.”<sup>4</sup> Director Grewal took this a step further, cautioning that “to achieve the intended deterrent effect, it may be appropriate to impose more significant penalties for comparable behavior over time,” and “while penalties levied in the past are certainly a relevant data point for our conversations, you should not expect comparable cases to be the beginning and end of our analysis.”<sup>5</sup> A recent \$125 million settlement for violations of recordkeeping requirements illustrates this approach.<sup>6</sup>

## The Wells Process

The involvement of senior enforcement officials in the Wells process has been an important aspect of defending clients before the Commission. Often these meetings allow for a fresh look and perspective that may be lacking with the investigators and supervisors who have been living with a case for years. With the stated goal of “Trusting and Empowering SEC Staff,” Director Grewal explained that, absent a novel legal or factual issue, parties will not have access to the director or deputy director.<sup>7</sup> Further, the Commission will be limiting the number of White Paper submissions made prior to any Wells process to address issues of delay. This discussion serves to emphasize the importance of engaging early and at the staff level with the Commission.

## Admissions

Both Chair Gensler and Director Grewal recently noted that admissions were back in the Enforcement Division’s toolbox of remedies because “[w]hen it comes to accountability, few things rival the magnitude of wrongdoers admitting that they broke the law, and so, in an era of diminished trust, we will, in appropriate circumstances, be requiring admissions in cases where heightened accountability and acceptance of responsibility are in the public interest.”

## Self-Reporting of Violations

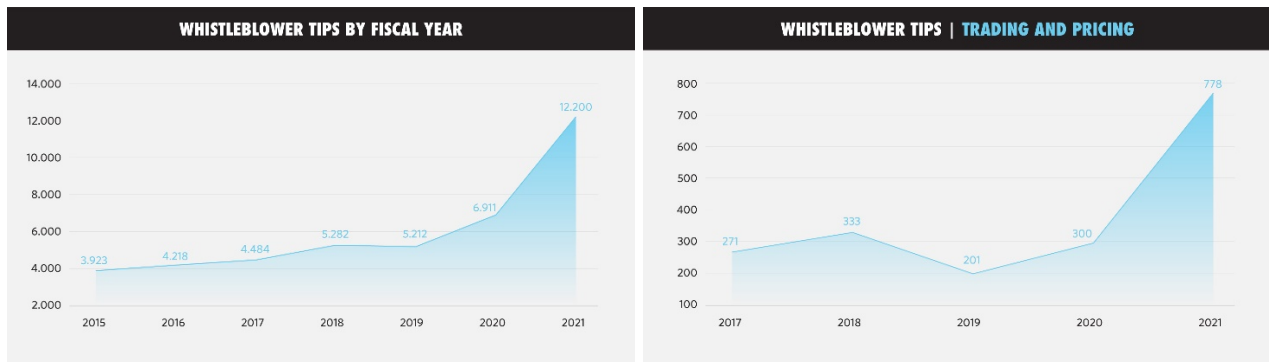
In the past, through initiatives such as the Municipalities Continuing Disclosure Cooperation Initiative and the recent Share Class Selection Disclosure Initiative, the Division of Enforcement has leveraged limited resources into numerous actions through self-disclosure. We expect similar efforts in the coming year,

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including with regard to cyberincident disclosure.<sup>8</sup> Rulemaking efforts are furthering this approach. Finally, Director Grewal recently went one step further, admonishing registrants in a press release announcing a settled action to “scrutinize their document preservation processes and self-report failures such as those outlined in today’s action before we identify them.”<sup>9</sup>

## Whistleblowers

In fiscal year (FY) 2021, the Commission awarded approximately \$564 million to 108 whistleblowers, the largest dollar amount and the largest number of individuals awarded in a single fiscal year.<sup>10</sup> These record amounts demonstrate the maturation of the program as actions aided by whistleblower tips are moving to resolution and resulting in awards. Further, a constant stream of press releases announcing whistleblower awards apparently has driven dramatic growth as new whistleblower tips increased by 76% year-over-year from 6,911 in 2020 to 12,210 in 2021.<sup>11</sup> Given that whistleblower awards can only be paid to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions resulting in monetary sanctions of more than \$1 million, the effect of hundreds of eligible whistleblowers on the Enforcement program has been, and will continue to be, dramatic.



## 2021 RECAP: ENFORCEMENT ACTIONS INVOLVING INVESTMENT ADVISERS

### Recordkeeping

At the end of 2021, the SEC announced a \$125 million fine against a firm and its affiliates for failure to preserve employee texts, emails from personal accounts, and WhatsApp messages related to the firm’s securities businesses.<sup>12</sup> According to the SEC, the firm “frequently did not search for relevant records contained on the personal devices of its employees” in response to subpoenas and document requests, which “meaningfully impacted the SEC’s ability to investigate potential violations of the federal securities laws.” The order also indicates that senior executives and supervisors, including managing directors, used their personal devices to communicate about the firm’s securities business.

Notably, the firm admitted to the allegations in the order. This follows comments by Director Grewal in October indicating that the SEC will require admissions in which “heightened accountability and acceptance of responsibility are in the public interest.”<sup>13</sup> The order also encourages firms to self-report violations by contacting the SEC directly.

Although the order does not apply to investment advisers on its face, in 2018 the Division of Examinations issued a risk alert “to remind advisers of their obligations when their personnel use electronic messaging and to help advisers improve their systems, policies, and procedures by sharing the

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staff's observations from these examinations."<sup>14</sup> The alert states that firms should prohibit employees from using certain apps and calls on firms to review their policies and procedures, training, supervision, and technology requirements to ensure compliance with recordkeeping rules.

What's the takeaway? Investment advisers should carefully look at their policies and procedures for retaining employee business communications—including texts from personal messaging apps. Recently several firms publicly announced that they are being investigated by the SEC for potential recordkeeping violations, and more enforcement actions are expected.

## Conflicts of Interest: Rollovers

The Division of Enforcement also focused on rollover recommendations to plan participants—a perennial risk area—and identified the following issues related to sales practices:

1. **Sales Process.** Enforcement focused on allegations that a firm trained advisers to identify a client's "pain points," diagnose "financial vulnerabilities," and prescribe a managed account as the solution.
2. **Compensation Plan.** Allegations that a firm's compensation plan awarded high-performing advisers as much as 16 times more for putting clients into some products, including managed accounts, versus other products. Further, allegations that a firm "did not have a reasonable, documented basis to represent that the incentive compensation associated with recommending [a managed account] was commensurate with the degree of effort required."
3. **Disinterested Advice.** Allegations that a firm made misleading statements that its advisers offered "objective," "non-commissioned" advice even though the advisers had financial incentives to favor rollover that made the advice "non-objective."
4. **Conflicts Disclosure.** Allegations that a firm failed to adequately disclose conflicts of interest resulting from its incentive compensation program, among other things.
5. **Policies and Procedures.** Finally, allegations that a firm did not adequately implement certain policies and procedures regarding rollover recommendations.

## Conflicts of Interest: Fees and Expenses

Conflicts of interest and related disclosure issues, in particular as they relate to fees and expenses, remained a pocket of significant focus of the Enforcement Division through 2021. This topic has been a stated Division of Examinations priority, and there were more than 15 settled orders or litigation matters initiated or resolved in 2021.<sup>15</sup>

Some of these matters involved entities that did not self-report during the Share Class Selection Disclosure (SCSD) Initiative that was launched in early 2018<sup>16</sup> and, as a result, many of the settlements involved civil penalties.<sup>17</sup> One litigation matter filed in 2021 marks the first SEC conflicts case filed that focuses on conflicts and disclosures relating exclusively to fee markups.<sup>18</sup> More generally, the staff's focus continues to be on conflict and disclosure issues relating to revenue sharing, fees, transactional and other markups, 12b-1 fees and the availability of lower-cost share classes, and sweep-account revenue.

This trend is continuing in 2022. There has already been a new litigation matter initiated,<sup>19</sup> as well as a few significant settled orders,<sup>20</sup> including a very recent \$30 million settlement against an investment adviser for allegedly investing client assets in proprietary mutual funds that paid a fee to the adviser

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when similar competitor funds were available that did not generate a fee, without sufficient disclosure to negate the conflict.<sup>21</sup> We expect to see more of the same as the year progresses.

## Data Analytics

Chair Gensler, a former MIT professor, is well versed in data analytics. He sees this as an area that will transform the financial industry. In October 2021, he commented that “[p]redictive data analytics, including machine learning, are increasingly being adopted in finance,” and that this transformation “could be every bit as big as the internet was in the 1990s.”<sup>22</sup>

It’s no surprise then that the SEC is increasing its use of data analytics in enforcement matters. Of note, the Enforcement Division has brought six matters arising from its Exchange Traded Product (ETP) Initiative. These matters came from the SEC’s review of trading data analytics and the staff’s identification of potential unsuitable sales.

By way of example, in July 2021, the SEC announced a settled action against a firm for alleged compliance failures relating to sales of a volatility linked ETP.<sup>23</sup> The order alleges that although the issuer of the ETP warned against holding the products for extended periods, hundreds of accounts held the product for more than a year, resulting in losses. The order calls for disgorgement, interest, and penalties totaling more than \$8 million. Issues like this one are readily identifiable with data analytics. Investment advisers can expect additional enforcement actions based on data analytics in 2022 and beyond.

## 2022 ENFORCEMENT AND EXAMINATION TRENDS

### Examination Priorities

On March 30, 2022, the Division of Examinations issued its 2022 Examination Priorities. From an enforcement perspective, registrant examinations continue to be a significant source of enforcement investigations through referrals. During FY 2021, Examinations completed 3,040 exams, issued more than 2,100 deficiency letters, and made more than 190 referrals to Enforcement.<sup>24</sup>

Given that Enforcement typically opens approximately 900 investigations a year, exam referrals account for a significant amount of enforcement investigative activity and exam priorities are a leading indicator for enforcement focus. This year’s focus areas for investment advisers include:

- private funds, including with regard to fees and expenses, preferential treatment of certain investors, custody rule compliance, cross-trades, principal transactions and distressed sales, and conflicts relating to liquidity;
- information security controls;
- digital investment advice and other financial technologies used by investment advisers;
- assessment of practices regarding consideration of alternatives (e.g., with regard to potential risks, rewards, and costs);
- management of conflicts of interest (e.g., incentive practices that favor certain products or strategies over others);
- trading (e.g., RIA best execution obligations);
- disclosures (e.g., disclosures provided in Form ADV);
- account selection (e.g., brokerage, advisory, or wrap fee accounts); and
- account conversions and rollovers.<sup>25</sup>

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The 2022 Examination Priorities also note that “[d]ually registered RIAs and broker-dealers remain an area of interest for the Division.” Focus areas will include:

- the sale or recommendation of high-fee products;
- the sale or recommendation of proprietary products of the firms or their affiliates;
- incentives for financial professionals to place their own or their firms’ interests ahead of customers/clients (e.g., transactions that reduce costs to the adviser and increase expenses borne by the client);
- compensation structures that inappropriately influence investment recommendations; and
- whether firms have implemented written policies and procedures to effectively mitigate and address conflicts and to minimize the risk of, and monitor for, misaligned incentives that may result in recommendations and advice to retail investors.

## Environment, Social, and Governance (ESG)

ESG, a key priority for the Divisions of Examinations and Enforcement in 2022, will continue to garner much attention from the staff.

The Division of Examinations conducted an ESG sweep exam in early 2021 and issued an ESG Risk Alert in April 2021,<sup>26</sup> outlining a number of staff observations regarding “potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks.” In particular, the staff noted a number of deficiencies, including “a lack of policies and procedures related to ESG investing; policies and procedures that did not appear to be reasonably designed to prevent violations of law, or that were not implemented; documentation of ESG-related investment decisions that was weak or unclear; and compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials.”<sup>27</sup>

Similarly, the Enforcement Division launched its Climate and ESG Task Force in March 2021, which is charged with “develop[ing] initiatives to proactively identify ESG-related misconduct” and “coordinat[ing] the effective use of Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants, to identify potential violations.”<sup>28</sup>

SEC officials, including Chair Gensler, have issued a constant drumbeat of statements focused on ESG issues, and we expect that this attention will manifest itself in increased enforcement activity in this area.

Complicating the landscape are proposed and expected ESG-related rules requiring issuers to provide climate-related information in their registration statements and annual reports,<sup>29</sup> and setting “rules related to investment companies and investment advisers to address matters relating to environmental, social and governance factors.”<sup>30</sup> These rules will be focal points for SEC examinations and investigations.

Investment advisers should closely examine their statements regarding ESG investing, whether in filings, advertising, or responses to requests for information, for consistency and accuracy, as well as their procedures to ensure the same.

## Additional Aggressive Rulemaking

The SEC is already aggressively issuing new regulations affecting investment advisers in 2022. Why is this relevant in the enforcement context? Because the same internal focus that drives these rules will also be an emphasis for Enforcement.



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For example, the SEC proposed new rules related to cybersecurity risk management for investment advisers. The proposed rules would require advisers to adopt and implement written cybersecurity policies and procedures, report cybersecurity incidents to the SEC and the public, and preserve records containing cybersecurity information. For a detailed discussion of the proposed amendments, look to this Morgan Lewis LawFlash, [SEC Proposes Sweeping New and Amended Rules Under Advisers Act to Overhaul Private Fund Industry](#). On the same day, the SEC proposed comprehensive changes to the regulation of private fund advisers that would require them to provide investors with quarterly statements detailing information regarding fund fees, expenses, and performance, and would prohibit preferential treatment of investors absent disclosure. The new rules would also prohibit private fund advisers from engaging in many different activities, such as seeking indemnification for certain activity, and charging certain fees and expenses.

In addition, the SEC proposed sweeping new filing requirements for private funds by proposing amendments to Form PF, the private fund reporting form, that would require private funds to report to the SEC within one business day of the occurrence of a number of specific events. New regulations are also possible in the areas of cryptocurrency and payment for order flow, to name a few.

The SEC's regulatory agenda currently has almost 50 proposed rulemakings or amendments. Almost 75% of the rule proposals issued under Chair Gensler have provided only a 30-day comment period, which stands in stark contrast to prior chairs, who generally provided at least a 60-day comment period. The pace and breadth of recent SEC regulatory activity has led some to speculate that this could be the most significant era of securities regulatory reform since the Dodd-Frank Act in 2010.

## A Trio of Exam Initiatives

The Division of Examinations issued three risk alerts over a two-week period in fall 2021 that are likely to present risk areas for investment advisers in 2022. Each of the alerts relates to a different compliance initiative by the Division: (1) the Advisory Fee Initiative; (2) the Electronic Investment Advice Initiative; and (3) the Registered Investment Company (RIC) Initiative. Here are the takeaways:

1. **Advisory Fees.** The focus on advisory fees is not new. This has been a priority dating back to 2018. The risk alert warns advisers to implement a robust system to test for fee calculation errors, including overbilling, inaccurate calculation of breakpoint fees (especially due to incorrect householding of accounts), and a failure to make fee credits, including prepaid fees for terminated accounts or prorated fees for onboarding clients.
2. **Robo-Advisory Services.** The use of robo-advisers continues to grow. The risk alert focuses on robo-advisers providing adequate disclosure regarding the nature of the services provided and performance history. It also discusses regular testing of algorithms to ensure that they are operating as expected.
3. **RIC Initiative.** Although this release is principally directed at fund companies, it also impacts investment advisers. It warns advisers to address risks related to conflicts of interest (no surprise there), including in "dual capacity" instances where the adviser to an index fund also acts as the index provider.

Investment advisers should expect more attention from the SEC in the coming year, both on the exam and the enforcement side, especially as more customers move from brokerage to advisory accounts.

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## ABOUT US

Morgan Lewis is recognized for exceptional client service, legal innovation, and commitment to its communities. Our global depth reaches across North America, Asia, Europe, and the Middle East with the collaboration of more than 2,200 lawyers and specialists who provide elite legal services across industry sectors for multinational corporations to startups around the world. For more information about us, please visit [www.morganlewis.com](http://www.morganlewis.com).

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<sup>1</sup> See SEC Division of Examinations, [2022 Examination Priorities](#) (Mar. 30, 2022).

<sup>2</sup> Gurbir Grewal, SEC Director of Enforcement, [Remarks at PLI Broker/Dealer Regulation and Enforcement Conference 2021](#) (Oct. 6, 2021).

<sup>3</sup> Gary Gensler, SEC Chairman, [Remarks at the Securities Enforcement Forum](#) (Nov. 4, 2021).

<sup>4</sup> Caroline A. Crenshaw, SEC Commissioner, [Moving Forward Together – Enforcement for Everyone](#) (Mar. 9, 2021).

<sup>5</sup> Gurbir Grewal, SEC Director of Enforcement, [Remarks at PLI Broker/Dealer Regulation and Enforcement Conference 2021](#) (Oct. 6, 2021).

<sup>6</sup> Press Release, [Securities and Exchange Commission, JPMorgan Admits to Widespread Recordkeeping Failures and Agrees to Pay \\$125 Million Penalty to Resolve SEC Charges](#) (Dec. 17, 2021).

<sup>7</sup> Gurbir Grewal, SEC Director of Enforcement, [Remarks at SEC Speaks 2021](#) (Oct. 13, 2021).

<sup>8</sup> Securities and Exchange Commission, [In the Matter of Certain Cybersecurity-Related Events \(HO-14225\) FAQs](#) (June 25, 2021).

<sup>9</sup> Press Release, Securities and Exchange Commission, [JPMorgan Admits to Widespread Recordkeeping Failures and Agrees to Pay \\$125 Million Penalty to Resolve SEC Charges](#) (Dec. 17, 2021).

<sup>10</sup> Securities and Exchange Commission, [Whistleblower Program 2021 Annual Report to Congress](#) (Nov. 15, 2021).

<sup>11</sup> *Id.*

<sup>12</sup> See Press Release, [JPMorgan Admits to Widespread Recordkeeping Failures and Agrees to Pay \\$125 Million Penalty to Resolve SEC Charges](#) (Dec. 17, 2021). On the same day, the CFTC announced a related settlement against the bank and affiliates for \$75 million, bringing the combined settlement payments to \$200 million. See Press Release, [CFTC Orders JPMorgan to Pay \\$75 Million for Widespread Use by Employees of Unapproved Communication Methods and Related Recordkeeping and Supervision Failures](#) (Dec. 17, 2021).

<sup>13</sup> See Remarks at [SEC Speaks 2021](#) (Oct. 14, 2021).

<sup>14</sup> See [Observations from Investment Adviser Examinations Relating to Electronic Messaging](#) (Dec. 14, 2018).

<sup>15</sup> See, e.g., *In the Matter of Kestra Advisory Services, LLC* (Kestra AS), Advisers Act Release No. 5770 (July 9, 2021) and *In the Matter of Kestra Private Wealth Services, LLC* (Kestra PWS), Advisers Act Release No. 5771 (July 9, 2021) (cumulative \$10.3 million settlement); *SEC v. Westport Capital Markets LLC et al.*, Litigation Release No. 25138 (July 7, 2021), Civil Action No. 3:17-cv-02064 (D. Conn., originally filed Dec. 11, 2017) (judgment entered against investment adviser firm and owner for undisclosed compensation practices: \$633K disgorgement; \$188K interest; \$700K in civil penalties); *In*

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*the Matter of Pruco Securities, LLC* (Pruco), Advisers Act Release No. 5657 (Dec. 23, 2020) (\$18.3 million settlement); *In the Matter of Voya Financial Advisors, Inc.* (Voya), Advisers Act Release No. 5651 (Dec. 21, 2020) (\$22.9 million settlement).

<sup>16</sup> See [Share Class Selection Disclosure Initiative](#) (May 1, 2018).

<sup>17</sup> See, e.g., *In the Matter of 1<sup>st</sup> Global Advisors, Inc.* (1<sup>st</sup> Global), now known as *Avantax Advisory Services, Inc.* (Avantax), Advisers Act Release No. 5932 (Dec. 20, 2021) (\$16.9 million settlement, including \$2 million civil penalty).

<sup>18</sup> *Securities and Exchange Commission v. TCFG Investment Advisor, LLC, TCFG Wealth Management, LLC and Richard James Roberts*, No. 8:21-civ-01615 (C.D. Cal. filed Sept. 30, 2021).

<sup>19</sup> *Securities and Exchange Commission v. Cambridge Investment Research Advisors, Inc., et al.*, No. 22-cv-00071-SMR-SBJ (S.D. Iowa filed Mar. 1, 2022).

<sup>20</sup> *In the Matter of Ameritas Advisory Services, LLC*, Advisers Act Release No. 5970 (Feb. 25, 2022) (\$4.6 million settlement); *In the Matter of O.N. Investment Management Co.*, Advisers Act Release No. 5944 (Jan. 11, 2022) (SCSD non-self-report: \$1.2 million settlement).

<sup>21</sup> See Press Release, [City National Rochdale to Pay More Than \\$30 Million for Undisclosed Conflicts of Interest](#) (Mar. 3, 2022).

<sup>22</sup> See [Prepared Remarks at SEC Speaks](#) (Oct. 12, 2021).

<sup>23</sup> See Press Release, [UBS Settles Charges Related to Investments in Complex Exchange-Traded Product](#) (July 19, 2021).

<sup>24</sup> 2022 Examination Priorities, at 3.

<sup>25</sup> *Id.* at 13.

<sup>26</sup> [The Division of Examinations' Review of ESG Investing](#) (Apr. 9, 2021).

<sup>27</sup> *Id.*

<sup>28</sup> Press Release, [SEC Announces Enforcement Task Force Focused on Climate and ESG Issues](#) (Mar. 4, 2021).

<sup>29</sup> [The Enhancement and Standardization of Climate-Related Disclosures for Investors, SEC Rel. No 33-11042](#) (Mar. 21, 2022).

<sup>30</sup> Fall 2021 SEC Regulatory Agenda.