Morgan Lewis

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Investment Adviser Considerations for Retail (TB:2)

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I. Current Issues with Large Firm Examinations

A. Retirement-Targeted Industry Reviews and Examinations ("ReTIRE") Initiative[1]

1. In June 2015, the Office of Compliance Inspections and Examinations ("OCIE") of the Securities and Exchange Commission ("SEC" or the "Commission") announced the launch of a multi-year ReTIRE initiative to review higher-risk areas of investment advisers' and broker-dealers' sales, investment, and oversight practices and processes impacting retail investors saving for retirement.

2. Areas of focus include whether investment advisers and broker-dealers, consistent with applicable regulatory obligations:

a. Develop a reasonable basis for recommendations in (1) selecting account types, (2) performing due diligence on investment options, (3) making investment recommendations, and (4) providing ongoing account management;

b. Identify, mitigate, and disclose conflicts of interest, with a particular focus on sales and account selection practices considering fees charged, services provided, and expenses of the services;

c. Oversee and supervise the activities of their representatives dealing with retirement investors, including with respect to branch offices and outside business activities; and

d. Comply with applicable advertising restrictions, including whether brochures, sales, and marketing materials, and other disclosures are true and accurate and do not omit material information where there is a duty to disclose; are

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* Copyright 2016 Morgan, Lewis & Bockius LLP. All rights reserved. This outline was prepared with the help of associate Brian J. Baltz. The portions of this outline on current enforcement actions are drawn in part from our publications, *Select Broker-Dealer, Investment Adviser, and Investment Company Enforcement Cases and Developments: 2015 Year in Review* (forthcoming), and *Select Broker-Dealer, Investment Adviser, and Investment Company Enforcement Cases and Developments: 2014 Year in Review,* available at https://www.morganlewis.com/pubs/securities_lf_2014yearinreview_19feb15.

[1] National Exam Program, OCIE, SEC, Risk Alert: Retirement-Targeted Industry Reviews and Examinations Initiative, Vol. IV, Issue 6 (June 22, 2015), *available at* https://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf.

complete and accurate in describing fees; and provide information about credentials and other endorsements that are valid and meet applicable standards.

B. OCIE's Examination Priorities for 2016[2]

1. *Exchange-Traded Funds ("ETFs"):* In addition to issues related to registration of ETFs and exemptive relief, OCIE will review "sales strategies, trading practices, and disclosures involving ETFs, including excessive portfolio concentration, primary and secondary market trading risks, adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs."

2. *Branch Offices:* OCIE will continue its review of supervision of branch offices, including through data analytics, to identify potentially inappropriate trading.

3. *Fee Selection and Reverse Churning:* OCIE will continue its review of investment advisers and dual registrants that offer multiple fee arrangements, including whether recommendations about account types "are in the best interest of the retail investor at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such arrangements."

4. *Variable Annuities:* OCIE will review issues related to suitability, adequacy of disclosure, and supervision of variable annuity sales.

5. *Public Pension Advisers:* OCIE will review pay-to-play, gifts and entertainment, and other risk areas related to advisers to municipalities and other government entities.

6. *Cybersecurity:* OCIE will continue its review of broker-dealers' and investment advisers' cybersecurity compliance and controls (discussed below).

7. *Recidivist Representatives and Their Employees:* OCIE will continue to use analytics to identify representatives with prior misconduct issues and examine the broker-dealers and investment advisers that employ them, including an assessment of compliance and oversight controls of such persons.

8. *Product Promotion:* OCIE will examine for potential suitability issues and breaches of fiduciary obligations in the sale of new, complex, and high-risk products.

9. *Never-Before-Examined Investment Advisers and Investment Companies:* OCIE will continue to select registered investment advisers and investment companies that have not been examined and conduct focused, risk-based examinations of those entities.

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2 National Exam Program, OCIE, SEC, Examination Priorities for 2016 (Jan. 2016), *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

II. Fee Selection and Reverse Churning

A. As noted above, OCIE has been reviewing issues related to fee selection (e.g., selection of accounts at inception) and reverse churning (e.g., ongoing review of trading in accounts), including to determine whether a selected account is appropriate for a retail investor when opened and what controls advisers have instituted to review the ongoing appropriateness of those accounts, including where the services provided and trading activity in the accounts may not justify fees charged to the clients. OCIE has highlighted its concerns about account appropriateness issues in its 2014, 2015, and 2016 examination priorities,[3] as well as in its 2015 alert announcing the ReTIRE initiative. As of March 2, 2016, the SEC has yet to bring an enforcement action under this initiative.

B. In July 2015, the Financial Industry Regulatory Authority ("FINRA") barred Thomas J. Buck from association with a member for violation of NASD and FINRA rules, as well as Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder with respect to account appropriateness violations.[4] FINRA found violations of FINRA Rule 2010, NASD Rule 2310, and FINRA Rule 2111 for "conducting business in commission-based accounts which should have been conducted in fee-based transactions" and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as FINRA Rules 2010 and 2020, for misleading "clients about the potential advantages of using fee-based accounts in order to keep the clients in higher-cost commission-based accounts."

III. Cybersecurity

A. Over the last year and a half, the SEC has intensified efforts at promoting the adoption and implementation of adequate cybersecurity policies and procedures by registered investment advisers and broker-dealers. Specifically, OCIE published two

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[3] National Exam Program, OCIE, SEC, Examination Priorities for 2015 (Jan. 13, 2015), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf; National Exam Program, OCIE, SEC, Examination Priorities for 2014 (Jan. 9, 2014), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

[4] *See Thomas J. Buck*, FINRA Letter of Acceptance, Waiver and Consent No. 2015044745701 (July 24, 2015).

Risk Alerts on cybersecurity;[5] the SEC published a guidance update on cybersecurity;[6] and the Commission hosted a Cybersecurity Roundtable.[7]

B. Recently, the SEC accepted an offer of settlement from R.T. Jones Capital (the "Respondent"), a registered investment adviser, resulting from the Respondent's alleged failure to adopt written policies and procedures reasonably designed to protect customer records and information, as required by Rule 30(a) of Regulation S-P.[8]

1. Specifically, the Commission alleged that during a nearly four-year period from 2009 through 2013, the Respondent failed to adopt any written policies and procedures to ensure the security and confidentiality of personally identifiable information ("PII") and protect it from anticipated threats or unauthorized access.

2. In July 2013, an unauthorized, unknown third party hacked into the Respondent's web server and gained access rights and copyrights to the data on the server. According to the SEC, after the incident, the Respondent appointed an information security manager to oversee data security, adopted written policies and procedures in accordance with Regulation S-P, stopped saving sensitive PII on its web server, encrypted any such information stored on its internal network, and installed a new firewall.

3. The Commission issued an order censuring the Respondent, enjoining it from future violations of Regulation S-P, and requiring it to pay a civil penalty of $75,000.

C. On the same day, the SEC's Office of Investor Education and Advocacy published a new Investor Alert, "Identity Theft, Data Breaches, and Your Investment Accounts."[9] The alert offers steps for investors to take regarding their investment accounts if they become victims of identity theft or a data breach.

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[5] *See* National Exam Program, OCIE, SEC, Risk Alert: Cybersecurity Examination Sweep Summary, Vol. IV, Issue 4 (Feb. 3, 2015), *available at* https://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf (providing summary observations from the examinations of 57 broker-dealers and 49 advisers conducted under OCIE's Cybersecurity Initiative); *see also* National Exam Program, OCIE, SEC, Risk Alert: OCIE Cybersecurity Initiative, Vol. IV, Issue 2 (Apr. 15, 2014), *available at* *https://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf.*

[6] Cybersecurity Guidance, IM Guidance Update No. 2015-02 (Apr. 2015), *available at* https://www.sec.gov/investment/im-guidance-2015-02.pdf.

[7] *See generally* SEC, Cybersecurity Roundtable, *available at* https://www.sec.gov/spotlight/cybersecurity-roundtable.shtml.

[8] *In re R.T. Jones Capital*, Investment Advisers Act Release No. 4204 (Sept. 22, 2015).

[9] Office of Investor Education and Advocacy, SEC, Investor Alert: Identity Theft, Data Breaches and Your Investment Accounts (Sept. 22, 2015), *available at* https://www.sec.gov/oiea/investor-alerts-bulletins/ia_databreaches.html.

IV. Enhancing Investment Adviser Examinations

A. The SEC continues to face resource-related challenges in examining SEC-registered investment advisers. In 2014, the SEC examined approximately 10% of investment advisers.[10]

B. The SEC's 2016 budget request states: "By FY 2016, OCIE estimates that there will be more than 25 advisers per examiner due to growth in the population of advisers. In addition to the growth in the number of firms registered with the SEC, the firms will predominately be larger and more complex than they are now. Without additional resources, it is likely that the coverage level of investment advisers will remain in the range of 10 percent annually." To address this gap, the SEC's budget request, if granted, would allow the SEC to add 225 examiners, 102 of which would be dedicated to examining registered investment advisers and investment companies.

C. In another step to increase examinations of investment advisers, Chair Mary Jo White recently announced that the SEC would be shifting 100 broker-dealer examiners to investment adviser exams throughout the course of 2016.[11]

D. In addition, Chair White has asked the SEC Staff to prepare a recommendation for proposed rules requiring investment advisers to obtain third-party compliance reviews to complement reviews by OCIE.[12]

V. Regulatory Focus on Portfolio Management and Risk

A. OCIE has been conducting examination sweeps concerning alternative mutual funds and fixed income mutual funds, and prioritized those issues for broader examinations in 2015.

1. "Alternative" Investment Companies: OCIE has been reviewing funds that offer "alternative" investments or use alternative investment strategies, particularly (1) policies and practices related to leverage, liquidity, and valuation; (2) internal controls, with a focus on staffing, funding, and empowerment of board, compliance personnel, and back-offices; and (3) how these funds are marketed to investors.

2. Fixed Income Investment Companies: Building on pilot exams conducted in summer 2014, OCIE has been conducting a sweep to "review whether mutual funds with significant exposure to interest rate increases have

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[10] SEC, FY 2016 Budget Request by Program, *available at* https://www.sec.gov/about/reports/sec-fy2016-budget-request-by-program.pdf.

[11] *See* Melanie Waddell, *SEC to Move Examiners from BDs to RIAs in 2016: Chief White*, THINKADVISOR (Feb. 19, 2016), *available at* http://www.thinkadvisor.com/2016/02/19/sec-to-move-examiners-from-bds-to-rias-in-2016-chi.

[12] *Examining the SEC's Agenda, Operations, and FY 2017 Budget Request, Hearing Before the H. Comm. on Fin. Servs.*, 114th Cong. (2015) (statement of Mary Jo White, Chair, SEC).

implemented compliance policies and procedures and investment and trading controls sufficient to ensure that their funds' disclosures are not misleading and that their investments and liquidity profiles are consistent with those disclosures."

B. In addition, the Financial Stability Oversight Council ("FSOC") has sought comment on whether the asset management industry presents a risk to financial stability, and SEC Chair White has stated that the SEC is separately considering rulemaking initiatives regarding portfolio management and risk. FSOC is looking to understand the extent to which asset management products and activities, including risks related to liquidity and redemptions, leverage, and operational risk, could pose potential risks to U.S. financial stability. The comment period as extended closed on March 25, 2015.

C. On May 20, 2015, the SEC proposed rules intended to further modernize and enhance its monitoring and regulation of the asset management industry.[13]

1. The proposal would require investment advisers to report certain new categories of information, particularly with respect to separately managed accounts and the types of assets and derivatives held in those accounts. With respect to registered investment companies, the proposal would:

a. Require reporting of information relating to the use of derivatives, including information on counterparties, asset and issuer types, and changes or losses in value, organized by types of derivative exposure; securities lending activities; liquidity and valuation of portfolio holdings; and certain aspects of ETFs, including information on authorized participants and creation units.

b. Require disclosure of certain basic risk metrics relating to their exposures to potential changes in risk factors and asset prices.

c. Create new enhanced and standardized disclosure requirements relating to derivatives and securities lending in financial statements.

d. Allow shareholder reports to be delivered online.

D. On September 22, 2015, the SEC proposed rules designed to strengthen the management of liquidity risk by certain registered open-end investment companies, including mutual funds and ETFs.[14] The proposed new Rule 22e-4 under the Investment Company Act of 1940 ("Investment Company Act") would require funds to establish a liquidity risk management program and determine a minimum percentage of

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[13] *See* Investment Company Reporting Modernization, Securities Act Release No. 9776, Securities Exchange Act Release No. 75002, Investment Company Act Release No. 31610 (May 20, 2015); Amendments to Form ADV and Investment Advisers Act Rules, Investment Advisers Act Release No. 4091 (May 20, 2015).

[14] *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Securities Act Release No. 9922, Investment Company Act Release No. 31835 (Sept. 22, 2015).

net assets that must be convertible to cash within three days. It would also enhance liquidity disclosure requirements, codify SEC guidance that limits a fund's illiquid investments to 15% of the fund's net assets, and amend Rule 22c-1 under the Investment Company Act to permit certain funds to use "swing pricing," which would allow managers to adjust the price at which shareholders transact in fund shares during periods of heavy redemptions or purchases.

VI. Key Themes in SEC Enforcement Actions Involving Investment Advisers

A. Advertising

1. *In re Alpha Fiduciary, Inc.*, Investment Advisers Act Release No. 4283 (Nov. 30, 2015).

a. The SEC accepted an offer of settlement from Alpha Fiduciary, Inc. ("Alpha"), a registered investment adviser, and Doglione, its majority owner, managing member, president and former chief compliance officer (collectively, the "Respondents"). The Commission alleged that the Respondents created and distributed to clients and prospective clients performance advertising that failed to disclose with sufficient prominence and detail that certain advertised performance was hypothetical rather than actual. The performance data in question was created when Doglione back-tested static models dating back to the preexistence of Alpha, consisting of indices that generated minimized volatility and maximized returns.

b. The Commission alleged that while several pieces of performance advertising contained disclosure noting the use of "certain hypothetical performance and portfolio information," the Commission found that disclosure to be imprecise and often not located on the same page as the hypothetical performance data. Specifically, the Commission noted that the disclosure did not make clear that all of the performance data with respect to certain strategies was completely hypothetical and the disclosure was located at or near the end of a 25- or 60-page document. Further, the Commission found that disclosure to be contrary to other statements indicating that the performance data represented actual, rather than hypothetical, returns.

c. In addition, the Commission alleged that Alpha's advertising materials included examples of favorable investment decisions with returns up to 58.62% without providing or offering to provide all of Alpha's investment decisions, and that Alpha showed a redacted report of an existing client's portfolio with high gains without considering whether it was representative of the performance of other firm clients.

d. Finally, the Commission alleged that the Firm failed to implement written compliance policies and procedures reasonably designed to prevent its employees from presenting performance advertising to clients or prospective clients that violated the Investment Advisers Act of 1940 ("Advisers Act") and its rules. In determining to accept the offer of settlement, the Commission took the Respondents' remedial efforts into account.

e. The Commission ordered the firm to hire an independent compliance consultant to conduct a review of its compliance program. The Commission censured the Respondents and ordered the Respondents to cease and desist from future violations of Section 206(2) and 206(4) of the Advisers Act and Rules 206(4)-1 and 206(4)-7 thereunder. The Commission further ordered the Respondents to pay civil monetary penalties of $250,000.

2. *In re Virtus Inv. Advisers, Inc.*, Investment Advisers Act Release No. 4266 (Nov. 16, 2015).

a. The SEC accepted an offer of settlement from Virtus Investment Advisers, Inc. ("Virtus"), a registered investment adviser. The SEC alleged that Virtus made false statements to certain of its separately managed account and mutual fund clients concerning its subadviser's materially inflated, and hypothetical and back-tested, performance track record for a certain strategy (the "Strategy").

b. Specifically, the SEC alleged that, in certain client presentations, marketing materials, filings, and other communications regarding the Strategy, Virtus used hypothetical and back-tested historical performance figures that had been miscalculated by the subadviser, resulting in substantially inflated performance, and falsely stated that the Strategy in question had been in use beginning approximately seven years earlier than was actually the case.

c. The SEC alleged that Virtus was negligent in not knowing that the subadviser's track record and performance were false, noting that Virtus had expressed skepticism at the outset of the relationship but had taken no steps to verify the data, and had failed to follow up to obtain answers regarding conflicting representations about the Strategy or allegations that the track record may have been miscalculated.

d. The SEC further alleged that, despite being notified by FINRA in 2009 that the subadviser's performance prior to a certain date was back-tested and may have been manipulated, Virtus continued to use the misleading performance figures in prospectuses and marketing materials.

e. Furthermore, Virtus allegedly failed to maintain adequate books and records necessary to substantiate the calculation of the subadviser's performance, and to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules by addressing the accuracy of marketing materials or performance information obtained from subadvisers and ensuring the retention of books and records required with respect thereto.

f. The SEC censured Virtus and ordered it to cease and desist from violating Sections 204, 206(2), and 206(4) of the Advisers Act and Rules 204-2, 206(4)-1, 206(4)-7, and 206(4)-8 thereunder and Section 34(b) of the Investment

Company Act, and to pay disgorgement of $13.4 million, prejudgment interest of $1.1 million, and a civil penalty of $2 million.

3. *In re Trust & Inv. Advisors, LLC*, Investment Advisers Act Release No. 4087 (May 18, 2015).

a. The SEC accepted an offer of settlement from Trust & Investment Advisors, Inc. ("TIA"), a registered investment adviser, and its chief executive officer, Pitts, and its senior vice president and CFO, Prugh (collectively, the "Respondents").

b. The SEC alleged that the Respondents failed to cure deficiencies noted during OCIE's 2005 and 2007 on-site examinations, which included a failure to complete an annual compliance review or develop a compliance manual, and the use of misleading statements in TIA marketing materials. Despite assurances from TIA that its errors would be corrected, OCIE identified the same deficiencies in a 2011 examination.

c. In its 2011 examination, OCIE uncovered additional misleading statements in TIA's marketing materials, such as the distribution of misleading performance information in weekly summary marketing emails.

d. The SEC alleged that Pitts and Prugh, as TIA's ultimate decisionmakers, repeatedly failed to ensure that TIA was in compliance with federal securities laws and failed to address the numerous deficiencies cited in OCIE's examinations.

e. As part of the settlement, Pitts and Prugh were ordered to undertake 30 hours of compliance training. TIA was also required to engage an independent compliance consultant to render compliance services for a period of at least three years. The SEC also ordered TIA and Pitts, jointly and severally, to pay a $50,000 civil penalty, and Prugh to pay a $10,000 civil penalty. The SEC further censured the Respondents and ordered them to cease and desist from future violations of Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-7 thereunder.

B. <u>Best Execution/Mutual Fund Share Classes</u>

1. *In re Everhart Fin. Group, Inc., et al.*, Investment Advisers Act Release No. 4314 (Jan. 14, 2016).

a. The SEC accepted an offer of settlement from Everhart Financial Group, Inc. ("EFG"), an investment adviser, Richard Scott Everhart, EFG's president and majority owner, and Matthew James Romeo, EFG's chief operating officer and minority owner. The SEC found that, despite significantly higher fees, some representatives at EFG almost always invested non-retirement individual advisory accounts in shares that charged a 12b-1 fee without providing adequate disclosure to clients.

b. The SEC also found that "[b]y not choosing mutual fund share classes with a view to minimizing transactional and ongoing costs, and by failing to disclose that best execution would not be sought for mutual funds with multiple share classes available, Everhart and Romeo failed to seek best execution on behalf of their individual advisory clients."

c. Further, the SEC found that EFG had several compliance failures, including failure to perform annual compliance reviews over several years and issuing insufficient disclosures regarding the receipt of 12b-1 fees.

d. The SEC found that EFG violated Sections 204, 206(2), 206(4), and 207 of the Advisers Act, and Rules 204-3(a), 204-3(b)(1) and (2), and 206(4)-7 thereunder; that Everhart violated or caused violations of Sections 204, 206(2), and 206(4) of the Advisers Act and Rules 204-3(a), 204-3(b)(1) and (2), and 206(4)-7 thereunder; and that Romeo violated or caused violations of Sections 204, 206(2), and 207 of the Advisers Act and Rules 204-3(a) and 204-3(b)(1) and (2) thereunder. EFG, Everhart, and Romeo were censured; ordered to cease and desist from further violations of those sections of the Advisers Act and rules thereunder; and to pay total disgorgement of $201,985.66 and prejudgment interest of $23,422.66. In addition, EFG was ordered to pay a civil penalty of $80,000. Everhart was ordered to pay a civil penalty of $40,000, and Romeo was ordered to pay a civil penalty of $20,000.

2. *In re Pekin Singer Strauss Asset Mgmt. Inc.*, Investment Advisers Act Release No. 4126 (June 23, 2015).

a. The SEC accepted an offer of settlement from Pekin Singer Strauss Asset Management Inc. ("PSSAM"), a registered investment adviser, and its president, R. Strauss, and two of its portfolio managers, Pekin and J. Strauss. The SEC alleged that PSSAM, Pekin, and J. Strauss failed to seek best execution for certain clients and failed to adequately disclose their conflicts of interest in placing and maintaining certain clients who were eligible for a less expensive share class in the more expensive share class of an open-end mutual fund that PSSAM managed.

b. The SEC also alleged that PSSAM failed to conduct timely annual compliance program reviews and failed to implement and enforce provisions of its policies and procedures and code of ethics.

c. In addition, R. Strauss failed to provide sufficient guidance, staff, and adequate resources to the chief compliance officer and the PSSAM's compliance program, and allowed PSSAM's Form ADV to include misleading disclosures regarding its code of ethics.

d. Finally, the SEC also alleged that PSSAM, Pekin, and J. Strauss failed to seek best execution for certain clients and failed to adequately disclose their conflicts of interest in placing and maintaining certain clients who were eligible for a less expensive share class in the more expensive share class of an open-end mutual fund that PSSAM managed.

e. The SEC ordered PSSAM to cease and desist from future violations of Sections 204A, 206(2), 206(4), and 207 of the Advisers Act and Rules 204A-1 and 206(4)-7 thereunder; R. Strauss to cease and desist from future violations of Sections 204A, 206(4), and 207 of the Advisers Act and Rules 204A-1 and 206(4)-7 thereunder; and Pekin and J. Strauss to cease and desist from future violations of Sections 206(2) and 207 of the Advisers Act. The SEC further ordered PSSAM to pay a civil penalty of $150,000, and for each of R. Strauss, J. Strauss, and Pekin to pay a $45,000 civil penalty. Further, the SEC censured PSSAM, Pekin, and J. Strauss, and suspended R. Strauss from acting in a compliance or supervisory capacity for 12 months. Notably, the SEC did not include any charge against the chief compliance officer.

3. *In the Matter of Manarin Inv. Counsel, Ltd.*, Investment Advisers Act Release No. 3686 (Oct. 2, 2013).

a. The SEC filed a settled administrative proceeding against Manarin Investment Counsel, Ltd. (“MIC”), a registered investment adviser; Manarin Securities Corp. (“MSC”), a registered broker-dealer; and Roland R. Manarin (“Manarin”), the founder, owner, and president of MIC and MSC. The SEC alleged that MIC and Manarin failed to obtain best execution for three investment funds managed by MIC (including a mutual fund) (the “Funds”) by purchasing higher-cost mutual fund shares, even though cheaper shares in the same mutual funds were available. As a result, the Funds paid avoidable fees on their mutual fund holdings and passed these fees through to MSC, the affiliated broker-dealer that executed the purchases.

b. According to the SEC, from at least June 2000 through mid-2010, Manarin and MIC breached their fiduciary duties as investment advisers by causing the Funds to buy the Class A shares of underlying mutual funds even when the Funds were eligible to own lower-cost, so-called “institutional” shares of the same mutual funds. As a result, the Funds paid approximately $3.3 million in avoidable 12b-1 fees on their mutual fund holdings, which were passed through to MSC. The SEC alleged that this practice was a violation of MIC’s and Manarin’s duty to seek best execution and was inconsistent with disclosures in the Fund’s offering materials and MIC’s Form ADV.

c. The SEC also alleged that, between October 2008 and December 2011, MSC executed transactions in ETF shares on behalf of its affiliated mutual fund and charged commissions that exceeded the usual and customary broker’s commission for such transactions.

d. The SEC’s settled Order charged that (i) MIC and Manarin violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder; (ii) Manarin violated Section 34(b) of the Investment Company Act; (iii) MIC, MSC, and Manarin violated Section 17(a)(2) of the Securities Act; and (iv) MSC violated Section 17(e)(2)(A) of the Investment Company Act. MIC, MSC and Manarin consented to cease-and-desist orders and censures. MSC and Manarin also agreed, jointly and severally, to pay disgorgement totaling $685,006.90 and prejudgment interest totaling $267,741.72. Further, Manarin agreed to pay a civil penalty of $100,000.

C. Principal Trading

1. *In re Citigroup Glob. Mkts., Inc.*, Investment Advisers Act Release No. 4178 (Aug. 19, 2015).

a. The SEC accepted an offer of settlement from Citigroup Global Markets, Inc. ("CGMI"), a dually registered investment adviser and broker-dealer. The SEC alleged that CGMI failed to review thousands of trades executed by several of its trading desks during a 10-year period due to omissions of relevant trades in the electronically generated daily reports on executed trades resulting from technological errors.

b. The SEC also alleged that CGMI inadvertently routed more than 467,000 of its advisory client transactions to an affiliated market maker, which then executed the transactions on a principal basis despite having policies and procedures to the contrary. The SEC alleged that this occurred as a result of deficient policies and procedures and faulty trade surveillance.

c. CGMI voluntarily paid $2.5 million (its total profits from the principal transactions) to the affected advisory client accounts. The SEC also censured CGMI and ordered it to cease and desist from violating Section 15(g) of the Exchange Act and Section 206(4) of the Advisers Act and Rule 206(4)-(7) thereunder. CGMI further agreed to pay a $15 million civil money penalty and retain a consultant to review and recommend improvements to its trade surveillance and advisory account order handling and routing.

2. *In re Nat'l Asset Mgmt., Inc.*, Investment Advisers Act Release No. 4243 (Oct. 26, 2015).

a. The SEC accepted an offer of settlement from National Asset Management, Inc. ("NAM"), a registered investment adviser, for alleged violations of the Advisers Act. The SEC alleged that NAM failed to disclose to and obtain the consent of its advisory clients to more than 21,000 securities trades executed in a principal capacity by NAM's affiliated broker-dealers.

b. NAM also allegedly failed to report in its Form ADV and timely disclose to its clients the disciplinary histories of several of its associated persons.

c. The SEC also alleged that NAM did not enforce its code of ethics when its CEO, several directors, and many of its employees failed to submit hundreds of required reports on their personal securities trading to NAM.

d. The SEC further alleged that NAM failed to adopt and implement compliance policies and procedures reasonably designed to prevent violations of certain provisions of the Advisers Act and the rules thereunder, and failed to conduct a required annual review of its compliance policies and procedures.

e. The SEC ordered NAM to retain an independent consultant to review its policies and procedures relating to compliance with Section 206(3) of the Advisers Act, Form ADV disclosures, enforcement of its code of ethics provisions on reporting of personal securities transactions, and ensuring completion of annual compliance reviews pursuant to Rule 206(4)-7(b). The SEC further ordered NAM to submit to the SEC annual written reports regarding principal trades for three years, to notify existing and potential clients of the order and post the order on the home page of NAM's website, and to certify in writing its compliance with these undertakings within 60 days of their completion. The SEC also censured NAM, ordered it to cease and desist from violating Sections 204, 204A, 206(3), 206(4), and 207 of the Advisers Act and Rules 204-1, 204-3, 204A-1, and 206(4)-7(a)-(b) thereunder, and required it to pay a civil penalty of $200,000.

3. *In re Parallax Invs., LLC, et al.*, Investment Advisers Act Release No. 4159 (Aug. 6, 2015).

a. The SEC accepted offers of settlement from Parallax Investments, LLC ("Parallax"), a formerly registered investment adviser; Bott, its sole owner and manager, and an officer and owner of affiliate Tri-Star Financial ("TSF"), a broker-dealer; and Falkenberg, chief compliance officer for both the firm and TSF (collectively, the "Respondents"). The SEC alleged that Parallax engaged in at least 2,000 principal transactions with advisory clients through TSF, its broker-dealer affiliate, without giving prior disclosure to and obtaining transaction-by-transaction consent in writing from clients.

b. The SEC also alleged that Respondents violated the Custody Rule by failing to obtain audited financial statements by an independent auditor registered with the Public Company Accounting Oversight Board for a private fund client, and failing to distribute audited financial statements to the private fund's limited partners within 120 days of the fund's fiscal year-end.

c. The SEC further alleged that the Parallax failed to adopt and implement written compliance policies and procedures and a code of ethics for two years.

d. The SEC censured the Respondents and ordered each to cease and desist from future violations of Sections 204A, 206(3), and 206(4) of the Advisers Act and Rules 204A-1, 206(4)-2, and 206(4)-7 thereunder. The SEC ordered Parallax to retain an independent consultant to conduct a comprehensive compliance review designed to prevent and detect prohibited principal transactions, and to adopt and implement adequate compliance policies and procedures. The SEC further ordered Falkenberg to complete 30 hours of compliance training related to the Advisers Act. The SEC also ordered Parallax to pay a civil penalty of $200,000, Bott to disgorge

$450,000 plus prejudgment interest of $5,604 and pay a civil penalty of $70,000, and Falkenberg to pay a civil penalty of $40,000.

4. *In re Tri-Star Advisors, Inc.*, Investment Advisers Act Release No. 4160 (Aug. 6, 2015).

a. The SEC accepted an offer of settlement from Tri-Star Advisors, Inc. ("TSA"), a registered investment adviser, and its principals Payne and Vaughan, who both were owners of Tri-Star Financial ("TSF"), an affiliated broker-dealer (collectively, the "Respondents"). The SEC alleged that TSA engaged in approximately 2,212 principal transactions with advisory clients through TSF, its broker-dealer affiliate, without giving prior disclosure to and obtaining transaction-by-transaction consent in writing from clients. Of the $1.9 million in gross sales credits received by the broker-dealer for the principal transactions, approximately $1 million was paid to the Respondent principals of the firm.

b. The SEC further alleged that TSA failed to adopt and implement written compliance policies and procedures addressing principal transactions.

c. The Respondents were permanently enjoined from future violations of Sections 206(3) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The SEC ordered TSA to retain an independent consultant to conduct a comprehensive compliance review designed to prevent and detect prohibited principal transactions, and to adopt and implement adequate compliance policies and procedures. TSA was ordered to pay a $150,000 civil penalty. The SEC ordered Payne to pay disgorgement of $142,500, prejudgment interest of $3,235, and a civil penalty of $50,000. The SEC also ordered Vaughan to pay disgorgement of $232,500, prejudgment interest of $5,278, and a civil penalty of $50,000.

D. <u>Proprietary Products</u>

1. *In re JPMorgan Chase Bank, N.A. & J.P. Morgan Securities LLC*, Investment Advisers Act Release No. 4295 (Dec. 18, 2015).

a. The SEC accepted an offer of settlement from JPMorgan Chase Bank, N.A. ("JPMCB") and J.P. Morgan Securities LLC ("JPMS") in an action alleging that JPMCB and JPMS negligently failed to disclose conflicts of interest arising from preferences for proprietary products in managed account programs.

b. The SEC found that from May 2008 to 2013, JPMS negligently failed to adequately disclose, including in documents filed with the SEC, conflicts of interest associated with its use of affiliated mutual funds in an investment advisory program. Specifically, the order found that JPMS failed to disclose (a) that JPMS preferred affiliated mutual funds and had an expectation that a majority of client assets would be invested in affiliated products; (b) that the discounted pricing of certain services provided by an affiliate, including overlay and sub-advisory services, was tied to the amount of assets that JPMS invested in affiliated products; and (c) that certain affiliated mutual funds offered a lower-cost share class than the share class purchased for clients. In addition, the Order found that JPMS failed to implement written policies and procedures to ensure adequate disclosure of these conflicts of interest.

c. The SEC also found that, from February 2011 to January 2014, JPMCB negligently failed to disclose a preference for affiliated mutual funds in certain discretionary investment portfolios managed by JPMCB and offered through two lines of business. In addition, the SEC found that, from 2008 through January 2014, JPMCB negligently failed to disclose a preference for affiliated hedge funds in certain of those portfolios offered through the U.S. Private Bank, and that, from 2008 to August 2015, JPMCB negligently failed to disclose a preference for retrocession-paying third-party hedge funds in certain of those portfolios offered through the U.S. Private Bank.

d. JPMS and JPMCB consented to the entry of the order finding that JPMS willfully violated Sections 206(2), 206(4), and 207 of the Advisers Act and Rule 206(4)-7 thereunder, and that JPMCB willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933. The Order censured JPMS; ordered JPMS and JPMCB to cease-and-desist from committing or causing any violations and any future violations of the above-enumerated statutory provisions; and required JPMS and JPMCB to pay a total of $266,815,000 in disgorgement, interest, and civil penalty.

E. Trade Allocation

1. *In re Welhouse & Assocs. Inc.*, Investment Advisers Act Release No. 4231 (Oct. 16, 2015).

a. The SEC accepted an offer of settlement from Welhouse & Associates, a registered investment adviser, and Welhouse, its owner, principal and chief compliance officer (collectively, the “Respondents”). The SEC alleged that the Respondents executed a cherry-picking scheme by disproportionately allocating trades that had appreciated in value during the course of a trading day to Welhouse’s personal and business accounts, while allocating trades that had depreciated in value during the day to the accounts of the Welhouse & Associates’ advisory clients.

b. The SEC also alleged that Welhouse & Associates’ Form ADV falsely stated that it did not trade for its own account and that it restricted the trading of employees’ accounts and failed to discuss the conflicts of interest such trading presents.

c. The Respondents were ordered to cease and desist from future violations of Section 10(b) and Rule 10b-5 of the Exchange Act and Sections 206(1) and 206(2) of the Advisers Act. The firm was censured and Welhouse was barred from association. The Respondents were together ordered to pay disgorgement and prejudgment interest of $468,500 and a civil penalty of $300,000.

2. *In re Structured Portfolio Mgmt., L.L.C., et al.*, Investment Advisers Act Release No. 3906 (Aug. 28, 2014).

a. The SEC filed a settled administrative proceeding against Structured Portfolio Management, L.L.C. ("SPM") and its affiliated advisers for failing to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act concerning trade allocation and the review of investor disclosures.

b. As alleged in the SEC order, SPM disclosed and allowed a trader to trade the same securities across three SPM-advised hedge funds, but without having appropriate controls in place. In one of the funds, the trader's responsibility was to make a profit, while in the other two funds it was to hedge interest-rate risk. Although trading the same securities across the three funds created a conflict of interest, which was disclosed, SPM did not update or modify its policies and procedures. The firm used trade blotters that did not identify the fund for which securities were traded.

c. In addition, SPM did not adopt and implement written policies and procedures reasonably designed to prevent inaccurate investor disclosures, which resulted in offering documents and other disclosures that did not indicate that a fund was no longer trading in mortgage-backed securities.

d. The SEC found that SPM violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. SPM was censured, ordered to engage an independent compliance consultant, ordered to cease and desist, and ordered to pay a civil penalty of $300,000.

F. <u>Valuation</u>

1. *In re Lynn Tilton et al.*, Investment Advisers Act Release No. 4053 (Mar. 30, 2015).

a. The SEC instituted public administrative and cease-and-desist proceedings against Lynn Tilton and the Patriarch Partners advisory firms that she controls (collectively, the "Respondents"), alleging that the Respondents breached their fiduciary duties and defrauded clients by failing to value assets using the methodology described to investors in offering documents for certain funds (the "Funds") investing in collateralized loan obligations ("CLOs"), which have portfolios composed of loans to distressed companies. Instead, according to the SEC, nearly all valuations of loan assets reported to investors by the Respondents were unchanged from the time they were acquired, despite many of the companies making partial or no interest payments to the Funds for several years.

b. The SEC alleged that such misrepresentations misled Fund investors to believe that objective valuation analyses were being performed and that through the misrepresentation, Respondents have avoided significantly reduced management fees because the valuation methodology described in Fund documents would have given investors greater Fund management control and earlier principal repayments if collateral loans were not performing to a particular standard.

c. The SEC also alleged that the Respondents subsequently misled investors about asset valuations in Fund financial statements. The Respondents are alleged to have violated Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206-4(8) thereunder. The SEC has ordered public administrative cease-and-desist proceedings to determine whether the allegations are true and what should be the appropriate remedial action, if any. Those proceedings have not yet occurred.

2. *In re Oppenheimer Asset Mgmt. Inc. & Oppenheimer Alternative Inv. Mgmt., LLC*, Admin. Proc. File No. 3-15238 (Mar. 11, 2013).

a. The SEC filed a settled administrative proceeding against registered investment advisers Oppenheimer Asset Management Inc. ("OAM") and Oppenheimer Alternative Investment Management, LLC ("OAIM") alleging that the firms made misrepresentations and omissions to investors and prospective investors about the net asset value of a fund of funds private equity vehicle (the "Fund of Funds") that they managed. The SEC further alleged that the firms' policies and procedures did not contain provisions reasonably designed to prevent such misrepresentations and omissions.

b. The SEC alleged that from October 2009 through 2010, OAM and OAIM disseminated marketing materials to prospective investors and quarterly reports to existing investors stating that the Fund-of-Funds' net asset values were "based on the underlying managers' estimated values" when in fact, the portfolio manager for the Fund-of-Funds decided to value its largest holding at par, which was a significant markup to the underlying manager's estimated value. The change in the valuation methodology for its largest holding made the Fund-of-Funds' performance appear significantly better as measured by its internal rate of return. The employees of OAIM allegedly made further representations in connection with marketing the Fund-of-Funds, including that the increase in the value of the portfolio holding was attributable to performance, when, in fact, it was due to the change in valuation methodology.

c. According to the SEC, the above misrepresentations and omissions were made possible, in part, by the firms' failure to adopt and implement policies and procedures reasonably designed to ensure that valuations were determined in a manner consistent with written representations provided to investors.

d. The SEC's settled Order charged that the firms violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Section 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. Pursuant to the settlement, OAM and OAIM consented to a censure and a cease-and-desist order. OAM and OAIM also agreed to distribute $2,269,098 to investors who invested in the Fund-of-Funds during the period of the alleged misrepresentations. This amount represented $2,128,232 in disgorgement and $140,866 in prejudgment interest. The firms also agreed to pay a civil penalty of $617,579. The firms agreed to retain an independent consultant to conduct a review of the firms' valuation policies and procedures, send a copy of the

Order to existing advisory clients and prominently post a hyperlink to the Order on their websites.

e. In a separate action brought by the Commonwealth of Massachusetts, OAM and OAIM agreed to pay $376,700 in disgorgement and $23,935 in prejudgment interest. The firms also agreed to pay a penalty of $132,421.

VII. Robo Advisers

A. The SEC has recently increased its focus on automated investment tools, also known as "robo advisers," in light of the increasing growth in this market. On May 8, 2015, the SEC's Office of Investor Education and Advocacy and FINRA issued an investor alert about robo advisers that provided five tips for investors considering a robo adviser: (1) understand any terms and conditions; (2) consider the robo adviser's limitations, including any key assumptions; (3) recognize that the robo adviser's output directly depends on what information it seeks from the investor and what information the investor provides; (4) be aware that a robo adviser's output may not be right for an investor's financial needs and goals; and (5) safeguard personal information.[15]

VIII. Uniform Fiduciary Standard of Care Developments

A. Section 913 of the Dodd-Frank Act requires that the SEC conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for providing personalized investment advice and recommendations about securities to retail customers and whether there are legal or regulatory gaps, shortcomings, or overlaps in those legal or regulatory standards.[16]

B. The SEC staff (the "SEC Staff" or the "Staff) published its Study on Investment Advisers and Broker-Dealers (the "IA/BD Study") in early 2011, which recommended, among other things, a uniform fiduciary standard for both broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, that is no less stringent than currently applied to investment advisers under the Advisers Act.[17] When the IA/BD Study was published, then-SEC Commissioners Troy Paredes and Kathleen Casey issued a statement expressing concern that the study did not, among other things, appropriately account for the potential overall cost of the recommended regulatory actions.[18]

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[15] Office of Investor Education and Advocacy, SEC, Investor Alert: Automated Investment Tools (May 8, 2014), *available at* https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtm.html.

[16] *See* Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[17] *See* STAFF OF THE SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (Jan. 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[18] *See* Statement by SEC Commissioners Troy Paredes and Kathleen Casey: Statement Regarding Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011), *available at* http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

C. On March 1, 2013, the SEC published a release, titled "Duties of Brokers, Dealers, and Investment Advisers," requesting data and other information, including quantitative data and economic analysis, relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers.[19]

D. In March 2015, Chair White expressed her support for a uniform fiduciary standard. While at the same time acknowledging that there are many challenges in proposing a uniform fiduciary standard, Chair White stated: "After significant study and consideration, I believe that broker-dealers and investment advisers should be subject to a uniform fiduciary standard of conduct when providing personalized securities advice to retail investors. As set forth in Section 913, the financial professional giving advice to a retail client should be required to provide advice that is in the client's best interests, without regard to the financial or other interests of the financial professional."[20]

E. The SEC has now included a personalized investment advice standard of conduct on its regulatory agenda, with the possibility of a proposed rule in the fall of 2016.[21]

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[19] Duties of Brokers, Dealers, and Investment Advisers, Securities Exchange Act Release No. 69013 (Mar. 1, 2013).

[20] *Examining the SEC's Agenda, Operations, and FY 2016 Budget Request, Hearing Before the H. Comm. on Fin. Servs.*, 114th Cong. (2015) (statement of Mary Jo White, Chair, SEC).

[21] SEC, Regulatory Agenda, Personalized Investment Advice Standard of Conduct (Fall 2015).