SEC Hot Topics

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CompliGlobe Limited

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THE WORLD'S REGULATORY ADVISER™

What we'll cover

- Fiduciary duties
- Supervision and Director liability
- Examinations
- Enforcement trends
- *Your questions …*

Fiduciary duties

- Every adviser subject to the Advisers Act is a fiduciary

  "[t]he Investment Advisers Act of 1940 reflects a … congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."

  "[I]nvestment advisers are fiduciaries of their clients, and therefore owe those clients "an affirmative duty of utmost good faith."
  SEC v Capital Gains Research Bureau, 375 U.S. 180 (1963)

- Duties of loyalty and care
- Obligations that flow from the fiduciary duty
  - Disclose fully *all* material facts, including conflicts of interest and the means to address them
  - Suitable advice
  - Reasonable basis for recommendations
  - Best execution

“Key aspects” of a Compliance program

- Board-level commitment and management buy-in: “compliance tone at the top”
- Based upon your business
  - Identify risks and record these in the Compliance Risk Inventory (“CRI”)
  - Identify material conflicts of interest and the means to address them and record these in your Conflicts Log
- Written policies and procedures reasonably designed, Rule 206(4)-7 (“WPPs”), that reflect your business, its risks, conflicts and legal and regulatory requirements
- “Truth in Disclosure”: Form ADV Parts 1, 2A and 2B, IMAs and advertising
- Code of Ethics, Rule 204A-1
- Monitoring and forensic testing
- Cybersecurity and Business Continuity Plan – current and tested regularly
- Reg. S-P and Identity Theft Red Flags (data protection) – if applicable

“Compliance Tone at the Top”

- The environment your leadership establishes in which compliance is a bedrock value and a critical component of every employee’s job
- It is *demonstrated* by the Managing Director, the Chairman, partners and supervisors
- A key consideration that OCIE will look for in you
  - Is there a tone at the top? What is it and its framework, in terms of culture, environment, discharge of fiduciary duty? How is it documented?
  - What are your "lines of defence"? Who supervises, how are they responsible for their subordinates and for compliance (the CCO is not a supervisor but the "trusted adviser")?
  - Compliance is the trusted adviser, not the doer. The business does compliance - how does management "backstop" this?
  - In sum, "who is responsible for "record keeping", "pre-trade allocation", "best execution monitoring and testing" and so on, and who checks *these* people?"

Failure to supervise

- Must supervise with a view to *preventing* violations of the U.S. federal securities laws
  - All persons acting on your behalf
  - Includes associated persons of a participating affiliate, solicitors and third parties and affiliates providing services to you
- Nearly every violation of the Advisers Act and the rules thereunder is a failure to supervise
- What you must do
  - Implement and administer policies and procedures reasonably designed to facilitate supervision and to prevent and detect violations of law
  - Keep evidence that the supervisor reasonably discharged the duties and obligations under such procedures without reasonable cause to believe they were not being complied with

Who are supervisors?

- The Chairman, Managing Partner and management – and designated/line supervisors
- An individual is a supervisor:
  - when you or organizational documents identify them as another person's supervisor
  - when asked or instructed to be responsible for another person, or takes charge under instructions or on their own
- This is a "facts and circumstances" test: does a person have the responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue
- Cannot "delegate" the responsibilities inherent in supervision
- Cannot say: "watch out for him/her/it and let me know if anything comes up"

Director/partner liability

- Directors and partners have been held liable in the following circumstances
  - Failure to supervise
  - Controlling person liability: partner was reckless or intentionally permitted violations to occur
  - Failure to follow up on red flags and ignoring issues/"pushing them down", delegating responsibilities and failing to follow up. *In re J. Kenneth Alderman, CPA; Jack R. Blair; Albert C. Johnson, CPA; James Stillman R. McFadden; Allen B. Morgan Jr.; W. Randall Pittman, CPA; Mary S. Stone, CPA; and Archie W. Willis III, Admin Proc 3-`5127 (June 13, 2013),* https://www.sec.gov/litigation/admin/2013/ic-30557.pdf
  - Failure to provide adequate resources to the CCO. *Pekin Singer Strauss*, Admin Proc 3-16646 (June 23, 2015), https://www.sec.gov/litigation/admin/2015/ia-4126.pdf

Examinations

- Section 204 of the Advisers Act gives the SEC authority to examine the books and records that advisers are required to keep
- Types of examinations
  - Risk-based (based upon expanded Form ADV data)
  - Cause – tips, complaints, whistleblower information, referrals from non-U.S. regulators
  - Thematic – to address on a cross-sectional basis compliance issues that are in need of staff attention
  - "Presence" examinations
  - Correspondence examinations
- Even if a non-U.S. SEC registered adviser does not manage U.S. client assets, it is still subject to SEC examination

Which advisers are to be examined?

- Identified through risk analysis
- Sources of information used in the decision-making process
  - OCIE Risk Analysis Group
  - Division of Enforcement Asset Management Unit
  - Prior exam results
  - Publicly available information
  - Changes in an adviser's profile – new CCO, more assets, new private funds – *or* no changes over a period of time
  - Tips from other regulators or "TCRs" received by the SEC
  - Other areas of the SEC
- Analysis
  - Systematic (Form ADV disclosures) by industry
  - Tactical (abberational performance, events, &c.)

Focus of examinations

- Risk identification and conflicts controls, relative to the adviser's business
- Strength or weakness of a compliance program
- CCO not doing his or her job
- No compliance tone at the top
- Monitoring and testing: using or ignoring results?
- Affiliations
- Changes implemented when and as required
- Responses to breaches and developments
  - Be dynamic, not static
  - Fix it, find out what it happened and take proper action
- If things are not being caught, why?
- Control environment

- Understand the Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers: www.sec.gov/ocie/risk-alert-5-most-frequent-ia-compliance-topics.pdf

Core risks commonly examined

- Conflicts of interest
- Fees and expenses
- Performance advertising
- Safe-keeping of clients' assets (custody)
- Undisclosed compensation arrangements
- Deal allocations among clients
- Brokerage arrangements and trading
- Code of ethics and personal dealing
- Valuation of clients' positions
- Marketing and promotional activities

What do we do to prepare for an examination?

- Always be ready!
- Provide all requested materials promptly and keep a duplicate set of documents
- Ensure that everyone will be present during the exam or, if this is really not possible, make sure that requested persons/key staff are available for a phone interview
- Form and prepare the exam team
  - The CEO, the CCO and key staff
  - Conduct refresher compliance training
  - Conduct mock interviews
  - Confirm all systems are operational and all records are available
  - Do not change or hide anything and do not alter any records
  - Know the practical implications of the exam – this is “our opportunity to shine” and not “they’re here to catch us out or find something”
- Do the “30 minute drill”
  - Review all Code of Ethics materials, reports, reviews and breaches
  - Review the breaches log and trade errors log
  - Review output from the last two annual reviews

- The SEC is examining advisers in countries where it has never before examined firms
- The number of examinations is rising
- OCIE is showing up at RIAs unannounced to conduct “surprise” examinations
- The SEC has been conducting these unannounced “surprise” exams to
  - better understand how an RIA operates when it thinks no one is looking
  - avoid situations where an RIA “cleans up” its compliance program and records after receiving notice of an impending SEC exam with a document request letter

What attracts the Division of Enforcement?

- No demonstration of “compliance tone at the top”
- Poor cybersecurity controls
- Fees and expenses issues: disclosure does not match actual practice
- “Light touch” or “slap on the wrist” response to breaches
- Failure to disclose conflicts of interests
- Poor or misleading disclosure

Enforcement actions

- *Capital Dynamics* (2017)
  - Misallocation of RIA expenses to the Fund
- Potomac Asset Management (2017)
  - Misallocation of expenses and failure to reduce fees from reimbursements
- *GLG Partners, Inc.* (2013)
  - Misvaluing fund assets because of internal control failures
- *The Robare Group, LTD.* (2016)
  - Failure to effectively disclose conflicts, and use of the word "may" in disclosure documents
- *Paradigm Asset Management* (June 2014)
  - Conflict of interest in that fund GP who owned adviser could not give effective consent for the fund
- *In the Matter of Feltl & Company (November 2011)*
  - Policies and procedures must be bespoke and evolve
- *Wunderlich* (May 2011)
  - You must have and follow your compliance policies and procedures
- *Navigator Money Management, Inc.* (January 2014)
  - Monitor the use of social media
- *Lincolnshire Management, Inc. (*September 2014)
  - Do not misallocate expenses with a private fund

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