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ACA Insight

The weekly news source for investment management legal and compliance professionals

"You should assume that the information will be conveyed to the Division of Enforcement."

Exam Referrals to Enforcement: How Much Should Advisers Worry?

It's every advisory firm's nightmare. SEC examiners visit, find some deficiencies and suggest some corrective actions, which the adviser makes. Some months later, the advisory firm learns that it is the subject of a Division of Enforcement investigation, based on a referral from the exam team.

Likely or unlikely? The answer comes down to that attorney maxim: It depends.

continued on page 2

New Share Class Settlements May Increase Self-Reporting Pressure on Advisers

Is it a coincidence? With just under two months before the SEC's Share Class Selection Distribution initiative's self-reporting deadline, the agency on April 6 announced new share-class settlements with three advisory firms containing civil money penalties that collectively total almost $2 million. The SEC used the occasion to issue a press release that "strongly encourage[s]" advisers to participate and avoid such fines themselves.

The agency announced its share-class initiative in February (*ACA Insight*, 2/26/18). It's designed to encourage advisers to voluntarily report if they failed to disclose that

continued on page 3

Trade Pre-Clearance and Blackout Periods: Use Them Wisely

Trade pre-clearance and blackout periods are two reliable methods used by advisers seeking to avoid certain kinds of problems when trading securities or with personal trading. That's not to say, of course, that these methods don't carry their own problems if not done right.

It all really comes down to striking the right balance between setting restriction levels that do their job and not discouraging legitimate trading.

"It's very easy to create a prohibition that overwhelms reasonable trading, and very

continued on page 6

Exam Referrals

continued from page 1

"While examinations are not stalking horses for Enforcement – historically only approximately 10 percent of exams conducted by the agency's Office of Compliance Inspections and Examinations are referred to Enforcement – the two groups are in constant communication in the SEC's offices across the country and therefore are highly coordinated in setting priorities and sharing information and field observations," said **Debevoise** partner and former Division of Enforcement Asset Management Unit co-chief **Julie Riewe**.

Kirkland & Ellis partner and former SEC Division of Investment Management director **Norm Champ** noted that since the 2008 financial crisis, "the effort has been to involve Enforcement earlier if OCIE thinks there are possible violations of law. The idea is to get a read from Enforcement sooner and have them consult more so they know the facts. While this is good practice, it doesn't seem to be increasing the rate of referrals, which is currently about 6 percent."

It should be noted that it is not entirely clear what constitutes a "referral" as that metric is reported by the SEC's exam program. For example, it could be that the metric tracks only formal documented referrals from the exam staff to enforcement, as opposed to enforcement actions that result from more preliminary or less formal interactions between exam and enforcement staff.

"It's important to keep in mind how OCIE chooses what to investigate," said **Stern Tannenbaum** partner **Aegis Frumento**. "Yes, there are exam priorities coming from Washington, but OCIE really operates in the regions, and reacts more to what is happening in the regions. Also, its resources are constrained by the budgets and workload of the regions it operates in."

"It is too simplistic to say that OCIE is an early scout for the enforcers," he said. "It's probably more accurately the reverse, because OCIE will react in its exams to what the Division of Enforcement staff has found to be problem areas as a result of enforcement actions. So, sure some OCIE exams will uncover a problem so serious that enforcement action will follow. But it is better to say that you are being examined for a particular matter because someone like you was charged with wrongdoing in connection with that matter."

"Once the SEC has been educated about a certain conduct through an enforcement action, OCIE will know what to look for," Frumento said. "The SEC will then use OCIE exams to see how prevalent the problem is. Sometimes that will result in enforcement actions, sometimes in a new rule, sometimes only in annoyance. But to say that OCIE is looking for cases to refer to the enforcement staff is going too far. That isn't really its job."

"The person said to me, 'What are you talking about? We've been talking to Enforcement about this exam since its second week.'"

Bifurcation

The issue of just how separate OCIE and the Division of Enforcement are was discussed during a panel at last month's **Investment Adviser Association's** 2018 Compliance Conference in Washington, DC. Asked about Enforcement staff accompanying exam staff during examinations, SEC Division of Enforcement co-director **Stephanie Avakian** said that when this occurs, "it's almost entirely circumstances when Enforcement is trying to learn."

Debevoise partner and former SEC Division of Enforcement Asset Management Unit co-chief **Robert Kaplan**, who was also on the panel, said that the issue was more complex than simply enabling regulatory staff members to learn – although he agreed that "from a resource, integration and staff education perspective, I understand why the Commission would want Enforcement there."

Nonetheless, he said, having Enforcement staff present during examinations "dramatically changes the complexion of an exam."

"To the extent you were ever told by your counsel five or six years ago, 'We're going to approach an exam by voluntarily surfacing issues and problems as transparently as possible, and if we have an issue, we'll fix it and that will be the end of it,' I think the stakes have changed dramatically," Kaplan said. Now he tells clients that when they talk to the examination staff to be honest and accurate, but talk "as if they are talking to the Division of Enforcement, because there is much more of a fluid relationship between the two."

As an anecdotal example, he shared a story from what he said was about four years ago, at the end of what was a lengthy exam that resulted in deficiencies and a request for substantial remediation. During a discussion with the head of an SEC regional office's exam staff, Kaplan said, he asked whether, if the advisory firm took certain actions, that would satisfy the agency and there would not be a referral to the Division of Enforcement.

"The person said to me, 'What are you talking about? We've been talking to Enforcement about this exam since its second week,'" Kaplan said. "So there is not the same bifurcation of processes anymore. I think that probably doesn't encourage the same sort of open-vest approach that may have been the case years ago."

What does this all mean? Probably that the safest course for an adviser to take when visited by examiners is to treat such visits as though they will be referred to the Enforcement Division, said **Paul Hastings** partner **John Nowak**. "It would also be wise to check with outside counsel and to be proactive in evaluating whether the examiners might look at additional areas – beyond those areas in which the examiners initially expressed an interest."

An advisory firm would be wise to take the approach that "when you are talking to examiners, you are talking to the SEC writ large," Kaplan said. "You should assume that the information will be conveyed to the Division of Enforcement."

New Share Class Settlements

continued from page 1

they placed clients in certain share classes when less expensive share classes for the same investment were available. The carrot dangled by the SEC is that advisers that take advantage of the program, while still having to pay disgorgement and prejudgment interest, censure and the possibility of individual liability, will not have to pay civil money penalties.

Civil money penalties can be substantive, as these new settlements show – although the size of the fines may be explained, at least in part, by the fact that the advisers involved are quite large, with billions of dollars in assets under management.

Adding a stick to the carrot, the SEC, when it issued the initiative, said that advisers that do not self-report, and that are later found to have had share class violations prior to the initiative, may face "additional charges," and that "a settlement against an eligible adviser that fails to self-report under the SCSD initiative may include greater penalties than those imposed in past cases involving similar disclosure failures."

Failure to disclose share-class arrangements "cause[s] real harm to clients," said Division of Enforcement Asset Management Unit co-chief **Dabney O'Riordan** in issuing the new settlements. "We strongly encourage eligible firms to participate in the recently announced Share Class Selection Distribution initiative as part of an effort to stop these violations and return money to harmed investors as quickly as possible."

Benefit or no benefit

Whether the initiative is something that advisers should take advantage of has raised strong opinions. Several defense attorneys have pointed out the risks of self-reporting, including advisers opening themselves up for long periods of investigation into other potential violations found by examiners, loss of credibility when the settlement becomes public, and a possibility of shareholder class actions or third-party lawsuits."

The announcement of the settlements "sends a clear message that the SEC wants registered investment advisers to investigate and self-report share class issues," said **Rogers & Hardin** partner **Stephen Councill**. "RIAs should explore all financial arrangements that create (or have created) financial benefits, and should confirm that clients have been placed in the best available share class."

"The timing of these SEC share-class actions, which included some sizeable penalties, and the SEC's press release on the cases appear choreographed to drive self-reporting by firms before the fast-approaching deadline," said **Bell Nunnally** partner **Robert Long**. "Ultimately, before self-reporting, a firm needs to understand whether it violated the federal securities laws, whether the violations fit within the scope of the SECs share class initiative, and the consequences of self-reporting to the SEC."

Now that the SEC has provided its shareholder initiative, "the advisory street now can make voluntary self-reporting of similar misconduct in order to benefit from lesser Division of Enforcement sanctions when settling," said **Scarinci Hollenbeck** partner **Paul Lieberman**. "This is a good thing for the industry. The issue is, how much of a good thing? Will there be Division of Enforcement discretion so that settlements still become individual negotiations?"

Share classes and their selection

Most mutual funds offer investors different types of shares, each known as a "share class," with each share class representing an interest in the same portfolio of securities with the same investment objective. The main difference among the share classes is the fee structure.

For instance, the SEC said, Class A shares typically charge 12b-1 fees to cover fund distribution and shareholder services. These recurring fees are deducted from the mutual fund assets on an ongoing basis and paid to the fund's distributor or principal underwriter, which then remits the fees to the broker-dealer that distributed or sold the shares. The 12b-1 fee is typically 25 basis points per year.

Mutual funds also offer other share classes, however, that do not charge 12b-1 fees, and are sometimes known as Class I shares. "While many Class I shares have higher initial investment minimums as compared to Class A shares, many funds waive or substantially reduce these thresholds for client purchases, particularly in advisory accounts [with] wrap fee programs offered," the agency said in one of the settlements.

"A client who holds Class I shares of a mutual fund will pay lower fees over time – and earn higher returns – than a client who holds Class A shares of the same fund," the SEC said. "Therefore if a mutual fund offers a Class I share, and a client is eligible to own it, it is almost invariably in the client's best interest to purchase or hold the Class I share."

Now let's take a look at two of the settlements and what they entailed.

> *"The timing of these SEC share-class actions, which included some sizeable penalties, and the SEC's press release on the cases appear choreographed to drive self-reporting by firms before the fast-approaching deadline."*

Securities America Advisors

Nebraska-based **Securities America Advisors** (SAA), registered with the SEC since 1994, has more than 1,700 investment advisory representatives and, as of September 2017, approximately $15.6 billion in assets under management, most of which are associated with discretionary accounts. It also has a broker-dealer affiliate, **Securities America, Inc.** (SAI). During the period covered by this settlement, the broker-dealer affiliate acted as the introducing broker-dealer for its affiliated advisory firm's clients, according to the SEC's April 6 order instituting the settlement.

From February 2012 through December 2016, SAA offered asset management services to its advisory clients through wrap advisory programs, the SEC said. "Each wrap fee program enabled SAA's IARs to invest client assets in various mutual funds across numerous fund complexes. For each wrap fee program, SAI acted as the introducing broker-dealer on all securities transactions. . . . Virtually all of SAA's IARs also acted in dual capacities as registered representatives of SAI."

What happened, according to the agency, is that from February 2012 through December 2016, SAA invested advisory clients in mutual fund share classes "that charged 12b-1 fees based on these investments, of which SAI paid a portion to its registered representatives, who acted as investment adviser representatives of SAA for the relevant SAA advisory client accounts."

Unfortunately, according to the settlement order, "SAA's disclosures failed to adequately inform its clients of the conflict of interest presented by its IAR's share class selection practices. In particular, SAA failed to disclose that its IARs had a conflict of interest as a result of the additional compensation an IAR received for investing advisory clients in a fund's 12b-1 fee paying share class when a less expensive share class was available for the same fund."

On top of that, the SEC said, "the practice of investing advisory clients in mutual fund share classes that charged 12b-1 fees rather than lower-cost share classes of the same funds was inconsistent with SAA's duty to seek best execution for those transactions," the agency said.

The bottom line violation in these cases, according to the agency, is not so much that clients were placed in more expensive share classes, but that the advisory firm did so without properly disclosing all the material facts to its clients – including the alleged conflicts of interest between itself and its clients that could affect the advisory relationship. "SAA failed to disclose that SAA and its IARs had a conflict of interest as a result of the additional compensation they received for investing advisory clients in a fund's 12b-1 fee paying share class when a less expensive share class was available for the same fund. Additionally, SAA failed to disclose that its IARs would and did select share classes paying 12b-1 fees when less expensive share classes were available."

As part of the settlement, SAA was charged with several violations of the Advisers Act, including willfully violating Section 206(2), which prohibits fraud; Section 206(4) and its Rule 206(4)-7, the Compliance Program Rule, for failing to adopt and implement written compliance policies and procedures; and Section 207, for making untrue statements of material fact in any registration application or report filed with the Commission.

The SEC credited the adviser with taking a number of remedial actions, including implementing several policies to address its mutual fund share class selection practices, and requiring that IARs complete all new purchases of mutual funds in advisory accounts at the lowest cost share class available. SAA was censured, ordered to pay disgorgement of approximately $4.47 million, $580,423 in prejudgment interest, and a civil money penalty of $775,000.

A spokesperson for SAA said that the firm "strives to adhere to the highest standards in providing to our advisers a framework to deliver unbiased financial advice and exceptional service to their clients. Many firms have already or are in the process of resolving matters with the SEC regarding the use of 12b-1 fee mutual funds in advisory accounts. In 2017, we revised our disclosures, instituted new policies regarding fund share classes and transitioned existing holdings in client advisory accounts to the lowest-cost mutual fund share class available."

Geneos Wealth Management

Colorado-based **Geneos Wealth Management**, an advisory firm registered with the SEC since 2003 and as a broker-dealer since 2002, has approximately 250 IARs and, as of September 2017, approximately $2.6 billion in AUM, a majority of which is associated with discretionary client accounts, according to the SEC's administrative order instituting the April 6 settlement.

The Geneos settlement is similar to the SAA settlement in some ways, and different in others.

From February 2012 through April 2017, Geneos invested some of its advisory clients in mutual fund share classes that charged 12b-1 fees when those clients were eligible to invest in less expensive share classes of the same funds that did not charge such fees. "Geneos financially benefitted from investing advisory clients in mutual fund share classes with higher fees," the SEC said, "which created a conflict of interest that Geneos failed to adequately disclose in its Forms ADV, Part 2A . . . or otherwise." The advisory firm received at least $1.05 million in these 12b-1 fees, the agency said, something that was allegedly "inconsistent with its duty to seek best execution."

In addition, from February 2012 through January 2018, Geneos allegedly failed to disclose to its clients that it received compensation through agreements with two third-party broker-dealers, and conflicts arising from that compensation. "Pursuant to the agreements, the clearing brokers agreed to share with Geneos certain revenues that the clearing brokers received from the mutual funds in the clearing brokers' no-transaction-fee mutual fund programs. These payment totaled approximately $386,186, the SEC said, and "created a conflict of interest in that they provided a financial incentive for Geneos to favor the mutual funds in the [no-transaction-fee] programs over other investments when giving investment advice to its advisory clients."

Like SAA in its settlement, Geneos, in its own settlement, was charged by the SEC with several violations of the Advisers Act, including Section 206(2), which prohibits fraud; Section 206(4) and its Rule 206(4)-7, the Compliance Program Rule, for failing to adopt and implement written compliance policies and procedures; and Section 207, for making untrue statements of material fact in any registration application or report filed with the Commission.

As part of its settlement, Geneos was required to send a copy of the settlement order to its advisory clients within 30 days, and certify in writing its compliance with the undertakings to which it agreed as part of the settlement. The advisory firm was censured, and ordered to pay disgorgement of approximately $1.05 million, prejudgment interest of $87,512, and a civil money penalty of $250,000.

In a public statement following the settlement, Geneos said that, "As made clear in the Commission's Share Class Disclosure Initiative issued on February 12, 2018, many investment advisers have not met the Commission's standards in making adequate disclosures of potential conflicts of interest regarding the variety of fees that may be paid by different mutual funds, or by different share classes offered by a single fund. We are glad to have this matter behind us, and we will continue to focus on helping our many clients meet their financial goals, as we have been doing since 2003."

Councill, in regard to the multiple share class settlements announced April 6 by the SEC, said that they "provide additional details about what compliance personnel should explore in deciding whether their firms' have disclosure and best execution issues."

"For example," he said, "the Geneos settlement notes that Geneos's agreement with its clearing firms allowed Geneos' clients to avoid transaction charges. Geneos' Form ADV disclosed it may receive 12b-1 fees, which created a conflict, but this disclosure was inadequate in the SEC's view because it did not disclose that it received a financial benefit from not placing clients in the best available share class."

Restricted Lists

continued from page 1

easy to create an exception that overwhelms the protection," said **Shearman & Sterling** partner **Russell Sacks**, who advises financial institutions on issues including review of personal trading.

In deciding how broad to make trading restrictions, consider the facts and circumstances surrounding each client, as well as the trade strategy the firm pursues, and where any MNPI exposure may lie. Questions may involve the role of an employee or another person involved, or when a rumor is likely to become a fact.

Sacks suggested that chief compliance officers at advisory firms would be wise to seek advice from CCOs at other firms, as well as those at banks and broker-dealers, to see what they do in regard to trading restrictions, he said.

Trade pre-clearance

"The purpose of trade pre-clearance is to try to avoid either trading in MNPI or in material nonpublic market information," which may enable individuals to front run, or trade ahead, of the market, Sacks said.

The order management systems used by many firms have built-in controls that require trade pre-clearance

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when potential trading in certain securities is entered. On the client side, if a client doesn't want certain trades, such as in derivatives, the firm enters that information into the trading software. The same system is not typically used for employee and firm trading. An order management system will actually prevent a trade on behalf of a client in a restricted list security, while personal trading software will alert the chief compliance officer to a request to trade a security that is on the restricted list, allowing the CCO to deny the employee's request for trading.

> *"The purpose of trade pre-clearance is to try to avoid either trading in MNPI or in material nonpublic market information."*

Advisory firms that do not have trading software may perform trade pre-clearance manually, which means that they would need to require employees to physically send, or personally submit, such requests to the Compliance Department.

Stark & Stark attorney **Max Schatzow** suggested that advisers ask themselves some key questions before approving any trade pre-clearance requests:

- What is our firm's trading strategy?
- What kind of inside information do we have?
- What securities are we trading?

Before requiring trade pre-clearance, advisers should first decide "how wide they want to make each category of interest," said Sacks. They also need to ensure that they are complying with all relevant guidance and have necessary controls in place.

"Striking the balance is a business decision, really," Schatzow said. "Most investment advisers will choose a pretty restrictive stance."

Blackout periods

Blackout periods are essentially what the name implies, creating a time frame when trades will not be allowed. In that sense, they are similar to restricted lists, which also impose moratoriums on trading in certain securities or firms, said Sacks. The similarity between the two methods is particularly pronounced when restricted lists are updated frequently, so that trade restrictions on certain securities may last only 30 or 60 days, much like blackout periods.

When prohibited trades are entered in the system, the trading software recognizes them and they are automatically restricted for the length of the blackout period.

Mistakes to avoid

Whether your firm uses trade pre-clearance, blackout periods or both, consider taking the following steps to prevent the following mistakes:

- **Don't unnecessarily restrict clients.** Trade restrictions that go too far may prevent clients from doing business. For instance, a firm may have distant satellite offices, the activities of which are not well-known at the home office. Those in the home office would have little reason to restrict client trades in securities exclusive to the satellite office. Advisers can make use of "information barriers" that prevent information from one unit from spreading to another.
- **Failure to make clear in policies and procedures the importance of trade pre-clearance.** If a firm's policies and procedures do not properly articulate its position in regard to when various kinds of trades require pre-clearance, then it should be no surprise when employees fail to do so, said Schatzow.
- **Failure to refresh lists.** Whether these are lists for blackout periods or for pre-clearance – or, for that matter, just restricted lists – they need to be reviewed and updated fairly frequently, perhaps as often as once a month. Facts and circumstances will lie behind each decision of what to remove, but information that is six months old or more should be considered for removal.
- **Letting management or ownership of the advisory firm off the hook.** It's never easy to challenge the boss, but firm managers and owners need to follow the same rules involving trading restrictions as other employees, otherwise your policies and procedures lose credibility, said Schatzow. Failure of managers and owners to follow trading restrictions may also lead to problems with examiners or the SEC's Division of Enforcement down the line.

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