

SECURITIES ENFORCEMENT ACTIONS TRENDS AND WHY INVESTMENT ADVISERS SHOULD TAKE NOTE

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Co-Authors:

Ronak V. Patel, Partner, Kelly Hart & Hallman LLP
Toby M. Galloway, Partner, Kelly Hart & Hallman LLP

The Securities & Exchange Commission recently announced its enforcement results for the 2016 fiscal year, which ended on September 30.ⁱ The total number of enforcement actions in fiscal year 2016 was a new high for the SEC. Out of a total 868 actions, the SEC reported 548 independent or standalone enforcement actions, which is a roughly eight percent increase from fiscal year 2015. Furthermore, “follow-on” administrative proceedings, which the SEC uses to sanction brokers and investment advisers previously found liable for securities laws violations, increased by approximately 16% from 168 in 2015 to 195 in fiscal year 2016. Of course, these statistics also include cases resulting from the SEC’s “broken windows” approach, which tends to involve actions related to violations much more minor than frauds. Yet, an analysis by the Wall Street Journal indicates that the SEC would have exceeded its previous enforcement record even without so-called “broken windows” cases.ⁱⁱ

In September 2016, the North American Securities Administrators Association (NASAA) reported “for the first time” in the history of NASAA’s annual enforcement survey that more registered individuals and firms were respondents in state enforcement matters than unregistered individuals and firms.ⁱⁱⁱ It is clear that the SEC and other regulators continue to increase their enforcement activities in a number of areas involving registered entities. Of particular note is the level and variety of enforcement actions against investment advisers and investment companies.

INCREASED AND INTERESTING ENFORCEMENT ACTIVITY

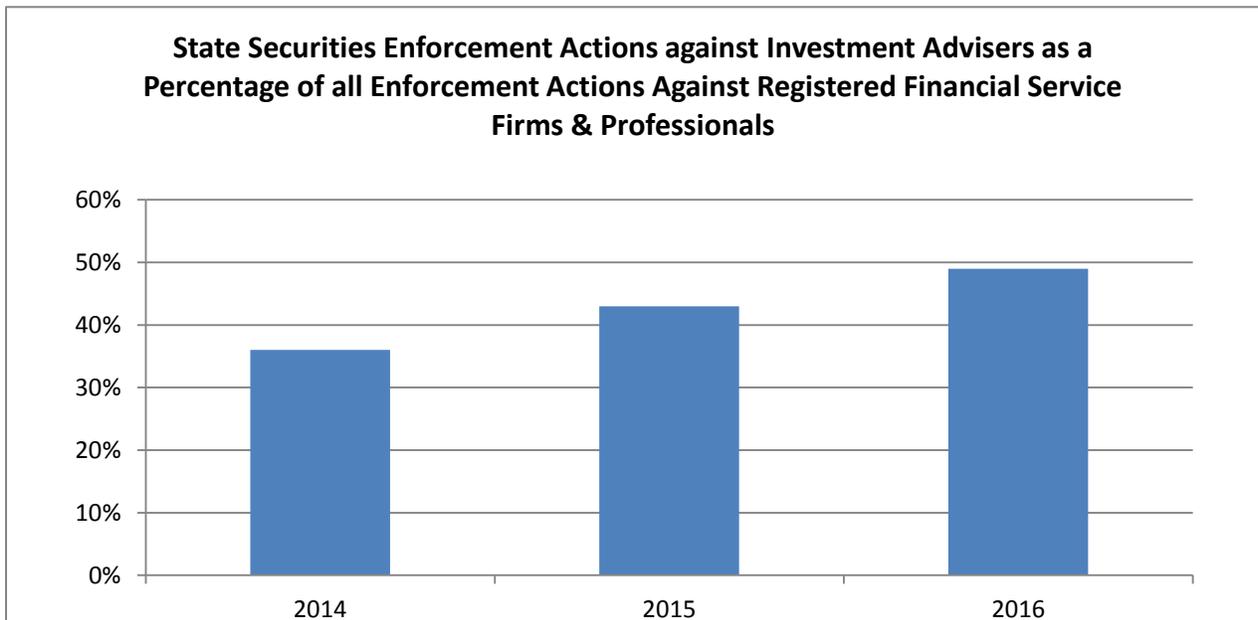
Asset managers should note the apparent increase in actions by the SEC against investment advisers and investment companies. The SEC reports that fiscal year 2016 included the highest number of actions involving investment advisers or investment companies – 160.^{iv} And it is not just the SEC. State regulators are also increasingly focusing their enforcement actions against registered investment advisers. According to enforcement reports by NASAA, state enforcement activity related to investment advisers and investment adviser representatives appears to have steadily increased over the prior three years.

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Enforcement statistics, while eye-catching, are only as meaningful as the substance of the actions behind the statistics. In recent years, securities regulators have enhanced their risk identification processes and increased the use of big data analytics to bolster their oversight of asset managers. Furthermore, revitalized efforts to enforce the broader scope of investment advisers' fiduciary duty may also be a cause for increased enforcement activity. As a result, recent enforcement matters against investment advisers include numerous actions aimed at addressing issues with long existing practices and at encouraging meaningful enhancements to investment advisory services.

Consider the following issues alleged in enforcement actions against investment advisers by the SEC and state securities regulators:

- Investment advisers withdrawing undisclosed and unauthorized fees from client accounts under the advisers' management.ⁱ
- Various issues with private equity funds and their advisers including: funds' payments of undisclosed expenses; agreements between the funds and parties affiliated with the private equity fund advisers; and failure to register as a broker-dealer in connection with activity related to acquisition of portfolio companies.ⁱⁱ
- Breaches of an investment adviser's fiduciary duty resulting from its recommendation of the broker-dealer used for its clients' transactions and the undisclosed financial arrangement between the broker-dealer and the investment adviser.ⁱⁱⁱ

- In 2011, after an investment adviser discovered that the valuations of certain investment companies managed by the adviser were inaccurate due to a flaw in a third-party analytical tool, the investment adviser initiated remediation efforts. In 2016, the investment adviser was found to have engaged in non-scienter fraud based on “negligent conduct” in connection with the remediation effort, which resulted in some of the funds’ shareholders not receiving the correct amount of compensation.^{ix}
- Incomplete and untimely responses to regulatory requests for information and failures to address deficiencies cited by examiners face increasingly significant consequences – including revocation of an investment adviser’s registration.^x
- Failures to enforce written supervisory procedures related to investment adviser’s participation in block trades alongside clients whereby investment adviser failed to pre-allocate the shares included in block transaction.^{xi}
- Non-scienter fraud findings against multiple investment advisers as a result of the investment advisers’ circulation of advertisements **prepared by a third-party investment adviser**, which included misrepresentations about the performance of the third-party adviser’s investment strategy.^{xii}

THOUGHTFUL AND INFORMED PREPARATION IS KEY

Many financial service professionals do not have the time, resources, or expertise to prepare effectively for regulatory scrutiny. However, investing some time into basic considerations, such as the ones below, is not only feasible but potentially invaluable. In addition to bolstering protections in regulatory matters, considered diligence on supervisory controls may support your firm’s efforts to attract assets from sophisticated investors.

- Do not assume that long-existing practices will not face regulatory criticism – even if the regulators have been aware of the practices. Advancements in industry practices, shifts in regulatory priorities, abuses uncovered at other firms, and increased sophistication among regulators can justifiably result in scrutiny of practices that may have been implicitly, if not explicitly, accepted by regulators previously.
- Closely review your written supervisory procedures (WSPs) and Form ADV filings (both Part 1 and 2) and update as necessary. Many investment advisers purchase templates from consultants or copy materials used by another firm. Unfortunately, these advisers often fail to ensure that these documents are consistent with their own firm’s practices and business activity. Of course, the most significant concern is that the WSPs and the Part 2 (aka, “firm brochure”) address all aspects of a firm’s investment advisory activities. However, this should not be a reason to include (i.e., not remove from the template) procedures and language that have nothing to do with your firm’s business. Finally, engaging in a thoughtful review of the WSPs and Form ADV filings with informed advisers on a regular basis will ensure that these documents grow with your firm and your supervisory system maximizes the use of advancements in technology.

- If you have not been examined by the SEC or a state regulator for an extended period, consider engaging a consultant or lawyer to conduct a mock audit. Experienced and knowledgeable counsel will know the regulatory priorities and understand how regulatory exams are conducted. More importantly, this type of independent advice will afford your firm the opportunity to identify and address any potentially significant issues before regulators even step in the door.
- Establish a recurring process to review any potential conflicts of interests. This review should not replace the conflicts review conducted before making a change in your business model or in the products recommended to clients. Instead, an annual conflicts review can be used to better ensure that the controls and disclosures already in place remain meaningful and effective.
- As the amount of assets managed by investment advisers continues to grow, expect issuers and other product sponsors to increase their marketing towards investment advisers. Exercise appropriate diligence when approached with new products and pay attention to how compensation arrangements could raise potential conflicts of interest. Senior personnel and regulatory experts should be used to best understand alternative or unique investment products before recommending them to clients. Finally, limit communications about an investment product to representations reasonably based on information you gained through independent diligence into the product.
- Document, document, document. Documentation is perhaps the simplest – and most underutilized – aspect of compliance efforts by investment advisers. Do not compromise the value of the steps discussed above by failing to create and retain documentation of the diligence otherwise exercised. While documenting a thoughtful approach to compliance and disclosure of conflicts may not prevent a violation of the law, it could mitigate liability and will lend credibility to your firm should any regulatory issues arise.

CONCLUSION

It is widely understood that investment assets are increasingly managed by investment advisers across the United States. Moreover, the SEC is shifting significant examination efforts towards investment advisers and investment companies.^{xiii} State securities regulators already examine advisory firms registered in their jurisdictions as frequently as annually, and most commonly on a four-year cycle. Consequently, investment advisers should expect the trend of increased regulatory scrutiny and enforcement activity to continue into the foreseeable future. Fundamental, and often simple, compliance measures should serve investment adviser firms well in connection with regulatory matters. In addition, an investment advisory practice that includes a strong compliance foundation may differentiate your firm from others and meet the expectations of more sophisticated clients as you look to grow your firm.

ⁱ See SEC Press Release - <https://www.sec.gov/news/pressrelease/2016-212.html> (October 11, 2016).

ⁱⁱ Jean Eaglesham, SEC Tallies Record By Aiming Small, WALL ST. J., Oct. 12, 2016, at C001.

ⁱⁱⁱ NASAA 2016 Enforcement Report. http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2016/09/2016-Enforcement-Report-Based-on-2015-Data_online.pdf

^{iv} <https://www.sec.gov/news/pressrelease/2016-212.html>

^v Source data obtained from NASAA Enforcement Reports for 2014, 2015 and 2016, which report on activity in 2013, 2014, and 2015 respectively. Reports available on NASAA website: www.nasaa.org

^{vi} *Securities and Exchange Commission v. Kingdom Legacy General Partner, LLC and Mark C. Northrop*, Civil Action No. 2:16-cv-00441-SPC-MRM (M.D. Fla. filed June 7, 2016); Tex. State Sec. Bd. *In the Matter of the Investment Adviser Representative Registration of Sarah Helen Hancock*, Order No. IC16-REV-07 (March 23, 2016); Tex. State Sec. Bd. *In the Matter of the Investment Adviser Registration of J. Pinkernell Global Wealth, LLC and the Investment Adviser Representative Registration of Jen Pinkernell*, Order No. IC16-SUS-17 (October 14, 2016).

^{vii} Blackstone Management Partners L.L.C., et. Al., Investment Adviser Act Release No. 4219, (October 7, 2015); Fenway Partners, LLC et. Al., Investment Advisers Act Release No. 4253 (November 3, 2015); Blackstreet Capital Management, LLC and Murry N. Gunty, Exchange Act Release No. 77959, Investment Advisers Act Release No. 4411 (June 1, 2016).

^{viii} Tex. State Sec. Bd. *In the Matter of the Investment Adviser Registration of Mowery Capital Management, LLC and the Investment Adviser Representative Registration of Frederick Eugene Mowery*, Order No. IC16-CAF-06 (March, 18, 2016).

^{ix} Calvert Investment Management, Inc., Investment Adviser Act Release No. 4554, Investment Company Act Release No. 32321 (October 18, 2016).

^x *In re Landmark Financial Planning, LLC*, No. AP-16-34, 2016 WL 5349040 (Mo. Div. Sec. Sept. 2, 2016); *In re Shastry*, No. XY-2015-03, 2015 WL 6687970 (Colo. Div. Sec. Sept. 29, 2015)

^{xi} Tex. State Sec. Bd. *In the Matter of the Investment Adviser Registration of Valor Capital Management, LLC*, Order No. IC16-CAF-14 (August 8, 2016).

^{xii} See SEC Press Release - <https://www.sec.gov/news/pressrelease/2016-167.html>. (August 25, 2016)

^{xiii} See speech by Marc Wyatt, Director SEC Office of Compliance Inspections and Examinations, *Inside the National Exam Program in 2016*. Available at: <https://www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html> (Oct. 17, 2016)