SEC COMPLIANCE OUTREACH PROGRAM

FOR INVESTMENT ADVISER AND
INVESTMENT COMPANY SENIOR OFFICERS

CHICAGO REGIONAL OFFICE

JUNE 13, 2017

Josh Saccurato, Jim Leahy and Danielle Sayegh contributed to compiling this outline. The Compliance Outreach agenda, reference materials and partial webcast archive may be found on the SEC's website at https://www.sec.gov/info/cco/cco-regional-seminars-ia-ic-2017.htm. A listing of the reference materials may also be found at Exhibit A to this outline and a summary of many of the cases referred to during the program may be found at Exhibit B. If you have any questions please do not hesitate to reach out to us at jleahy@orical.org or (212) 257-5790.

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Speaker Bios

Ahmed Abdul-Jaleel

Assistant Regional Director, CHRO IAIC Examination Program

Ahmed Abdul-Jaleel is an Assistant Regional Director in the SEC's National Examination Program. Ahmed directs examinations of registered investment companies and investment advisers, including private equity and hedge fund managers. Ahmed's examinations have resulted in multi-million dollar SEC proceedings and recoveries for investors. He served as co-chair of the Portfolio Valuation and Alternative Assets Committee and is a member of the Private Fund Working Group. Ahmed has led national and local examination initiatives and is a multi-year recipient of the SEC National Examination Program Director's Award. Ahmed has also been responsible for handling tips, complaints, and referrals. Prior to joining the SEC in 2010, Ahmed was an Audit Manager at Deloitte & Touche LLP.

Alicia Tate

Risk Management Strategist, CHRO IAIC Examination Program

Alicia Tate develops exam strategies for the IAIC Examination Program. Her position is relatively new and was created in the SEC's Chicago office for a dedicated person to help with our exam planning, understanding a registrant population, exam schedules issues.

Andrea Seidt

Commissioner, Ohio Division of Securities

Andrea Seidt is the Commissioner of the Ohio Division of Securities Administrator Association. She also chairs the IA section and the SRO.

Andrew Shoenthal

Senior Advisor, AMU, Enforcement Division

Andrew Shoenthal is in the Specialized Unit of the Division of Enforcement. He worked in private practice and has since been in the unit for seven years. Andrew has been with the Commission since 2007.

Belinda Hoskins

Exam Manager, CHRO IAIC Examination Program

Chris Hetner

Senior Cybersecurity Advisor to the Chairman

Bio: Chris Hetner is a Senior Cybersecurity and Risk Management Executive with over 25 years of experience in assessing, planning, implementing and leading global Cybersecurity risk management capabilities for financial services firms. He is highly skilled in all business and technical aspects of Cybersecurity, change management, technology risk, operational risk, vendor risk management, continuity of business, physical security and regulatory compliance. He joined the Commission in 2015 and was the Cybersecurity Lead for the Technology Control Program within the SEC's Office of Compliance Inspections and Examinations ("OCIE").

Dabney O'Riordan

National Co-Chief, Asset Management Unit (AMU), Enforcement

Dabney O'Riordan is a National Co-Chief of Enforcement's Asset Management Unit. She currently works in the SEC's Los Angeles office. She joined the commission in 2005, and prior to joining the Asset Management Unit she served as counsel to the Director of the Division of Enforcement as well as Assistant Director in the Asset Management Unit. Prior to joining the SEC, she also practiced in private practice.

David Glockner

Regional Director of the Chicago Regional Office (CHRO)

David Glockner has spent 25 years as a criminal prosecutor in the U.S. Attorney's Office for the Northern District of Illinois, including 11 years as Chief of the Criminal Division. He has led the Chicago office of digital risk management and investigations firm Stroz Friedberg LLC. As director of the Chicago Regional Office at the SEC, David oversees the Chicago office's enforcement and examination operations covering a nine-state region in the Midwest.

James R. Reese

Acting Chief Risk Officer, OCIE

James Reese has been acting as chief risk officer for the OCIE after serving as assistant director in the Office of Risk Analysis and Strategy ("ORAS"). He served in that role since 2013. He leads a centralized unit of staff that is responsible for enhancing the National Exam Program's ability to target firms and practices that present the greatest risk to investors, markets and capital formation. He joined the SEC and OCIE in 1999 as an examiner and in his 18 + year career has assisted in over 450 examinations assisting on 50 rule making initiatives and dozens of data analytics projects.

Junaid A. Zubairi

Chair, Government Enforcement & Special Investigations Group, Vedder Price

Junaid Zubairi is the Chair of Vedder Price's Government Enforcement & Special Investigations practice and regularly practices before the SEC, US Attorney's Office, US Commodity Futures Trading Commission ("CFTC") and other federal and state agencies. Prior to joining Vedder Price, Mr. Zubairi was a senior attorney with the SEC, Division of Enforcement. Mr. Zubairi is the recipient of the Division of Enforcement Director's Award as well as several Special Act awards.

Louis Gracia

Deputy Associate Regional Director, CHRO IAIC Examination Program

Louis Gracia is the Deputy Associate Regional Director in the Investment Adviser – Investment Company Examination Program in the SEC's Chicago Regional Office. Louis has been with the SEC for over 21 years during which time he has led and supervised numerous examinations of investment advisory firms and mutual fund complexes. Louis has investigated and referred findings for Enforcement action for several '40 Act related issues including ponzi schemes, misuse of soft dollars, undisclosed principal transactions, false hedge fund valuation, false/misleading advertising, custody rule non-compliance, failure to supervise and inadequate compliance policies and procedures.

Mavis Kelly

Assistant Director, National Examination Program

Mavis Kelly is Assistant Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"). Prior to this position, she was the branch chief, having accumulated over 25 years of experience in the industry.

Max J. Gillman

Exam Manager, CHRO IAIC Examination Program

Max Gillman has been an examination manager since 2014. During his tenure with the Commission he supervised and participated in numerous examinations of investment advisors, investment companies, private funds and transfer agents as well as participated in many local and national working groups and projects focused on data analytics.

Paul Montoya

Assistant Regional Director, CHRO Enforcement Division, and AMU

Paul Montoya works with the Enforcement Division of the CHRO, where he heads up the AMU unit within the CHRO National Unit. He has been a close colleague in the exam program. He works very closely with AMU in talking about issues of the day and sharing initiatives of the day, with the program and enforcement.

Rebekah Kohmescher

Chief Operating Officer, Altair Advisors

Rebekah Kohmescher has been providing tax and investment consulting to wealthy families and individuals since 1999. As a Founding Partner of Altair Advisers, Rebekah helps clients in developing investment plans, recommends managers and tracks investment performance for clients. In addition to her client service responsibilities, Rebekah conducts investment manager due diligence serving as a member of the international manager search team.

Steven Levine

Associate Regional Director, CHRO IAIC Examination Program

Steven is with the Investment Advisor and Investment Company ("IAIC") exam program but also serves as Co -Chair of the National Exam Program's Exam Process Steering Committee. He joined the SEC in 2000 and spent his first ten years in the Trial Council and Enforcement Division and then was the senior special counsel in the Investment Adviser Investment Company Program before he was promoted to Associate Regional Director in 2013. Prior to that, he was a trial attorney for the EEOC and worked in private practice.

Thoreau Bartmann

Senior Special Counsel, Division of Investment Management, and Rulemaking Office

Thoreau is senior special counsel of the Division of Investment Management. He has led a variety of rule-making initiatives for the mission and notably branch chief effort that culminated in the 2014 adoption of structural reform to the $3 trillion money market fund industry.[1] He supervised the efforts of a number of staff attorneys on the 2015 fund derivatives proposal[2] and the liquidity rule[3] adopted by the Commission in 2016 and practiced in private practice as well.

Thu Ta

Regulatory Counsel, CHRO IAIC Examination Program

Thu Ta is an attorney in the Chicago office of the SEC. In that role, she provides legal counsel to the examiners and works with Enforcement. She joined the SEC in 1997.

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[1] *See* https://www.sec.gov/news/press-release/2014-143 for *SEC Money Market Reform Rules*

[2] *See* https://www.sec.gov/news/pressrelease/2015-276.html for the *Fund Derivatives Proposal*

[3] *See* https://www.sec.gov/rules/final/2016/33-10233.pdf for the *SEC Final liquidity Rule*

Tina Diamantopoulos
Counsel to the Director, CHRO

Vanessa Horton
Assistant Regional Director, CHRO IAIC Examination Program

Wendy D. Fox
Chief Compliance Officer, Ariel Investments
Wendy is Chief Compliance Officer at Ariel Investments, LLC in Chicago. She joined in 2004 as the Chief Compliance Officer of Ariel Investments and its affiliated broker dealer, Aerial Distributors, LLC. In 2014 she was appointed Chief Compliance Officer for the Ariel Investment Trust. She's responsible for regulatory risk oversight and administration of compliance programs covering investment, advisor, broker-dealer and mutual funds. Prior to Ariel, she spent 16 years working in the SEC's Chicago office where she was an attorney advisor in the Management Program as well as a liaison officer and senior attorney in the Division of Enforcement.

WELCOME AND OPENING REMARKS

Speaker:

David Glockner, *Regional Director of the Chicago Regional Office (CHRO)*

Purpose of this program:

Compliance and compliance outreach is at the core of what the SEC does. Our mission is not so much to hit people over the head with a 2 x 4 when things go wrong as it is to promote compliance and promote better conduct in the industry: That's why all of you (CCOs and other senior officers) are here; that's what your function is on a day-to-day basis. CCO's really are a primary player in the safety, stability, and integrity of the industry. CCOs provide a critical line of defense for firms in their own risk management.

The CCO's role is a crucial function for any regulatory compliance program. It's a tremendously challenging role. We recognize how difficult it is for you both in terms of the changing regulatory environment, and the changing market environment. It can be a challenging function within the firm given the dynamics of the firm; there are very few compliance offices that are profit centers for your firms. Our hope is that recognizing all these dynamics and with the information that we can impart to you today, and the conversation that we hope that we will have, will help inform and empower you in carrying out your functions.

We're going to be talking today about some of the things that we see as key risks in the industry, developments both legal and technological as well as regulatory changes and compliance issues we see developing. We will talk about some of the nuts and bolts of how we do exams, compliance issues that we're running into, new exam initiatives, developments within our examination program, and recent decisions of note. And also we hope that this will be an interactive program as opposed to just us panelists lecturing. We want to be as responsive as we can be to your concerns and questions. Questions are welcome and encouraged.

PANEL 1. SEC'S CHANGING LANDSCAPE

Panelists:

Steven Levine, *Associate Regional Director, CHRO IAIC Examination Program*

Dabney O'Riordan, *National Co-Chief, Asset Management Unit (AMU), Enforcement*

Thoreau Bartmann, *Senior Special Counsel, Division of Investment Management, and Rulemaking Office*

Wendy D. Fox, *Chief Compliance Officer, Ariel Investments*

Tina Diamantopoulos, *Counsel to the Director, CHRO (Moderator)*

Introductory Remarks:

Tina Diamantopoulos: Thank you for joining us today. We are hoping to have a discussion about some of the issues that we see happening. We'll discuss changes in the programs and the divisions, how we operate, how exams have changed, and how they've become more risk focused. To the extent we can, we will let you know what each of us thinks and the direction that we're going in. Along that front, we've been asked to throw out a question to the audience which is, we would like you to think about what the changes are in risk-focused exams, coordination, and generally what you see is working and what we could be doing better? We will start with Steven from the National Examinations Program perspective.

National Exam Program:

Tina: Steven, can you share with us what you think the change in landscape for the National Exam Program has been?

Steven Levine: I will share my perspective as to what the changes in our national program and our national landscape have been since I joined our program, and how I think they have impacted our examination program. First and foremost, we have become truly a risk based program and a data driven program. We have 12,000 registered investment advisers ("RIAs"), 850 registered investment companies ("RICs") with 11,000 mutual funds. That's too many for us to examine each year so we have to be risk based in how and what we chose to examine. We did 1600 IAIC exams in 2016, that's a 20% increase over the prior fiscal year. We need to be making good choices as to who and what we examine. We are much more of a national program than we have ever been. Many regions are working together on the same national initiative. Some of you refer to them as "sweeps". When we group together a set of exams across regions to get a better sense of the industry, we call that a national initiative. There's lots of collaboration among the regions.

Tina: How do you collaborate with the regions?

Steven: We collaborate in communicating about exams, exam times, findings and registrants. Regional Exam Teams may be going to other regions. When we go to other regions with respect to what we're exploring, we will have conversations with those other regions about the registrant that we're examining because they have better institutional knowledge. From an exam process standpoint, the exam process steering committee has representatives from every region. We want to be as consistent as possible with our execution of exams. We think consistency is important. Another reason why we like national initiatives is because they give consistency to our examinations. It should not be the case that one region examines a registrant differently than another region. We communicate among each other with the exam process;

we communicate from a top-down approach through discussions with our national leaders; and we are highly collaborative in designing our exam program.

<u>Tina:</u> Can you describe what you mean by an “initiative”?

<u>Steven</u>: An initiative is a series of exams that are thematically consistent. Typically, those initiatives and all those exams done under those initiatives have similar document requests and the same scope areas, and seek to obtain the same information. The results of the examinations are typically pooled together. What we get from these national initiatives is consistency, comparability, and measurability from exam to exam, and from registrant to registrant. Many of these national initiatives are to inform policy and policy makers as to a particular new product, a new practice, or the implementation of a new rule which will aid our policy-makers in understanding what is working and what is not. From an enforcement perspective, sometimes the initiatives show the outliers and one thing is that through the initiatives, we see the range of conduct, practice and compliance. Rather than a particular firm feeling like they're being picked on because we brought an enforcement action as a result of their exam and their conduct, we can honestly say there's been a range of conduct in this practice as well as outside the range of conduct, and for all these reasons we like the initiative.

<u>Tina</u>: Before you move on from that Steven, Enforcement can be part of that initiative work as well, right Dabney?

<u>Dabney O’Riordan</u>: We can. It obviously depends on the initiative and certainty with which the information comes back that there may be a serious problem whether or not Enforcement may handle it initially or whether or not you look at it initially. But it is a collaborative process and really more of a risk based approach.

<u>Wendy:</u> Are employees from Enforcement and Investment Management going on routine exams?

<u>Thoreau Bartmann</u>: Absolutely. And sometimes you will see a team of twenty people, and it's not all OCIE. Sometimes you are you are getting people from Enforcement, you are getting people from policy divisions and all sorts of other parts of the Commission designed to really have a breakdown of silos.

<u>Tina:</u> Who the personnel are that appear on the exam is not a secret. They should introduce themselves and indicate whether they are from the Division of Enforcement or from policy or other roles that they represent on the exam.

<u>Dabney</u>: If the division of enforcement has a member on the exam team, that is usually just for informational purposes for that individual. This helps them understand how an investment adviser generally works in practice, and it is not because you are a particular investment advisor. They will identify themselves as being a member of the division of enforcement.

<u>Steven:</u> To be full circle on this, our exam staff works with Enforcement if matters are referred to Enforcement in assisting with an enforcement investigation and assisting with any enforcement proceeding. Their factual knowledge of the registrant as well as particular expertise and skill sets is very helpful. We also think it’s great training for them in the same way that the cross-fertilization of having enforcement staff as a training exercise come into our program and observe how our exams operate. Not only will they come to understand the registrant but also understand the limitations of the exam process. <u>As you know the exam staff does not have subpoena authority</u>. We do not go far beyond the required records and firms and so to the extent there is other information that is necessary to fully understand the issue of a particular practice, having Enforcement understand what our exams cover and what they don’t, is important.

Another development that I have noticed makes a great difference is the access to more data. We are using data much more from more sources as an important part of our risk monitoring, selection and risk scoping. Also industry expertise, we have more industry expertise than ever before. We made a concerted effort to bring in industry experts and we typically call them senior specialized examiners.[4] They are helpful to us on complex issues, they are helpful to us on initiatives and industry driven concerns, and at some point you'll come into contact with one of our senior specialized examiners who may be running that initiative or having heavy input on a consulting basis or in the exam. Transparency is something that I think we have been much better at in recent years. Coupled with the national initiatives, what we have learned is we get a lot of bang for our buck for the Risk Alerts. We publish a Risk Alert to share our findings and observations with the entire industry. So that transparency also relates to other divisions, particularly with the Division of Investment Management, and almost every national initiative is coupled with a wide internal memo where we report up what our findings are with respect to that initiative.

Wendy: I want to emphasize how helpful those Risk Alerts have been as well as other materials, in particular the Cybersecurity publications and document request list. This has been very helpful to this industry, not only the information that was published by the SEC but also other regulators. In terms of us building our own controls at our firms to help us prevent our data from being hacked, these kinds of initiatives go far with the industry and are appreciated and we would love to see more of that as opposed to enforcements and getting guidance by enforcement.

Steven: One last point about these initiatives (we do local initiatives as well), is that registrants are not singled out. There are a number of firms that are looked at with respect to particular issues and help with the assessments. Many initiatives are not driven by a fear of nefarious practice by firms. They are not accompanied by a series of referrals. Brexit is an example. We wanted to understand the impact on firms of this issue.

Importance of Coverage:

Steven: The one other issue that I wanted to raise that I think has been somewhat significant, is the understanding and the importance of coverage. We have grown to having examined 1600 registrants last fiscal year. The number will be significantly higher this fiscal year. As most of you know, we've moved approximately 100 examiners from other programs, principally broker-dealer, into the IAIC program. Lack of coverage creates risk on both ends of the spectrum of registrants in terms of never having been examined before as well as those registrants we haven't examined in a very long time. In both of those cases, if we're not doing examinations of registrants early as they come in the door, or we haven't done an examination in 10 years of those registrants, it creates its own set of risks.

So one of the things that some of you may have seen, is that we are now doing examinations of new registrants. We started it with a pilot program of new registrant calls. We introduce ourselves as their regulator, as your regulator. We ask questions about your business, try to get some basic sense, but we said to ourselves, we want to go deeper than that. So, we created a program for new registrant exams, and we're trying to conduct exams within the first year of every new registrant. We carve out those who have related history, those that have experience in the industry. But this year we will probably do 60 new registrant examinations. And on the other side of it, we are taking a look at those registrants we have not seen in a long time and examining them, not necessarily because we think anything's wrong. But we need to see the registrant and we need to make sure that the developments that have happened in the industry and in our regulatory environment are things that are taken into account by those registrants.

[4] For more on this topic, *see* *https://www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html*

Wendy: Has the Chair given any thoughts on his view and coverage and hiring with connection of the exam staff?

Steven: I have not had any conversations with Chair Clayton or received messages indirectly from Chair Clayton as in direction. But what I can say is from Chairman Clayton's first major public statement which just came out, that it is clear that his focus is on retail, that he's deeply concerned about protecting retail investors and that with respect to the fiduciary rule and possible harmonization and other issues whether related to the DOL or to fiduciary concepts in general, it's an area he wants to think hard about. As the eyes and ears of the Commission, I would expect in the next fiscal year, we will be very focused on retail and remain focused on it.

Tina: Along those lines, there's a statement that came out last week on June 1st[5] for those of you who may not have had a chance to read it. It's also soliciting public comment and all comments and questions will be available so it could be an interesting way to get insight into not only what we're thinking at the Commission but what all of you are seeing as issues. Going back to our question of what do you think is working? What do you think is not working? Feel free to also add your comments there.

Investment Management Division:

Tina: We have a couple questions on initiatives that we are doing but I thought I would pause and I would turn it over to Thoreau. In the Investment Management Division ("IM Division"), what are the rule making changes you have going on now?

Thoreau: So as you heard, we have a new Chair. He has only been on for a month so we're still in the process of setting our agenda. The first thing that came out was the public statement[6] on the conduct standards for broker-dealers and investment advisers ("IAs") so that is the focus of the entire Commission.

We still have a number of outstanding rule proposals that we have to consider how to move forward with, if we do. We have had a lot of comments, very insightful and thoughtful comments, on ways to approach those rules (the derivatives rule, Business Continuity Plan ("BCP") transition plans, and the like). So, those are outstanding. I would also just like to highlight the fact that as part of our agenda setting we tend to look at macro trends in the industry, so things like the general shift from active to passive funds, the rise of robo advisors, the rise in ETFs, the changes in distribution in light of the DOL fiduciary rule, and other changes in the marketplace. All those inform what goes into the rule making agenda. I think a lot of those macro trends are reflected in the public statements that the Commissioners have indicated as areas of focus we looked at in the policy arena. It is no surprise that we are looking at an ETF rule which is an area we thought about for a long time. Again, we don't know – as far as that rule goes – where that falls in the Chair's agenda or priority list. But that's something the IM Division has thought of for a long time. Things like enhancing the delivery process for shareholder reports or the VA summary prospectus. Those are again things that have long been on our policy agenda but we will see how they develop. I think those are just broad areas that we're thinking about. I would stay tuned as the Chair publicly sets forth what he would like us to focus on.

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[5] *See* https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31 for Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers

[6] *See* https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-153941.htm for SEC Public Statement n IA-BD Standards of Conduct

Enforcement – Asset Management Division:

Tina: Dabney, from an enforcement perspective?

Dabney: So just to give more background, and to give you more context, the Asset Management Unit is part of the Division of Enforcement. We were started many years ago. There are several other units but we focus on investment advisors. While we focus on investment advisors, every investigation involving an investment advisor is not always conducted by the Asset Management Unit. They are sometimes conducted by the core staff who handles all sorts of different cases. We end up trying to take a deep dive into thinking about the current risks and issues that Enforcement should be dealing with in this particular space.

There are lots of benefits that I've observed – I've seen what the pre-AM Unit and post-AM Unit with the Division has been like; and there are a lot of advantages and I think those advantages go both ways in the sense that as soon as you start dealing with someone who is maybe a little bit more familiar with the laws and has taken a deeper dive on the issue, we can be much more efficient and effective in how we use our resources. We also have established relationships and regular communications with the other divisions and offices that are highly specialized in this area which again, I think provides enormous benefits of efficiency and effectiveness.

For example, we may get an idea for a case, but instead of just opening a new case and starting an investigation, people confer closely with the Division of Investment Management or OCIE. And it may be that the focus is not really an issue that you should be terribly concerned with so we don't even start that investigation. Or, they help us focus and figure out how we should be looking at something a bit more closely or a bit more streamlined. I think there are benefits both to the Commission and how the industry is regulated, as well as to the industry that is being regulated that we are more effective and efficient in how we conduct our work.

Wendy: How early on in an enforcement investigation being run by one of these "core groups" will they consult with the Asset Management Unit?

Dabney: They are not required to consult with our group. We are available. We have people in every regional office and home office. They also have an exam program that they can confer with if there are questions about the law and how things work – e.g. what the general practice in the area is. Our Division of Investment Management is excellent at conferring with the Division of Enforcement and making themselves regularly available to us. We do have an enforcement liaison who's group is dedicated to conferring with enforcement and talking to us, and so, the core doesn't necessarily talk to the Unit. We're available and they do confer with us regularly, but there are so many resources now to make sure everybody is talking to one another so that there is a lot of information out there.

Thoreau: I wanted to add that as you noted the IM Division has an enforcement liaison office, but it's not just them, they reach out to all the specialized people within the IM Division, so you will get the best policy views presented to enforcement in any one of these cases.

Dabney: So just to talk about where our priorities are, even though we are separate from the Division of Investment Management, our priorities often echo the priorities that are identified by the exam program. As a general overall theme, the purpose of what we keep in mind on a regular basis is maintaining confidence in the markets and maintaining confidence in the investment advisory industry because you guys are critical in the services that are provided to the average person or to the industry in general. With that, retail investors continue to be one of our primary areas of focus and has been for a very long period of time.

We are generally pretty concerned where there's undisclosed conflicts of interest for the investment advisor and how they give their investment advice, including undisclosed fees and mark ups from third parties and service providers for their companies. We have also brought a series of cases regarding mutual fund share class selection process, and the conflicts of interest associated with what share class is selected for clients where the advisor because of their dual registration may be getting compensation as a result of the share class selected.

Steven: Looking ahead to the Recent Decisions Panel, they will talk about those cases in detail.

Dabney: So, those are some of the areas where we have quite a bit of concern about and where we've brought some cases in recent history, and I expect we will be continuing to look at those area.

Publicly Publishing Priorities:

Tina: Before we go back to Steven for some of the initiatives that OCIE has developed, one change in the landscape is that a few years ago the National Exam Program started publishing publicly its priorities[7] and I think that's been well received. For the other people at the table, I don't think that happened yet, right Thoreau.

Thoreau: We do have the unified agenda, I know it's not the most useful document because it lays out a whole host of initiatives that stay on there for years and years. But it does give insight to where we're going and what we're thinking about. It is updated twice a year, so when things come off or things get added, I think that's pretty telling.

Tina: When was the most recent one published?

Thoreau: I believe it comes out in the fall and the spring. There are also things that are always going to be effecting us. For example, for any recently passed rule we go through a process – even though it's not on the agenda – of facilitating implementation. It's a long process of working with the industry, going out and doing outreach on things like liquidity[8] and reporting the modernization rules that were adopted, finding out what problems they're facing and trying to come up with guidance that will help facilitate the implementation. But I would look to the agenda and then speeches.

Dabney: We don't publish our priorities. As I said before, our areas of focus often mimic what OCIE does and they've done a fantastic job of publishing those priorities fairly regularly or each year. It's harder for us to publish any sort of priorities in the sense that we get information that leads to enforcement actions or even enforcement investigations in very different ways. Granted we get some of those through the exam referral process, to the extent it's a serious deficiency. But, a lot of our potential matters come in through tips or complaints that come in from the general public. For example, if a particular client or group of clients is having problems or notice a problem, they might file a complaint with us. So, where our cases come from is driven by various different sources.

Wendy: Regarding OCIE's focus areas, do you consult with enforcement in coming up with those areas?

Steven: I believe that at the national level, there's consultation with enforcement, and that the priorities are provided to the Commissioners before it is published.

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[7] *See https://www.sec.gov/news/pressrelease/2017-7.html* for the SEC's 2017 priorities

[8] *See* https://www.sec.gov/rules/final/2016/33-10233.pdf for the *SEC Final liquidity Rule*

Current and Upcoming Initiatives:

Tina: Steven if you could go into the current and upcoming initiatives.

Steven: Sure. I will be brief on most of these for a couple reasons. First, our Exam Priorities memo for 2017[9] covers much of this. Second, there are other panels that are going to be more detailed and get more into the weeds on some of these initiatives. However, let me tell you about the initiatives that are ongoing and that are on the horizon.

Let's begin with the retail priorities, we have three that we listed: retail investors, risk specific to elderly and retiring investors, and assessing market-wide risks from our monitoring functions and the exam program.

Some of the initiatives that are ongoing include the Multi-Branch Advisor Initiative[10], and those are supervision issues on IA branches. We've seen an increasing number of IAs using a branch model. That branch model has attendant risks relating to compliance and supervision issues we are looking at. There's a December 2016 Risk Alert for those that are operating with the branch model.

Supervision of RIAs is another exam initiative.[11] This deals with disciplined reps who come over from the broker-dealer side over to the investment adviser side. There have been a number of academic studies that show high recidivism rates among these employees going from the broker-dealer side to the IA side. We are taking a closer look at firms that are hiring folks that have been disciplined in the broker-dealer space to make sure that the diligence is adequate in terms of the process for hiring. Further, exploring their disclosures with respect to their disciplinary history, and that there is heightened supervision of these individuals as they come into the IA space. It is not to tell advisors who to hire and who not to hire. But if you do hire folks who have disciplinary history, I want to make sure you're aware and you're informing the investing public and that there are controls in place with respect to these folks. And by hiring them, yes, you do come on our radar screen probably for some attention.

There have also been discussions surrounding share class initiatives. There will be more on this topic, and we have published a Risk Alert, from July 2016[12] assessing that initiative.

New registrant exams[13] – I like these new registrant exams for a whole bunch of reasons. Part of that is improving compliance and monitoring risk. It's a great way to touch these registrants early and see what's going on, maybe help them if they're off course with respect to compliance or management. Every once in a while we learn about problems, and maybe not just with those registrants, but sometimes concerning other registrants which may be the reason why they started their own firm. So, it's helpful for us and I think it's helpful for those registrants as they're getting used to the regulatory environment in which they're operating.

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[9] *See* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf for the National Examination Priorities for 2017.

[10] See OCIE Risk Alert, "Multi-Branch Adviser Initiative," Dec. 12, 2016, https://www.sec.gov/ocie/announcement/risk-alertmulti-branch-adviser-initiative.pdf.

[11] See OCIE Risk Alert, "Examinations of Supervision Practices at Registered Investment Advisers," Sept. 12, 2016, https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf.

[12] See OCIE Risk Alert, "OCIE's 2016 Share Class Initiative," July 13, 2016, https://www.sec.gov/ocie/announcement/ocie-riskalert-2016-share-class-initiative.pdf.

[13] See OCIE's Letter to Never-Before Examined Investment Advisers, February 20, 2014, http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf.

Two others I will mention: the ETF Initiative and the Public Pension's Initiative are ongoing. There's more discussion of that in the priorities memo.

For the upcoming 2017 initiatives, we are looking at electronic investment advisers – also known as robo-advisers. There's a great deal of wisdom in the February 2017 investment management guidance[14] on electronic investment advisors. Our initiative will be focused on the areas of risk, which are outlined in that guidance.

The MMF, the Money Market Fund Initiative.[15] We have Thoreau, who basically drafted it. As part of our ongoing focus on retirement accounts, we're rolling out a couple of narrow initiatives, one relates to Target Date Funds. We would like to see what the practice is around target date funds and the glide path, and whether the disclosures are adequate with respect to the glide path, and whether or not the firms are following the glide path. I think there are some incentives to the extent that the yield remains higher to maybe delay the glide path a little bit so you can show yield above industry norms, and then slow into the glide path. We want to protect against that amongst other things, because the investors who invest into those target date funds have that expectation that the targeted funds will abide by the practices which were outlined in the disclosure documents.

Another area is Fixed Income Cross Trading and its relationship to retirement accounts. We would like to look at the controls surrounding cross trading both in the Investment Advisory ("IA") and the Investment Company ("IC") space.

ETFs and Cybersecurity will be continuing areas of focus for us. We have not announced new initiatives in either space, but you can expect that the National Exam Program will be focused in these areas in the coming year and probably in the years to come. I think that kind of wraps up the major initiatives that I think you will see come coming down the pipeline this year.

Dodd Frank Discussion:

Tina: Do we think Dodd-frank is dead? Who wants to start with that one?

Thoreau: I don't think Dodd-frank is dead, but that's just me personally. Just look where the CHOICE Act[16] is – and even that doesn't fully take away Dodd-frank. You know we provide technical assistance to all of the bills going on in Congress, and as a result we are apprised of how things are going and we try to give whatever information we can to help that legislative process. I would note that it's not just the Choice Act. There are a number of other standalone bills that effect the IA and the IC space, such as things like the ETF research reports bills and another that would repeal the money market reforms.

Wendy: Talking about rules, the new President has signed an Executive Order encouraging the agencies to reevaluate their rules. I think he had a formula for how many rules he wanted to get rid of. What is happening at the SEC with respect to this charge?

Thoreau: I think you're referring to the 2 for 1 rule Executive Order. My understanding is that it technically does not apply to us because we're an independent agency. However, you know that depends on the

[14] See https://www.sec.gov/investment/im-guidance-2017-02.pdf for more on this.

[15] See Money Market Fund Reform; Amendments to Form PF, Release No. 33-9616 (July 23, 2014), https://www.sec.gov/rules/final/2014/33-9616.pdf.

[16] See https://financialservices.house.gov/uploadedfiles/financial_choice_act-_executive_summary.pdf for the Choice Act.

Chair – whether the Chair would like us to follow that or not. In some cases, we follow Executive Orders that do not apply to us. We will see how the Chair reacts to that report.

Tina: Steven? Dabney?

Dabney: I'm going to defer to our legislative group.

Steven: We will do examinations around the rules that are on the books. I have no view as to what the future holds. As long as we have rules on the books we will examine for compliance with those rules.

Guidance Implementation:

Tina: We received a question from the audience on how OCIE reviews or implements guidance by IM Division? Is it like a rule or how does that work?

Steven: I will take the question to mean guidance and also the rules. Obviously, we examine around rules for compliance, and perhaps for guidance – which is not necessarily in the form of a rule but informs a rule. We can examine around guidance. Often what happens with guidance is that guidance is the result of the OCIE informing the policy division that there needs to be guidance around the rule because we're seeing problems with compliance or industry practices that differ. In terms of the timing, guidance usually follows a series of exams, not guidance comes out and then we do a series of exams. So for example, the guidance that recently came out with respect to the Custody Rule and standing letters of authorization.[17] That guidance came out in part because OCIE had identified there are issues with the springing custodies of unsuspecting advisers because of standing letters of authorization that gave them powers that maybe they didn't know they have or want to have. The guidance around that was to give advisers notice of this issue, and give them an opportunity to make a decision as to what direction they wanted to go. Do they want to embrace custody of client assets? In which case they need to do the surprise exams. Do they want to not embrace custody? In which case they need to take the steps to ensure they don't have custody.

We're not really examining around the guidance, the guidance comes out because of the exams. But, when we're deciding whether or not there is an issue – and to keep with the custody example – if it was within the scope of an exam, and we find you have a standing letter of authorization that gives you custody but you haven't performed any surprise exams, if you know the guidance you'll know there is kind of a window for correction. We will not write you up and refer the matter to Enforcement. We will ask you to make a decision as to which way you want to go. Maybe a year from now when we see firms that have springing custody through standing letters of authorization, we may take a firmer approach. For now, there's new guidance that came out. You need to be aware of the guidance, and put in place the procedures and practices you want to in light of that guidance. That's how it works. Guidance often flows from the exams. If the guidance seems like an amplification of rulemaking then it's incorporated within the scope area that we're examining, and informs our examiners what is required for compliance.

Wendy: The springing custody issue has been very troubling to the industry. As investment advisers, our client investment management agreement specifically outlines what type of custody we have or don't have, and we don't have a contractual relationship with the custodian other than by contract with the client to work with the custodian in connection with the trading of the client account and having discretion over their account. This has been very troubling to those of us in the industry because we're not looking to have custody. In fact, our contracts are specifically designed so that we don't have custody. We have no idea if we have custody, and further, the custodians have no relationship to us, so they're not helpful

[17] See IM Guidance Update: Inadvertent Custody https://www.sec.gov/investment/im-guidance-2017-01.pdf.

in giving us any information. We would rather spend our time focusing on managing our clients in connection with other things.

Steven: The purpose of the guidance is to make sure that registrants are informed so they can protect against the springing custody issue. And the guidance is to prevent that there's going to be some "gotcha" going on within the exam program with respect to springing custody. But this is something you need to be aware of and implement procedures to deal with it. If you don't want the custody, the guidance outlines measures to take to avoid custody. If the guidance does not hit the mark then you can get in touch with the Division of Investment Management and help them understand the ways in which it's missing the mark for you, or creating work or concern that you would prefer not to have with respect to the obligation to comply with the Custody Rule.

Thoreau: We (IM Division) have heard quite a bit of feedback on that guidance, and obviously take that into consideration. We do amend guidance from time to time. I'm not suggesting this will be amended, but we do a lot of outreach in this area, and afterwards as well.

Wendy: We also had some comments relating to some of the disclosures on Form ADV. Some were listened to and wasn't included in the final rules, but there are still some disclosures that we need to make that relate to custodians. It's very challenging for us because even though we have some relationship with custodians it's still very happenstance to the client.

Thoreau: I think one thing that we always struggle with is the guidance has to be within the confines of whatever rule was adopted, and we are limited to whatever the Commission said in the release. Sometimes an issue may arise after the rule is adopted and we try to provide some guidance clarifying the path, but I think we are limited to what the Commission said.

Publishing Examination Findings:

Tina: FINRA recently announced that it will release common exam findings – does the SEC plan to do that as well?

Steven: Our Risk Alerts talk about common findings with respect to these initiatives. I personally think that it's good practice for us to publish those areas where we're seeing deficiencies. My guess is a number of you have beefed up your practice with respect to due diligence, and protections, and testing for your vendors in the Cybersecurity space, and that may have come as a result of the fact that as part of our Phase One of the Cybersecurity Initiative, we identified this as an area of weakness among the majority of IAs registered with us. I think it helps you when we publish our findings with respect to these initiatives. I think many of the lessons that the IA community takes are often taken from enforcement actions.

A lot of the findings, I think the registrant themselves who are the subject of the finding may contest the finding. They may take corrective actions and put measures in place, but while they are doing that, they say they disagree with us on the merits, but are taking the corrective action that we have asked them to take to ensure they are complying in the manner in which we've asked them to comply. Keeping that in mind, I think it would be hard for us in each and every instance to publish those findings.

There are other agencies that actually publish selective examination findings – to date, we have not done so. We have some certain protections on disclosures of investigations under Rule 210(b) of the Investment Advisers Act that poses a little bit of a hurdle. But as far as I'm aware, we are not doing specific disclosures with respect to specific findings in specific firms. I do not have an understanding that there is a short-term design for putting out a list of our significant findings over the last year, but we do publish Risk Alerts, and those Risk Alerts do contain those findings.

Thoreau: Also, just to highlight, the Guidance Updates often do reflect the generalized findings of OCIE. So, for example, the "distribution in guise" Guidance Update that was issued recently highlighted a number of generalized findings that resulted from that Dig Initiative. I think just looking to the resources that are published may be useful, as opposed to looking at a specific finding of a specific firm.

Self-Reporting:

Tina: If a firm has an issue, CCO's are trying to balance when and how they should reach out to the Commission – Dabney, would you be able to talk about that in light of the Calvert[18] case, what your perspective on that might be?

Dabney: I'm an advocate of self-reporting when you identify a problem. As an initial matter, I can direct you to the Division of Enforcement Manual[19] which is publicly available on the SEC's website, and provides a very detailed manual that is updated as new information becomes available about how the enforcement process works and what we consider in conducting our enforcement investigations and in making recommendations to the Commission. Part of that is this idea of cooperation and self-reporting. We've heard a lot about how people don't feel like they get much credit for self-reporting their violations. I think there may be a bit of disconnect in what people view as self-reporting and cooperation. So, it may help to provide a little bit of clarity on that.

Calvert[20] is the most recent case. In the Commission's Order there's a paragraph (paragraph number 32) that expressly deals with the remedial efforts and it notes that the Commission agreed to reduce an imposed penalty that reflects the self-reporting of the improper fee payments at issue there, and how they conducted themselves during the course of the investigation. Things to highlight from that Order: the word prompt or promptly is used three times in a single paragraph. So, I would caution you that to the extent you identify a problem that is serious (e.g. one that caused your clients to be harmed in some way, or a serious undisclosed conflict of interest you've had for a period of time), that you not wait until the SEC knocks on your door to bring that violation to their attention. I would urge you to, on your own, promptly reach out to the exam program or the enforcement program to report the issue you've identified. So promptly self-reporting is a key, key feature in order to derive any benefit from that self-reporting.

It is also your conduct during that inquiry – whether it is an examination that results, or an enforcement investigation that results – that will determine if you derive a benefit. Lastly, the staff will also consider the extent your cooperation helps with the efficient completion of the investigation. I will direct you to the enforcement manual on that front. But, we are often trying to explain that simply responding to a

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[18] *See* In the Matter of CALVERT INVESTMENT MANAGEMENT, INC., https://www.sec.gov/litigation/admin/2016/ia-4554.pdf.

[19] *See* https://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

[20] *See* In the Matter of CALVERT INVESTMENT MANAGEMENT, INC., https://www.sec.gov/litigation/admin/2016/ia-4554.pdf.

subpoena either for documents or testimony is actually not considered cooperation. That is your legal obligation to respond to those types of requests.

A lot of times people will meet with us, and we'll hear: "this is what we see as a problem, we think this happened, and we did an inquiry and this is how we're fixing it right now." That's great information to get early, and as early as possible, and not allow us to get the sense that there's a wait and see for us to figure it out. It's a great reaction when we see it; when people really are proactive and show us how proactive they are and try to solve the problems. I think that's more often than not the goal of everybody involved: how to fix the problem.

Wendy: Are there instances of self-reporting that do not lead to enforcement action? Across the industry, Calvert was chilling to us because it was self-reported and it looked like it was correcting the activities; what about this made Calvert an enforcement case?

Dabney: I'm not going to speak directly to the Calvert case. You should look at the four corners of the Order for the opinion in that Order. I'm not at liberty to really go beyond that. What I can say as a very general matter is that where there is harm to clients and money needs to be paid back, that will be an area of concern for us, and making sure that the money is being paid back promptly and correctly is another area of concern. We can help you to figure that out and how to do the payment back to people in the best most accurate way. That is an area of concern and something that we think about. But there's lots of things that go into any decision on any enforcement matter that would apply across the board. What I can note is that self-reporting is something that is considered by the staff and is information that we give to the Commission.

Steven: I will add that it's difficult to argue the nonpublic examinations that don't lead to enforcement matters because we don't publish them. However, speaking from firsthand experience, and especially in the areas relating to supervision, that where registrants come to us and report the problem, so that we can help to get that individual bad actor out of the industry, and show us the work that they did in investigating the issue and remedying the issue, we take that into serious consideration. This includes when we are thinking about an examination in that area, or having conversations with – if we have conversations with – Enforcement at the registrant level, as oppose to the individual actor level.

But, for example, when we hear that there was a problem with a particular advisor, the advisor resigned, and there's nothing about that resignation that would lead anyone to understand that there was a real issue with respect to that advisor, and then the bad actor goes on to the next shop and harms more investors. That's more of a problem. So, I recognize the issue and when you see cases where someone's self-reporting and then all of a sudden there was an enforcement action brought, one of the questions to ask is: what would the civil penalty and injunctive relief have looked like had they not reported it? It's impossible to know the answer to that question. But, I think that where those registrants come and self-report and they do so in a manner that is consistent with the enforcement guidelines, it is taken into consideration. Maybe not to the extent the industry would like, but it is.

Tina: Dabney, on Calvert, William Blair[21] seems to have cooperated, self-reported and corrected their issue. Yet, the penalty was higher than Calvert's? Can you say anything about that?

[21] *See* https://www.sec.gov/litigation/admin/2017/ia-4695.pdf for In the Matter of WILLIAM BLAIR & COMPANY, L.L.C.

Dabney: I will have to direct you to the Orders themselves, both the William Blair and the Calvert Order, and you can do the comparison and see what was noted there by Commission. But we are really limited to what we can say to what is in those Orders.

DOL Fiduciary Rule/Cohesion amongst Various Regulators:

Tina: We have a couple people asking for our insights especially Thoreau's, on whether the SEC will be in favor of the DOL fiduciary rule? Thoreau, I'm not sure you're in the position to comment?

Thoreau: I can say a couple of things. Number one, we obviously have been involved in the consultative process with the DOL from the beginning, and provided plenty of technical assistance there. You can point to Chair Clayton's public statement regarding this area. From IM Division's perspective, one thing we can do, putting aside whether there is a uniform duty or not, is point to some of the guidance and other areas that we can help facilitate implementation. So, for example, we put out an interpretive letter on clean shares which has been well received in the industry and helped address some of the issues in fund distribution that have resulted from the DOL rule. We also put out guidance on doing 22(d)(1) schedules and fees and an appendix to a prospectus. We've tried to be as accommodating as possible, and we're always doing outreach to see where the impact of these rules are. So, of anyone has any particular issues, please let us know.

Wendy: One of the things that we encourage too, and I know you've been doing a really good job of this at the SEC, is helping break down silos between the regulators. We encourage you to do that because in light of the new DOL fiduciary rule, and the different standards on the SEC front, and some of us are also regulated by the CFTC. So, it would be much simpler and more efficient to have less regulation around the same thing. And I would push on behalf of my peers that whatever uniform fiduciary rule that the SEC puts together does not involve investment advisors because we have the capital gains fiduciary duty that we have been following over the years.

Thoreau: I hear that, and I think that's a common perspective in the industry. One thing to note on coordination with other agencies is that every rule is different. I have been on rules with seven other agencies, rules with just the SEC, and rules with just the CFTC. We always seek to try to minimize regulatory differences, but I think there are sometimes different missions between the agencies that have to be accommodated.

Steven: On the subject of coordination with other agencies, I was remiss in not mentioning that has also been a development in the exam program. We are working more closely with our sister agencies both at the federal level and at the state level. We will talk more about that on Panel 3, but we have done joint exams with the DOL. We have done exams together with state regulators. We refer matters back and forth between regulators. We don't want to be duplicative. To the extent that we can avoid it in enforcement matters with respect to the same conduct, getting hit by multiple agencies being the third agency in a particular matter. At the exam level, we are talking more. We've actually had a couple joint exams with a couple of the federal reserve districts as well. That flow of information back and forth; what are the risks that different folks are seeing, what are the pressure points in the different regulatory regimes, where they are inconsistent – we are also having those conversations at the exam level.

AML – FinCEN Rule:

Tina: With the all-encompassing AML rules, I have a question and a comment that they seem to really put a heavy burden on firms and the audience is asking what's currently happening with the proposed AML rules for RIAs?

Thoreau: We were involved in providing technical assistance for that as well. I can't speak as to the status of it, FinCEN has its own process for setting agendas. We will obviously be involved in providing assistance as needed.

Tina: I think this has been a theme in our conversation that when things place a burden on the industry, one way for the industry to communicate it to you is through comments. Is there anything else, Thoreau?

Thoreau: I thought the comments on that AML rule were very insightful and really highlighted issues for IAs – we read them independently, but obviously it's FinCEN's rule.

Reporting Violations:

Tina: How do we know who to report to within the SEC if there's a problem or we have a question?

Steven: We have a TCR[22] (tips, complaints and referrals) system on our website that provides information on how to report and different ways to report, and you can always report to me. If you don't know anyone else to report to, pick up the phone or send me an e-mail (levines@sec.gov). Some people make decisions as to where strategically they want to report. Regardless of the strategy of where you want to report, if you report to someone, it will get to the right place. Whenever a tip, complaint or referral comes into our agency, it goes through our tips, complaint and referrals system. It may be in the first instance that someone from the exam program puts it into the system, and having been aware of it and having had that introductory conversation with it, will then lead the conversation with others who may be the appropriate persons to decide whether or not it is something that we just want to take notice of, have a follow up conversation about and triage, or open exam or investigation relating to it. The starting point is who you give it to, but it usually will go, and it should go, to the place it's supposed to go. It may not be in region it is initially reported to. If it's for conduct that's outside of our region and you've report to our region, we will make sure it gets to where it's supposed to go. Online will give you more information as to where you can report, and you can always report to me and to anyone in my program.

[22] *See* https://denebleo.sec.gov/TCRExternal/disclaimer.xhtml for the SEC TCR portal.

Panel 2. Data Analytics and the National Examination Program

Panelists:

Vanessa Horton, *Assistant Regional Director, CHRO IAIC Examination Program (Moderator)*

James R. Reese, *Acting Chief Risk Officer, OCIE*

Max J. Gillman, *Exam Manager, CHRO IAIC Examination Program*

Introductory Remarks:

Vanessa: This panel will discuss data analytics and the National Exam Program. David already gave our disclosures so I'm not going to repeat it. My name is Vanessa Horton, I am Assistant Regional Director in the SEC's Chicago Regional Office. Hopefully with our distinguished panel we will learn about data analytics and how we use it at the Commission.

I woke up this morning with my cell phone which communicated with my watch and told me I did not get a good night sleep because I stayed up watching the NBA championships. That tells my coffee pot to make it extra strong so I could be awake for you this morning which also told me to ask my smart tower what the weather and traffic was like. Found out it's going to be hot so I knew how to dress. Found out traffic will be bad which informed my GPS where to go and how to get here the fastest. Got to the office, and my computer told me what the address was here. I got over here, and I took notes on my iPad. You're asking why I am telling you this? Well because it's IOT, the buzz word of the "internet of things." It's data; it's communicating about what we do, how we do it, how you run your life. It tells a story about you, tells a story about me, tells a story about your clients. And that story is very, very important to the SEC. We use data in various ways. We mine it, we look at it. Hopefully today we will shine a little light on how we use it and why we use it, and why we're asking the questions we ask when we go on the exam. Hopefully this will explain a little bit of that. We have our national representation from James, and Max is our local representation in the Chicago office. We can start up with James talking a bit about the data analytics and how we use it in the program.

National Level: Data Analytics and Exam Program

James: Thank you Vanessa. And in contrast, my alarm did not go off this morning. That set-off a chain of events that included me spilling coffee on myself, getting stuck in traffic, even though I had a block and a half to walk and almost being subdued by the security guards down stairs. So, technology can also work against you if not set up properly so you might hear some of those themes from Max and I today. Being part of this panel, we are here to talk to you about data. Hopefully, by the end, you will see how it flows into our processes and how it is making us better informed when we conduct our examinations (knowing more about you than we ever have, thanks to all the things you disclose to us as statutorily required). Also, how we leverage the information within an examination to better target areas and ask better questions, and ask them earlier in the process.

About a year and half ago, the National Exam Program formed the Office of Risk and Strategy ("ORAS"), and one of its primary goals was for risk and data professionals to try and serve as a central support mechanism for the rest of the examiners nationally. We see ourselves as a complement to the work done locally, and we also believe that a good framework and process can only survive when it involves both macro-level looks, as well as a bottom up look with that localized knowledge that is really, really impactful. The ORAS[23] brought together a quantitative analytics unit – PHDs, scientists, mathematicians and statisticians. Their role is developing tools for the National Exam Program to use. They also accompany examiners in the field, and they will interact with the quantitative elements of your organizations, whether if that's in trading, portfolio management, and more so what we're seeing in compliance.

The organization also brought in a large firm monitoring program that literally monitors and constantly interacts with the largest broker dealers. They also coordinate with other domestic and international regulatory authorities, both on the securities and banking side. There's another element of that group, the Risk Analysis Examination Team. Their primary function is to do examinations of large clearing broker-dealers. By doing those types of examinations, we try to become more impactful with our approach (common theme). Meaning, doing an examination or asking about information that will then give us a lot more information and potentially actionable intelligence about our other registrant population. They do this by going to large clearing firms which then gives us broader exposure to introducing firms as well as advisory accounts that clients may have at those firms.

We have an Operational Risk Team which is very inward looking – which again is just bringing together a bunch of different risk professionals and looking at our controls how well we're applying our policy and procedures and whether they're consistent. The last group is the Office of Risk Analysis and Surveillance, and what that attempts to do is to identify emerging risks and trends. Whether that's products, business units, changes in infrastructure, or to more broadly our registrant population. Then, they highlight those areas of concern which will flow out through our priorities and through other national and local initiatives.

Lastly, we have a quantitative piece where we try to leverage regulatory filings, third party information, tips, complaints, referrals, and information coming through suspicious activity reports. We then try to collect and correlate all that data and apply that framework to more broadly look at all the firms we have registered and try to see where certain outliers and key changes in information exist. That information will then be served up as an initial input into a broad assessment of our firms nationally. And that's where we fit. We sit in all the regional offices and pretty much, again, our role hopefully is supplemental and complimentary to all the local roles. Admittedly, sometimes there's push and pull; and sometime it works in reverse. That's where we're situated and those are our responsibilities.

Local Level: Data Analytics and Exam Program

Vanessa: Max, maybe you can give us a perspective on what we do on a local initiative?

Max: Data for us at the local level runs the gamut. Thinking about data analytics and the data we work with on everyday exams includes analyzing trade blotters or looking at performance or recalculating performance. But we're also doing some building up work that's done nationally at the local level, looking at if we can come up with local initiatives that are data focused. There's plenty of data to go around whether it's national or local. Locally, we're trying to see if there's opportunities to take data to perform analysis, or to identify advisers we want to look at that are actively involved in a particular market, particular strategy, or particular product. We think that's an effective use of our time. You may be wondering what's in it for me as a compliance professional or as a registered adviser, and I think it gives

[23] *See* https://www.sec.gov/news/pressrelease/2016-38.html for the SEC's March 8, 2016 press release announcing the creation of the Office of Risk and Strategy.

us a better perspective on where your firm falls relative to the other firms that are out there. When we're able to take a look at 15, 20, or maybe more firms that are active in a market or particular product, whatever our data analysis reveals, gives us the perspective of where your firm fits in a swath of the industry.

We often hear from CCO's that what they're doing or what the Commission is concerned about, everybody's doing it. And it's hard to judge that - but these initiatives and the data focus allows us to cast a wider net and properly assess. Do we have informed policy issue? Is your firm trailing the industry or have unique issues? The data announcements we do locally allows us to take a broader perspective and not just look at any particular issue on any given exam. By way of example, locally we have a project that we're working on, where we are using externally sourced data to take a look at soft-dollar practices to examine investment advisers and see what themes emerge from those soft-dollar practices. We are also looking at IPO allocation practices, again, utilizing externally sourced data along with data we maintain internally and/or that we received from the groups that James described, and using that to identify firms we would like to take a closer look at. Those are examples of projects.

In terms of technological resources, we use a variety of off-the-shelf products. We use extensive in-house programs and applications that James alluded to. Perhaps your firm is facing a tight budget. I can tell you first hand, and I think James and Vanessa will agree, you can do a lot of data analysis with Excel. It would be good not to walk away thinking about data analytics as purely a black box exercise where you have to have the most sophisticated technology to do anything meaningful. I would say that's not the case. I've seen our examiners do incredible analysis with Excel.

We have a lot going on locally, and there's plenty of data to keep us busy.

Data Requests:

Vanessa: Speaking of data to keep us busy, we do look at a ton of data on examinations and if we could talk a bit about what our expectations are on examinations?

James: While we're talking about exam expectations, let's talk about the data request. There's a ton of information I know that's available to you all. Some of that information we go through as well, but what type of things are we asking for on examinations, Max?

Max: To start at the local level, we often ask, for a lot of data from your firm. Sometimes you may be wondering are we really using all that data, or are we giving you a hard time just to see if you can produce years of information – that's not the case. We are analyzing everything we get. We are very cognizant of the burden that it places on the firm to request significant amount of information, so we are analyzing all of it. We are asking for: trade blotters, position records, information supporting your performance calculations, exception reporting out of your portfolio management software, exception reporting out of your CRM, your client relationship management software, if you're using it, e-mails, and exception logs. We may be asking you to download detailed data from your clearing firm and your custodial firm.

For us, in terms of the challenges we see, on the down side, we see incomplete data and inaccurate data. It's important to take the time when you're producing some of that information to make sure there's some kind of integrity checks on the data you produce. If you are producing trade data for 1000 accounts over a two year exam period and the search results include only 500 accounts, something's probably missing. I would hope you don't have 500 accounts for which there were no trades over the past two years. See if there are dates missing, are there values that don't make sense? Would you expect significant negative numbers for an asset price? Would you expect certain columns or fields to be blank?

Implementing simple data integrity checks would go a long way to address the kind of missing and incomplete data that we see. Another important thing to do is to interact with your IT folks who are maintaining these systems from which we're asking data to be produced. Get them involved. Having conversations with your exam team is vital. You talk to the IT folks, they tell you one thing and then you relay it to us, but we are missing things in terms of what are you capable of and what are you producing. We encourage you to talk to your IT folks. Also, information samples are very important. I typically ask the teams that I work with to produce a month or a quarter's worth of information during an examination. I think you need to talk to your team about that to produce a quarter's worth of examination and see if it meets our requirements. Then produce a full examination period.

Sometimes our data requests would require 25 particular fields. A couple of those fields may require input from a multitude of different platforms or systems and pulling it together will take weeks to do. If you have a stock report that you think touches 20 out of those 25 things you can produce by this afternoon, you should bring that up to the exam team and let them know that I think I can produce 95% of what you need by this afternoon. The other 5% will take a few weeks because of how the data is stored. Sometimes we say, we will take the current field production and get the exam rolling – so I think that it's really important to have those IT professional involved in the direct conversations with us and, basic integrity checks. There may be a number of pitfalls, but to the extent we can minimize the back and forth is really important.

Vanessa: So if I can just provide one bit of advice, as compliance professionals, be familiar with what type of reports that you can pull down from your systems. I can't tell you how many times we are out and we know exactly what types of reports are responsive to some of our requests and the operations or compliance staff is not familiar with those reports. Spend some time, you are paying tons of dollars for them. Make sure you get some type of tutorial in terms of what's available and what's not available if you need it. Learn about the reports you can pull down from many of your third-party services or even from your own proprietary systems. That is a conversation worth having.

James: Sometimes you have to do something outside of the system. So, if we're asking for something accounting or financial related, if there's any kind of externalities that exist that is allowing you to track for something unique or something to that extent, having that inventory then helps us better tailor our requests along the lines Max mentioned. Producing samples of information is a great suggestion, but it also goes along the lines of an iterative approach. If we provide a request of 10 items, work with the examination team, and communication is a huge part of this, but that doesn't mean to first start communicating by the end delivery date – that's when we need those 10 items. If you can produce stuff along the way, that will help a great deal. You can also help by providing time frames around the production, and doing the document screening earlier in the process.

Once you've been through an examination and you produced a variety of documents from your accounting systems, from your management systems, and from e-mail systems, you might want to put together just a one page memo on what you did to produce that information. Vanessa talked about being familiar with the reports coming out of your system and large extracts – you know you went through a process and you were able to produce that data. To the extent you might get examined in the next three years, or those that may have an affiliate or registered with FINRA, the state, or other regulatory agencies, you'll have a quick reference on what you did to extract information. What you did to produce a reliable and validated set of data to a regulator might be important. Having that inventory for what query you wrote or steps you took can be nice for the review to the extent we ask for it, and you're not always reinventing the wheel.

Vanessa: How is data sent securely?

Max: We have various encrypted approaches. Anonymizing the data could be a problem for us. For example, we need actual account numbers. We also need to identify actual trades for best execution purposes.

Vanessa: Many registrants are surprised at the volume of data the SEC asks for. But the trend is for larger data requests. We use this data to identify red flags and trends. What about the future?

James: Coming soon will be changes to Form ADV with more of an emphasis on separately managed accounts and adviser's internet presence. See our recent FAQs for more information.

Max: As part of your Annual Review process, check what your brokers and custodians can do as far as providing reports for your own purposes and to prepare for SEC exams. The days of manually looking at five emails are over. Look at fee billing as an example. Sample size is important as is trying to automate.

Vanessa: Do we use Form PF data?

James: Yes we do, in coordination with other data such as what is provided on Form ADV. We are looking at changes in the information provided, business activity and counterparty information.

Panel 3. IAIC Examinations: Priorities, Initiatives, Exam Selection, Common Deficiencies, Interplay with Enforcement

Panelists:

Steven Levine, *Associate Regional Director, CHRO IAIC Examination Program*

Alicia Tate, *Risk Management Strategist, CHRO IAIC Examination Program*

Paul Montoya, *Assistant Regional Director, CHRO Enforcement Division, and* AMU

Andrea Seidt, *Commissioner, Ohio Division of Securities (Moderator)*

Overarching Theme: The mission is to protect investors, ensure market integrity and ensure responsible capital formation through risk-focused strategy that improves compliance, prevents fraud, monitors risk, and informs policy.

Steven:

4 Mission Pillars of the National Exam Program:

1. Monitor risk (cyber as an example)
2. Improve compliance
3. Identify fraud & other misconduct
4. Inform policy

2017 Examination Priorities:

Priorities are organized around three thematic areas:[24]

1. Examining matters of importance to retail investors;
2. Focusing on risks specific to elderly and retiring investors; and
3. Assessing market-wide risks

1. Examining matters of importance to retail investors:

Summary: Retail investors face an evolving set of choices when determining how to invest their money. At the same time, the financial services industry continues to offer an ever-widening array of information, advice, products, and services for retail investors in response to their financial needs. We are pursuing a variety of examination initiatives to assess potential risks to retail investors that arise in the increasingly complex investment landscape.

Electronic Investment Advice: Investors are increasingly able to obtain investment advice through automated or digital platforms. We will examine registered investment advisers and broker-dealers that offer such services, including "robo-advisers" that primarily interact with clients online and firms that utilize automation as a component of their services while also offering clients access to financial professionals. Examinations will likely focus on registrants' compliance programs, marketing, formulation of investment recommendations, data protection, and disclosures relating to conflicts of interest. We will also review firms' compliance practices for overseeing algorithms that generate recommendations.

[24] *See* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.

Wrap Fee Programs: We will expand our focus on registered investment advisers and broker-dealers associated with wrap fee programs, which charge investors a single bundled fee for advisory and brokerage services. We will likely review whether investment advisers are acting in a manner consistent with their fiduciary duty and whether they are meeting their contractual obligations to clients. Areas of interest may include wrap account suitability, effectiveness of disclosures, conflicts of interest, and brokerage practices, including best execution and trading away.

Exchange-Traded Funds ("ETFs"): We will continue to examine ETFs, reviewing for compliance with applicable exemptions granted under the Securities Exchange Act of 1934 and the Investment Company Act of 1940 and with other regulatory requirements, as well as review ETFs' unit creation and redemption processes. We will also focus on sales practices and disclosures involving ETFs and the suitability of broker-dealers' recommendations to purchase ETFs with niche strategies.

Never-Before Examined Investment Advisers: We are expanding our Never-Before Examined Adviser initiative to include focused, risk-based examinations of newly registered advisers as well as of selected advisers that have been registered for a longer period but have never been examined by OCIE.

Recidivist Representatives and their Employers: We will continue to use our analytic capabilities to identify individuals with a track record of misconduct and examine the investment advisers that employ them. For example, we will assess the compliance oversight and controls of investment advisers that have employed such individuals, including those who have been subject to a regulatory action or barred from associating with a broker-dealer.

Multi-Branch Advisers: We will continue to focus on registered investment advisers that provide advisory services from multiple locations. The use of a branch office model can pose unique risks and challenges to advisers, particularly in the design and implementation of a compliance program and the oversight of advisory services provided at branch offices.

Share Class Selection: We will continue reviewing conflicts of interest and other factors that may affect registrants' recommendations to invest, or remain invested, in particular share classes of mutual funds. For example, we will identify and assess conflicts that certain investment advisory personnel may have, such as those who also are registered representatives of a broker-dealer, which may influence recommendations in favor of share classes that have higher loads or distribution fees. We will also assess the formulation of investment recommendations and the management of client portfolios.

2. Focusing on risks specific to elderly and retiring investors

Summary: As the U.S. population ages and investors become more dependent than ever on their own investments for retirement income, we are devoting increased attention to issues affecting senior investors and those investing for retirement.

ReTIRE: We will continue our multi-year ReTIRE initiative, focusing on investment advisers and broker-dealers along with the services they offer to investors with retirement accounts. This year, these examinations will likely focus on, among other things, registrants' recommendations and sales of variable insurance products as well as the sales and management of target date funds. We will also assess controls surrounding cross-transactions, particularly with respect to fixed income securities.

Public Pension Advisers: Pension plans of states, municipalities, and other government entities hold a large amount of U.S. investors' retirement assets. We will examine investment advisers to these entities to assess how they are managing conflicts of interest and fulfilling their fiduciary duty. We will also review other risks specific to these advisers, including pay-to-play and undisclosed gifts and entertainment practices.

Senior Investors: Today's Americans are more reliant on returns from their investment portfolios to fund their retirement compared to previous generations. We will evaluate how firms manage their interactions with senior investors, including their ability to identify financial exploitation of seniors. Examinations will likely focus on registrants' supervisory programs and controls relating to products and services directed at senior investors

3. Assessing market-wide risks

Summary: As part of the SEC's mission to maintain fair, orderly, and efficient markets, we will examine for structural risks and trends that may involve multiple firms or entire industries. In 2017, we will focus on the following initiatives:

Money Market Funds: In 2014, the SEC adopted amendments to rules governing money market funds to make structural and operational reforms to address redemption risks in money market funds, while preserving the benefits of the funds for remaining investors.[25] We will examine money market funds for compliance with these rule amendments, which became effective in October 2016. Examinations will likely include assessments of the boards' oversight of the funds' compliance with these new amendments as well as review of compliance policies and procedures relating to stress testing and funds' periodic reporting of information to the Commission.

Payment for Order Flow: We will examine select broker-dealers, such as market-makers and those that serve primarily retail customers, to assess how they are complying with their duty of best execution when routing customer orders for execution.

Clearing Agencies: We will continue to conduct annual examinations of clearing agencies designated systemically important and for which the Commission is the supervisory agency pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Areas for review will be determined through a risk-based approach in collaboration with the Division of Trading and Markets and other regulators, as applicable. Once compliance is required, the staff will examine for compliance with the Commission's Standards for Covered Clearing Agencies.

FINRA: We will enhance our oversight of FINRA, consistent with our aim to protect investors and the integrity of our markets. In addition to continuing to conduct inspections of FINRA's operations and regulatory programs, we will focus resources on assessing the quality of FINRA's examinations of individual broker-dealers. [26]

Regulation Systems Compliance and Integrity ("SCI"): We will continue to examine SCI entities to evaluate whether they have established, maintained, and enforced written policies and procedures reasonably designed to ensure their systems have levels of capacity, integrity, resiliency, availability, and security adequate to maintain operational capacity and promote maintenance of fair and orderly markets, and that they operate in a manner compliant with the Exchange Act. OCIE will also review, among other things, controls relating to how systems record the time of transactions or events, how they synchronize with other systems, as well as collection, analysis, and dissemination of market data.

[25] *See* https://www.sec.gov/news/press-release/2014-143

[26] *See* https://www.finra.org/file/what-expect-preparing-finra-cycle-examination for *What to Expect: Preparing for a FINRA Cycle Examination.*

Examinations will also assess entities' enterprise risk management, including whether these programs cover appropriate business units, subsidiaries, and related interconnected infrastructure.

Cybersecurity: In 2017, we will continue our initiative to examine for cybersecurity compliance procedures and controls, including testing the implementation of those procedures and controls. [27]

National Securities Exchanges: We will continue to conduct risk-based inspections of the national securities exchanges. These inspections will focus on selected operational and regulatory programs.

Anti-Money Laundering ("AML"): Money laundering and terrorist financing continue to be risk areas that are considered in our examination program. We will continue to examine broker-dealers to assess whether AML programs are tailored to the specific risks that a firm faces, including whether broker-dealers consider and adapt their programs, as appropriate, to current money laundering and terrorist financing risks. We will also review how broker-dealers are monitoring for suspicious activity at the firm, in light of the risks presented, and the effectiveness of independent testing. We will also continue to assess broker-dealers' compliance with suspicious activity report ("SAR") requirements and the timeliness and completeness of SARs filed.[28]

Other Initiatives: In addition to examinations related to the themes described above, we expect to allocate examination resources to other priorities, including:

- **Municipal Advisors:** We will continue to conduct examinations of municipal advisors to evaluate their compliance with SEC and Municipal Securities Rulemaking Board rules. This initiative will continue to include industry outreach and education.

- **Transfer Agents:** In addition to our examinations of transfer agents' timely turnaround of items and transfers, recordkeeping and record retention, and safeguarding of funds and securities, we will examine transfer agents that service micro-cap issuers, focusing on detecting issuers that may be engaging in unregistered, non-exempt offerings of securities.

- **Private Fund Advisers:** We will continue to examine private fund advisers, focusing on conflicts of interest and disclosure of conflicts as well as actions that appear to benefit the adviser at the expense of investors.

Enforcement: Enforcement agents showing up with examiners is no indication that an exam will lead to anything; it is educational for enforcement agents to have knowledge of examination procedure. In determining when an enforcement action is appropriate, the commission will look to evidence of fraudulent activity, whether it is ongoing, and if there is actual or potential harm to investors. Considerations include:

- Whether registrant is repeat offender;
- Tone of registrant during exam – conciliatory v. compliant;
- Relative strength/weakness of compliance program;
- Whether conduct is ongoing or historical;
- Whether registrant has taken correction action in response to an exam, not because they opened an enforcement action;
- Whether there's a need to charge individuals, or there's gate keepers involved;

[27] *See* https://www.sec.gov/files/risk-alert-cybersecurity-ransomware-alert.pdf for *SEC Cybersecurity Risk Alert.*
[28] *See* https://www.sec.gov/about/offices/ocie/amlsourcetool.htm for *SEC AML Source Tool Alert.*

- Will this result in a message case – is there a rule the industry is confused about; and
- Priorities for commission as identified

Other initiatives and issues that the exam program will include: recidivist employees (Bad Actors) that have perhaps come from the BD side to the IA side of the business; IPO allocations and soft dollars; exorbitant commissions (particularly in smaller accounts); service fees (without disclosure) to affiliated BDs; affiliated BDs and agreements with custodians; markups (such as postage) that clients do not see; undisclosed broker incentives; IA fees incorrectly calculated; IAs in a precarious financial position (heightened risk); web based email and cloud storage arrangements that allow service providers access to emails (Regulation SP concerns and data at risk).

Steven mentioned that he likes to see a Power Point explanation of the firm when the exam team arrives. He wants to see an explanation of the business and an identification of key risks as well as how they are managed. What is the firm's growth plan? Are there any new developments? Any new products? Steven explained that such a presentation gives comfort to the exam team. It gives the team an opportunity to assess the tone from the top, understand the business and how you identify and manage risk.

Steven also shared some factors to consider as an IA fiduciary: suitability of investments; acting in the best interests of clients; not favoring one client over another; putting clients first; best execution; avoid conflicts but disclose those that exist. Look very carefully at your disclosure and your use of the word "may". Performance advertising is often fraudulent. Take performance calculation reviews very seriously. The F-Squared debacle is something to avoid. Supervision of "bad actors" needs to be enhanced.

PANEL 4. CYBERSECURITY

Panelists:

Chris Hetner, *Senior Cybersecurity Advisor to the Chairman*

Rebekah Kohmescher, *Chief Operating Officer, Altair Advisors*

David Glockner, *Regional Director, CHRO*

Mavis Kelly, *Assistant Director, National Examination Program (Moderator)*

Key Takeaway: OCIE's cybersecurity initiative is designed to assess cybersecurity preparedness in the securities industry and to obtain information about the industry's recent experiences with certain types of cyber threats. The focus of the initiative is to promote better compliance practices, and inform the Commission's understanding of cybersecurity preparedness.

Breakdown of Focus Areas: As part of this initiative, OCIE will conduct examinations of more than 50 registered broker-dealers and registered investment advisers focused on the following focus areas:

1. Governance and Risk Assessment: Examiners may assess whether registrants have cybersecurity governance and risk assessment processes relative to the key areas of focus discussed below. Examiners also may assess whether firms are periodically evaluating cybersecurity risks and whether their controls and risk assessment processes are tailored to their business. Examiners also may review the level of communication to, and involvement of, senior management and boards of directors.

2. Access Rights and Controls: Firms may be particularly at risk of a data breach from a failure to implement basic controls to prevent unauthorized access to systems or information, such as multifactor authentication or updating access rights based on personnel or system changes. Examiners may review how firms control access to various systems and data via management of user credentials, authentication, and authorization methods. This may include a review of controls associated with remote access, customer logins, passwords, firm protocols to address customer login problems, network segmentation, and tiered access.

3. Data Loss Prevention: Some data breaches may have resulted from the absence of robust controls in the areas of patch management and system configuration. Examiners may assess how firms monitor the volume of content transferred outside of the firm by its employees or through third parties, such as by email attachments or uploads. Examiners also may assess how firms monitor for potentially unauthorized data transfers and may review how firms verify the authenticity of a customer request to transfer funds.

4. Vendor Management: Some of the largest data breaches over the last few years may have resulted from the hacking of third party vendor platforms. As a result, examiners may focus on firm practices and controls related to vendor management, such as due diligence with regard to vendor selection, monitoring and oversight of vendors, and contract terms. Examiners may assess how vendor relationships are considered as part of the firm's ongoing risk assessment process as well as how the firm determines the appropriate level of due diligence to conduct on a vendor.

5. Training: Without proper training, employees and vendors may put a firm's data at risk. Some data breaches may result from unintentional employee actions such as a misplaced laptop, accessing a client account through an unsecured internet connection, or opening messages or downloading attachments from an unknown source. With proper training, however, employees and vendors can be the firm's first line of defense, such as by alerting firm IT professionals to suspicious activity and understanding and following firm protocols with respect to technology. Examiners may focus on how training is tailored to specific job functions and how training is designed to encourage responsible employee and vendor behavior. Examiners also may review how procedures for responding to cyber incidents under an incident response plan are integrated into regular personnel and vendor training.

6. Incident Response: Firms generally acknowledge the increased risks related to cybersecurity attacks and potential future breaches. Examiners may assess whether firms have established policies, assigned roles, assessed system vulnerabilities, and developed plans to address possible future events. This includes determining which firm data, assets, and services warrant the most protection to help prevent attacks from causing significant harm

7. Hacking Client Accounts: Advisers should be aware of potential risks associated with cybersecurity breaches in their clients' accounts. The FBI has reported a 270% increase in business email hacks (see Goldman breach)[29], and incidents of fraudulent call-back wire requests have been documented. Suspicious emails from clients should be flagged, and advisers should encourage clients to change passwords regularly.

David commented that you need to do a risk assessment even if you are small. What are your risks? You need to protect customer data.

Risk Alerts and Notable Cases:

There are several Risk Alerts and other materials mentioned in the Reference Materials. There have been several cases brought in this area:

R.T. Jones[30], a Saint Louis based investment adviser stored sensitive personal information about its clients on it third party hosted web server which was hacked. R.T. Jones failed to adopt written policies and procedures reasonably designed to protect customer records and information in violation of Rule 30(a) of Regulation S-P.

Morgan Stanley[31] also violated Regulation S-P for having policies and procedures that were not reasonably designed to protect customer data. Morgan Stanley did not restrict the internal access and use of personally identifiable customer data, and they did not audit or test or even monitor employee access to this data.

Craig Scott Capital[32] also had difficulties in this area.

Final Remarks: The NIST Framework (National Institute of Standards and Technology) is a great starting point for developing a cybersecurity compliance program. In addition, designate a CI Security Officer; get engagement from senior management at your firm; and conduct a risk assessment.

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[29] *See* https://www.sec.gov/litigation/admin/2015/34-75331.pdf.

[30] *See* https://www.sec.gov/litigation/admin/2015/ia-4204.pdf and https://www.sec.gov/news/pressrelease/2015-202.html.

[31] *See* https://www.sec.gov/litigation/admin/2016/34-78021.pdf and https://www.sec.gov/news/pressrelease/2016-112.html.

[32] See https://www.sec.gov/litigation/admin/2016/34-77595.pdf.

BREAKOUT SESSION 1: RETAIL CLIENTS & RETIREMENT FUNDS

Panelists:

Louis Gracia, *Deputy Associate Regional Director, CHRO IAIC Examination Program*

Ahmed Abdul-Jaleel, *Assistant Regional Director, CHRO IAIC Examination Program*

Belinda Hoskins, *Exam Manager, CHRO IAIC Examination Program*

Opening Remarks:

Belinda Hoskins: On June 22, 2015, OCIE announced the launch of its Retirement Initiative ("ReTIRE Initiative") and a National Exam Program Risk Alert.[33] This initiative was designed to address our Fiscal Year 2016 examination priority of protecting retail investors and investors saving for retirement. The emphasis for 2016 was to assess several distribution models employed by investment advisers and broker dealers that target retirement assets. The examinations conducted were in part intended to provide insight on industry practices related to matters of importance to retail investors and investors saving for retirement. Including, whether the information, advice, products, and services being offered were consistent with applicable laws, rules and regulations. The exam scope was also set that examiners could assess firms' conduct and certain higher-risk areas where misconduct is likely to occur. This includes fee and account selection, sales practices, suitability, supervision and marketing.

In fiscal year 2016, OCIE initiated over 250 examinations; 75% were of investment advisers, 25% were of broker-dealer firms. The scope areas of these exams was similar to the National Examination Program's core review areas. Thus, while we applied retirement filter, deficiencies and or weakness have been consistent with common typical exam findings. Some of the findings from our 2016 examinations are still being analyzed, but here are our preliminary observations:

1. Reasonable basis for making a recommendation: In our ReTIRE risk alert, one of the focus areas was to determine whether there was a reasonable basis for making a recommendation. In examining this area, examiner's procedures included, among other items, an assessment as to whether the examined advisors 1) identify and understand the source of IRA rollover funds, 2) were aware of the types of products and services being offered, 3) monitor recommendations and transactions, and 4) maintain appropriate documentation.

One observation is the top three types of products being offered by these examined advisers were mutual funds, equities and fixed income securities. Most of the examined advisers appeared to have a reasonable basis for recommending IRA rollovers and considered whether investments were suitable or in the best interests of their clients. However, there were instances where examined advisers recommended clients liquidate their retirement accounts, and it was not in the client's best interest. Some of those examined advisers who recommended liquidation from an employer sponsored retirement plan, lacked documentation sufficient to substantiate prior to making the recommendation to liquidate and roll over. Those advisers did not understand the client's existing retirement plan investments, did not conduct a comparative analysis of existing and recommended investments, and did not conduct the comparative

[33] *See* https://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf.

analysis of exiting and projected fees and expenses. In other words, whether to maintain an existing plan, roll assets to a new employer's plan, or liquidate assets and roll them into a registrant-advised IRA. Those particular advisers also appeared to have insufficient compliance controls including inadequate or no written IRA rollover related policies and procedures, and failed to maintain documentation sufficient to demonstrate the effectiveness and oversight of IRA rollover-related policies and procedures.

2. Conflicts of Interests: Many registrants have inherent conflicts of interests that exist as a result of, among other things, their business structure, compensation structure, personal issues or relationships, or relationships with service providers. In the areas of conflicts of interest, we found that some examined advisors failed to disclose material conflicts of interests including compensation received through agreements with others, and had vague or omitted disclosures associated with fees and services.

For example, at one duly registered firm, clients were not being charged on equity trades, but were charged a postage and handling on each trade. The firm had an undisclosed relationship with the clearing firm, where the clearing firm was charging the advisory clients a postage and handling fee on behalf of the adviser, and part of the fee was being kept by adviser. During the two-year period, the firm was credited with approximately $21,000.00 in postage and handling fees. While the registrant had disclosed in its Form ADV that clients would be charged postage and handling fees, it failed to disclose it would receive part of the fees as part of such fee arrangement.

Another example is where an adviser failed to disclose material facts and information regarding its affiliation with a mutual fund it recommended to clients. In addition, the same adviser also engaged in prohibited transactions under ERISA when recommending purchases of the affiliated mutual fund.

A third example, is an advisory firm that failed to disclose conflicts of interest on its Form ADV with respect to using an affiliated broker-dealer. The Form ADV did not provide clear disclosure regarding the distinction between services being provided by the adviser, and services being offered by the affiliated broker-dealer. Including, it failed to disclose that certain products such as annuity products could only be purchased in a brokerage account, and not an advisory account.

3. Supervision and Compliance Controls: Under federal securities laws and SRO rules for broker-dealers, firms must reasonably supervise persons acting on their behalf, and adopt compliance programs which should include reasonably designed policies and procedures that are tailored to each firm's business. A high percentage of examined advisers' policies and procedures were inadequate due to a variety of reasons, and were not necessarily specific to providing retirement based products and services. The vast majority of examined advisers were found to have updated their policies and procedures within past few years. A few things we did note around policies and procedures, we found that some advisers had no policies and procedures for recommending clients take a lump sum distribution from their pension plan. Some had no policies and procedures to adequately monitor and supervise rollover from employee sponsored retirement plans. Some had either inadequate or no written procedures around fee-billing practices. We also found cases where there was no documentation around providing evidence to clients regarding costs and fees associated with rollovers.

4. Marketing & Disclosures: This is last focus area of this initiative. Most of the examined advisers are advertising their retirement-based services and products on their websites, at seminars, in printed materials and on social media. Most are advertising to private company employees. A fair number of examined adviser's marketing materials were deemed false, deceptive or misleading due to false claims or claims that could not be substantiated.

For example, in one exam the registrant had seminar handouts that said how annuities steal 30-40 percent of retirement income, but provided no basis for that statement. This particular registrant did not have any type of licenses, FINRA licenses, or insurance licenses.

A second case involved advertising that the adviser works with all sponsors within your retirement plan with zero conflicts of interest. It would be hard to substantiate that claim.

Another case involved an adviser that said they serve as your independent ERISA co-fiduciary. Belinda was not sure what that meant.

The next example involved an adviser who advertised on their website: "The Dr. Fiduciary v The Gypsy." In the adviser's opinion, advisory firms have a fiduciary obligation to their clients as qualified medical doctors with proper training to correct diagnosis and cure patients. In the case of the gypsy, the adviser felt they lacked the necessary training and skill to make good diagnosis to cure their patient. The SEC asked that adviser to remove such unsubstantiated statements.

We also found that some advisers failed to include performance-related disclosures. Some engaged in solicitation arrangements to have retirees or retirement assets referred to them, and found that a high number of those had failed to enter into a written solicitation agreement required by Rule 206(4)(3) – the Cash Referral Rule.

5. Other findings that were not a part of the ReTIRE Initiative: This finding was not part of the ReTIRE initiative, but we did have numerous observations around mutual fund share class selection, including failure to effect fee waivers available to certain retirement accounts.

That summarizes Phase One of ReTIRE. There is a Phase Two of ReTIRE. As stated in our 2017 examination priorities, retail clients saving for retirement will continue to be a main focus area. The 2017 ReTIRE efforts are composed of a series of individual strategic initiatives designed to focus resources on certain products and practices. These initiatives were selected based on previous exam observations, emerging practices, and/or resurging areas of potential risks as identified by industry trends and developments. This year, ReTIRE examinations will focus on, among other things, cross trading and fixed income securities, target date funds, and variable insurance products.

On the fixed income side, the exam staff will be assessing whether cross transactions were executed appropriately for clients fixed income securities, and whether the disclosures and compliance policies and procedures regarding such transactions are appropriate, and whether the transactions were executed in the best interests of clients from a portfolio management or trading perspective.

In addition, if the adviser is executing cross transactions for an ERISA accounts or mutual funds, the staff will review whether additional compliance factors were considered. These exams are scheduled to roll out over the next several weeks (from date of conference on June 13, 2017).

The second initiative under Phase Two of ReTIRE are target date funds. Specifically, these examinations will focus on the disclosures made to investors, the active management of the fund to ensure consistency of investment allocations with disclosures, and policies and procedures and marketing of such products. These examinations will launch late June or early July 2017.

The next component of Phase Two, variable insurance products, is still in the planning stages. While the focus areas have not been finalized, the topics currently under discussion include suitability of recommendations, reasonableness of fees and charges, conflicts of interests, compliance oversight, and disclosures.

Ahmed Abdul-Jaleel: I will discuss the three areas the SEC is seeing with findings concerning retail accounts across all examinations, not just across ReTIRE initiative.

1. Share class selection: The SEC continues to review conflicts on interest in this area. Essentially, the factors that go into recommendations to invest in particular classes of mutual funds. The issue is, a conflict exists when an investment adviser representative or an investment adviser dual registrant selects a mutual fund share class that pays 12b-1 fees when less expansive share classes are available to clients. In many instances, the investment advisory representative or the investment adviser has a direct financial incentive to select the more expensive mutual fund share class that does pay the 12b-1 fees.

Some observations from exams: we've seen fund promotion literature that will specifically target investment advisory reps, and state what sets the share class apart is that you the IA-Rep earn additional compensation as a result of this share class. In another example, IA-Reps were unaware that lower-cost share classes were available to clients due to confusion about what threshold would be met – the IA-Reps thought the threshold would be required at the client asset level when in fact some of the thresholds were met at the adviser threshold level. We've also seen instances where during interviews, we will pose the question directly, "why did you select one investment over another," and often will hear a candid response that there was additional compensation in store for the rep.

There are various business models that employ 12b-1 fees as a way of enhancing revenues. One unique model we've seen is where an IA has a wrap fee program and will arrange with its custodian to waive the custodial fees in lieu of earning 12b-1 fees from the client. So, the investment advisor will recommend mutual funds that pay the 12b-1s, the custodian then earns the 12b-1s, and the custodial fee arrangement between the adviser and the custodian is then waived.

These are recurring issues we're seeing across exams. To provide a sense on approximate numbers, the number of times we've cited a share class selection in the last fiscal year has increased threefold. Approximately a third of the retirement exams mentioned earlier by Belinda (250) also include findings concerning Share Class Selection.

Given the importance of this issue, in July 2016, the National Examination Program rolled out an initiative on share class selection. This is comprised of approximately 30 exams which are ongoing at this point. As part of initiative, examiners are looking at an adviser's fiduciary duties and best execution obligations, disclosures, and policies and procedures. On the disclosure front, I wanted to reiterate what was mentioned earlier. We are taking a close look at instances where "may" language is used. For example, "the adviser *may* select share classes that pay 12b-1 fees," but in reality, that is their actual business model. One case revealed an adviser who used that type of language, but over a third of its revenues were coming from 12b-1 fees being a dual registrant. Additionally, several exams have resulted in reimbursement to clients due to deficiencies concerning share class selection. There have also been a number of recent enforcement decisions concerning this area, which will be covered in the following panel on "Recent Decisions". Just at a high level, these matters concern instances when a share class was selected when a less expensive class was available, as well as failure to disclose conflicts of interest associated with the recommendations, or that disclosures were misleading, as well, finally, that policies and procedures were inadequate.

2. Use of Solicitors acting as Investment Adversary Representatives: This is the second area I would like to highlight. Steven Levine earlier mentioned on the angle on potential implications with respect to Rule 3a-4. I want to highlight the potential concerns that exists when solicitors cross into that realm of investment advisory rep type of activity.

We see situations where advisers are offering model programs, where the primary business model is for solicitors to bring in new clients. The issue is that the solicitors are not only responsible for the initial introduction to the firm, but continue to serve as the ongoing point of contact for the clients. In some situations, we have found from talking to clients that they don't even know who the investment adviser is. Even from the solicitor's perspective, the solicitor views these clients as their own, and is in the process of making on-going recommendations well above and beyond the initial introduction to the firm. These situations also arise from instances where there are contradictory disclosures from what's in the Form ADV, what's disclosed in advisory agreements and selling agreements, notably that the agreements don't provide for the solicitor to provide any sort of ongoing investment recommendations to clients.

3. WRAP Fee Programs: This is the last area to highlight, with focus here on potential reverse churning.

We've come across a number of instances where exams are yielding findings where clients are charged a higher fee in a wrap program, yet they're sitting idle in the wrap program with no trades for an extended period of time. A recent exam identified that the investment adviser actually had policies and procedures to note that if a client is in a wrap account and has not traded in one to two years, then the firm's policy stated that that client should not be in the wrap account. However, in that exam, we uncovered over 500 advisory accounts that had not traded in over 3-5 years in these wrap fee accounts.

Another exam identified worse conduct where the activity had gone on for 6-8 years, and there was no documentation in any of the client files or reviews as to why the client was still in the wrap account, when they could have been in a less expensive advisory or even brokerage account. In this instance, one rep had signed off on a client account review form stating some trades had been made, but upon further investigation, no trades had ever been made for that particular time period.

The last example is another exam where we identified investment advisory reps were responsible for paying transaction costs, and so, they had a disincentive to trade. Notably here, the advisory firm had failed to disclose that this conflict of interest existed from the investment advisory side.

These are some of the issues we'll continue to review as part of wrap fee programs. Wrap fee is one of the focus areas on the agenda for fiscal year 2017, and some of the specific areas of focus will include: wrap fee account suitability, effectives of disclosers, conflicts of interest, and brokerage practices including best execution and trading away.

Louis: I want to cover step-out trades, or more commonly called trade aways in wrap fee programs. In our review, we've looked at it both form the sponsor IA, and sub-adviser IA, and have found some issues, and some have gone on to settled cases. What is more important, instead of pointing out the cases, is some of the lessons we've learned from the exams we've had, because you don't see everything that is out there, only the ones that have been settled.

Disclosure not matching practices: From a sub-adviser point of view – essentially the underlying adviser who wanted to use these wrap fee programs, there being some disclosure in the ADV or elsewhere, saying that they generally would be executing trades through the designated broker-dealer. But as time went on, and change their practices, they started to more and more executed trades away from the designated broker-dealer. You begin to question, is a disclosure stating that you "generally use" the designated broker-dealer really accurate? I can't give you a specific marker – 50%, 60% … but when examiners came in there it was at around 80%, and it has historically gotten to that point some time ago, one felt pretty clearly, that the disclosure is no longer accurate. The Robare Case[34] discusses the use of "may" [in Form ADV disclosure], and when that use is not appropriate or really accurate to the actual practices. The example just provided is in the same vein – the idea of saying that we are going to generally engage in a practice, and then as time goes on (or maybe even from the start), that isn't an accurate reflection. This is a good example of monitoring your disclosures on an ongoing basis, and asking yourself: "Are our current practices really in line with those disclosures?"

Failing to adopt and implement adequate policies and procedures: We have found instances in which a firm hasn't even been tracking, hasn't been monitoring, doesn't know which subadvisors have been trading away, how much they've traded away, what's the nature when they're trading away, and whether they have received best execution. Our concern in those instances, is that part of your responsibilities – which you clearly indicated in the wrap fee program – was to monitor the investment advisers that you are recommending. This includes seeing how they're actually conducting transactions, whether they are really getting best price and best execution, or at least if they are meeting the targets you have set out for them. Knowing whether they have traded away, is a central point that should be reviewed. We have found instances where firms have not put policies and procedures in place, have policies and procedures in place but no one was reviewing them, and where firms did have policies and procedures in place and were reviewing them, but no one who was responsible for that monitoring distributed that analysis to any of the financial advisers or reps out there, who are really the decision makers for determining whether you should continue to recommend that sub-adviser.

Retirement account conversions: This area was covered in great detail by Belinda, but I wanted to highlight the failure of firms to have adopted policies and procedures that address the conflicts of interest that are inherent in doing account conversions. We concentrate on those times in which the adviser clearly is the decision maker – meaning that the client is coming in and expecting the adviser to recommend whether they should be rolling over or not. We particularly spend a lot of time when we find the likelihood of some issue. For example, when there is the likelihood of fees being generated through the conversion, the recommendation of affiliated products, and whether there are any other bonuses or incentives for reps in having an account convert over.

DOL Fiduciary Rule:

Last area I want to cover is a little touchy, the Department of Labor Fiduciary Rule. Technically it has been in effect since June 9th. Here are some things I'm willing to comment about, and what I understand. The DOL rule is in a transition period until January 1, 2018. Through a Field Assistance Bulletin, the DOL has essentially indicated that any firm that has made a good faith effort to be in compliance, isn't going to

[34] The case is summarized in Exhibit B and can be found at https://www.sec.gov/litigation/opinions/2016/ia-4566.pdf.

open to any enforcement action on their part, or treat it as a violation of the Rule. DOL Chairman Acosta issued an Op-Ed piece in the Wall Street Journal wanting to re-open the door to look at the Rule, and held an open hand to Chairman Clayton to do the same, and coordinate our efforts. With that, Chairman Clayton has put out a request for comment for the SEC assessment of possible future actions regarding Investment Advisers and Broker-Dealers standard of conduct. I highly recommend if you have an opinion to voice it.

I would like to highlight a couple of questions in particular. It is kind of been opened to retail clients, but he has left it open to anyone in the industry to offer their opinion. If I was the industry I would want to say something about the following:

- "If the commission were to proceed with a disclosure based approach to regulatory action, what should that be? If the Commission were to proceed with a standard of conduct based approach to potential regulatory action, what should that be? Should the standards for IA and BD be the same or different, and why?" This is the crux of the issue, essentially asking what should be the standard of care, should it be very prescriptive with rules based, or more principle based, and should it be equal to investment advisers and broker-dealers.
- "How would any such suggested approach – disclosure vs conduct – be implemented? Specifically, what initial steps would need to be taken to conform to the new rules, and what ongoing process – e.g. policies and procedures – would need to be put in place to promote compliance and oversight? Would we need to have additionally guidance, if so, what would that entail?" A very central based question would be how this should be rolled out?
- "For purposes of Commission action in this area, how should investment advice be defined? Should certain activities be expressly excluded from the definition of investment advice?"

Louis then opened up the panel for questions from the audience:

Audience Member One: How do you define "retail"?

Louis: We don't. I have to tell you, when we were told that we would handle retail and retirement accounts, I thought, "what else is there? What does that leave, hedge funds and investment companies?" That's a good question, and I would wonder whether you want to go down that road to define it. In particular, in thinking about any of the issues that we've raised, and even more so, when talking about the fiduciary rule. The industry was very upset by the bifurcation between retirement and non-retirement accounts under the fiduciary rule. Would you really want us to create the dividing line between who's a retail account and who's not? I'm not aware of any line between retail and non-retail, or that line being drawn at retirement accounts and non-retirement accounts. I am not sure whether the Commission is going to go down that route. For my own rule of thumb, if it's an individual, it's retail. I don't get into the further divvying up between high net worth individuals vs low net worth individuals, as though as if you're wealthy you shouldn't have the same protections. I did an exam of a registrant, in looking at how they were looking at reverse churning in wrap fee accounts. One of the things they looked at in their monitoring was if an account was under 25-50K, and excluded everyone else. My conclusion was they were saying that if you have a big enough account it's okay to not trade your account. It didn't make any sense to me, so I couldn't understand the dividing line – frankly enough, they couldn't explain it to me either. I would also include in my definition of retail anything that is like an individual, e.g. a trust, an IRA…Quite honestly, that doesn't really change our analysis. I think we just go into it knowing what that relationship is more likely to be with a retail account than it would be with an institutional account, per se.

Louis wrapped up the panel by posing a question to the audience:

Louis: One of the issues we're continuing to grapple with is dealing with an aging-investor class, and how do we deal with seniors in a thoughtful manner. FINRA recently issued a rule requiring an additional safeguard for clients over 65, e.g. obtaining the name and contact information of a trusted individual. The rule also allows for a temporary halt of the disbursement of funds if they suspect that the client may be the target of financial abuse or fraud. Would rule making or guidance on these issues be useful for the investment adviser industry?

One member of the audience addressed concerns of liability for the investment adviser for failing to do something to protect the investor. Louis mentioned that some states have already enacted written rules primarily driven around broker-dealers and maybe some state chartered banks, but the SEC has not. The SEC has issued some Risk Alerts but nothing that is such definitive guidance to the industry. Louis considers this area in many ways like cybersecurity – investment advisers and the SEC are on the same side; they don't want to see clients ripped off. This is one of those times where the SEC needs to collect some information, and think about what types of guidance we want to give to the industry. Furthermore, to be clear about what latitude they have in the monitoring of that conduct, and maybe what are going to be our expectations.

Another audience member raised concerns about aging advisers, and their capacity to properly execute their obligations. Louis mentioned the business continuity rule, which provides some authority – maybe not to the point of incapacity – to asks questions about what are the next steps for a firm, are the key persons rotating out, does the firm get sold?

In response, one audience member requested that, if there is a rule, it does not become too prescriptive. Louis notes the struggle in this space between principle based and specific guidelines. I would have a hard time thinking that the answer would be to give out such specific rules that then create gaps. Where someone is following the letter of the rule, but suddenly someone ends up getting defrauded anyway. That's not really helpful at the end of the day.

Another audience member raised the issue of an investor seeking to make the adviser their successor trustee, but the adviser would need to decline to avoid raising custody concerns. Louis stresses that it is not a rule that you can't have custody, it is just a business decision determining how much more value you can add to a client by assuming custody and offering those services, and how much of a compliance burden it would be to adhere to custody standards.

Lastly, an audience member raises issue about IRA accounts being non-protectable, and the vulnerability for them to be converted to the hands of their care-taker with little effort. It would help the advisor if they can help the investor protect their own assets. Louis thanked the member for their comment.

BREAKOUT SESSION 2: RECENT DECISIONS

Panelists:

Thu Ta, *Regulatory Counsel, CHRO IAIC Examination Program*

Andrew Shoenthal, *Senior Advisor, AMU, Enforcement Division*

Junaid A. Zubairi, *Chair, Government Enforcement & Special Investigations, Vedder Price*

Opening Remarks:

Thu Ta: For fiscal year 2016, OCIE conducted more than 2400 examinations of regulated entities. Of those, 1600 were completed by the IAIC Program. OCIE made approximately 200 referrals, or eight percent of exams resulted in referrals. The SEC brought 868 enforcement cases, and of those 160 involved investment advisors and investment companies. In Chicago, we conducted approximately 260 exams of IAIC's, and we referred approximately 25 of those exams – so our numbers are in line with the national numbers. The takeaway is that referrals are clearly the exception to the rule in the context of the exam program. As compliance professionals, we believe we have a shared interest, which is to promote compliance at your firm. That said, we are your regulators, not your compliance officers, and if we find issues that we believe should be addressed by an enforcement action, we will refer the matter to Enforcement. The majority of firms make a good faith effort to comply with the rules. So, the enforcement cases that result from the exams are generally outliers. But as such, we think they can be instructive to you.

Andrew: So to liven things up, we thought we would go through the recent decisions coming out either from the Commission or from the District Courts. All the cases that we are talking about are publicly available on the SEC's website under the Administrative Proceedings link in the Enforcement tab. I recommend you take some time to look through them.

In the past year, there were particular undisclosed sales practices that the Commission has focused in on. Of late, is the selection of mutual fund share class issue. Mutual funds come in different share classes with different attributes, whether it be a front load, no load, 12b-1 or not. The common theme, is certain advisers were preferring one share class over another without proper disclosure. If it's an adviser's practice to favor a 12b-1 share class over another, you can do that. The question is what information do you need to provide the advisory clients regarding that. If you always favor them, you should disclose that. There are a couple of cases that bring this point home.

One of the most recent cases is called Royal Alliance. The case dealt with three subsidiaries of AIG, in which the advisory clients were put into mutual funds that paid the adviser 12b-1 fees, instead of a lower fee alternative, mostly reserved for institutional investors. The issue is that if you do favor one share class over another as part of your advisory compensation scheme, you need to say that. In that case, there was also a reverse churning component as well. Reverse churning is a practice that the Commission has been clear on regarding wrap fee accounts and the lack of trading in those accounts. So again, choosing what kind of accounts to put your client into, whether it is a wrap fee or not, regarding connection with the amount trading in that account, there have been issues in the past. Royal Alliance was one of the first of a trilogy of cases dealing with mutual fund share class issues.

The other case is Everhart Financial Group. In this case, the adviser decided to compensate itself by reducing its advisory fee through 12b-1. That's fine, but the problem is, they never disclosed it in their Form ADV, in their brochure, or in an agreement that their practice was to favor 12b-1 share classes over other classes.

Another case is Pekin Singer, from 2015[35]. In that case, the adviser didn't make all the share classes that it had available to its clients. One being an institutional share class, which is by far cheaper than the others.

All these cases put together – and there is an investor bulletin regarding these share class selection issues – in the context of best execution, the Commission has viewed the failure to disclose a preference of one share class over another, as a failure to provide best execution. So this is an application of best execution outside of the brokerage context.

Junaid: With respect to share class, I think the activity has really picked up over the last three to four years to become a real focus from an Enforcement Program perspective. As Emmet said in the earlier panel, it is a big focus during exams as well. Combined with the enforcement activity and the exam focus, I've had the opportunity to represent a number of clients that are either undergoing investigations, or are in the remedial context as well. I will focus my comments on observations that come out of that process.

The key issue, is the need to place the client in the most optimal share class. As Andrew said, disclosure is going to be significant and will be evaluated by the SEC. So, what does the most optimal share class mean? It typically means the least expensive share class – though not always. There are circumstances where it may make sense to not put a particular client in the least expensive share class, and that's a case-by-case assessment. In general, it tends to be the least expensive share class. As highlighted by the enforcement activity, the Division of Enforcement is looking at this from a fiduciary duty perspective – whether or not advisers have acted and discharged their fiduciary obligations to their clients. The SEC is also, looking at this from a best execution perspective. Typically, you have a retail share class and an institutional share class. In the retail share class you've got low minimum investments, some type of a shareholder or 12b-1 fee associated with it. On the institutional side, you have higher minimums, with no shareholder servicing or shareholder administrative fee associate with it. Where I see clients get into trouble, is on the original set up. Logically, it makes sense that the institutional share class is reserved for "big fish" – the bigger investments will be reserved for that class. Then, the average client who requires a lot of handholding, will go into the retail share class because we're constantly engaging with them. It makes sense, because it has that additional fee associated with all the extra work they're doing. All of that has to be looked at from the framework of disclosure, and in the context of your fiduciary obligations. So, typically, you'll have disclosures in the ADV that are going to be critical on this. I've seen disclosures in the ADV that talk about, for example, aggregation. That will allow aggregation to take place, even though the threshold may be $1 million, but you can aggregate and get to that number, and it doesn't have to be on a client by client basis. Sometimes that's overlooked, and there is treatment that is given to external money that is coming in. But when it comes to internal sort of separately managed accounts, it is on a client-by-client basis. So,

[35] *See* https://www.sec.gov/litigation/admin/2015/ia-4126.pdf. This is a particularly instructive case that involves failure to pre-clear securities transactions, failure to maintain personal trading documentation, failure to document best execution reviews, failure to conduct annual compliance reviews, misleading disclosure in Form ADV, as well as failure to convert investors to a less expensive institutional share class.

depending on that disclosure, that could create a lot of issues, because there is also times and obligations to aggregate based on the internal estimated clients.

The other issue is correspondence. I mean I've seen examples where you'll have correspondence to third parties that will make exceptions, that will utilize a criteria that applies to external third parties, but that is not applied to the separately managed account side. That could create a potential issue that I have seen come up in investigations.

The last important point to note is the importance of documenting. I think documenting the practice of making exceptions, and the rational associated with it, if you're going to put someone in the most or least expensive share class. To document that is very important, because in 3-4 years when an examiner shows up, it may be difficult to justify that, and having contemporaneous documentation to support that can be helpful.

Real briefly, the other area that I've spent some time on is on the remediation side. If you've got a share class issue, with all the heightened scrutiny being placed in this area, I urge everyone to look into the various share classes, and make sure there is not an issue or a duty to convert to a different share class. If that is the case, I think it is important to evaluate that in the context of an attorney client privilege, and to consult with outside counsel. So, to the extent that there is an exam down the road, and you've determined that you want to keep that information confidential, it is protected by the privilege. If you've evaluated this, and come to a determination that conversation makes sense, then there are a number of other things to consider. For example, is there a component of reimbursing that needs to be considered. Meaning, if I am going to convert from a retail share class to an institutional share class, and the decision is based on a determination that the client should've been in that share class to begin with, is there an obligation or a duty to consider reimbursing the clients some amount to make them whole? If so, how is that going to happen from a practical standpoint? Is there going to be a credit on the account, are you going to issue checks...There are times where it gets really micro – if you can't find the client, what do you do in those circumstances? Those are all important considerations. Then, do you give some form of return on the money? Do you use the return that the fund has had over the years, or do you incorporate some form of interest component to the extent that you are going to reimburse? Then you have to consider client notification – what is the letter going to look like that informs the clients of the reimbursement, and not expose yourself to additional liability, potentially. So the description in that letter is going to be very important. Then lastly – and this is a topic within itself – whether or not it is appropriate to self-report to the SEC. There are a lot of pros and cons to doing that, and involving a regulator, but that is outside the scope of this presentation.

Andrew: Just to echo one thing that Junaid said, a common theme to all of these mutual fund share class selection cases and best execution cases, is that the adviser failed to consider that certain clients should be treated differently, and it treated all clients almost identically. They had an unwritten rule that they favored one share class over another, and it is when you apply this cookie cutter approach to share class selection that advisers get into trouble.

We are going to move to another topic, and that is dealing with undisclosed revenue. As a member of the Asset Management Unit, we have brought a series of cases that have exposed certain payments that either an advisor has received from a broker dealer or third outside party in connection with their advisory work. The Form ADV is very clear that compensation needs to be disclosed. Obviously, there are 12b-1 payments if you're a duly registered broker dealer, and the advisory fees. However, there are other forms of compensation you may not think about, forget about, or may not be aware about. That is the focus of these next few cases.

The first is called Advantage Investment Management (also see Washington Wealth Management): This dealt with undisclosed loans. Loans that charged no interest or low interest, that was provided by the clearing broker-dealer to the investment adviser/broker-dealer. Some of these loans were quite substantial. These advisers would not have been able to obtain the terms of these loans from anyone else. In this context, the advisers failed in their Form ADV or otherwise to include in their discussion with their relationship with their-broker dealer that they were receiving these payments. No interest may be viewed as a lack of payment, but there is an economic benefit being received by the investment adviser in connection with their adviser relationship.

These next cases deal with revenue sharing. Revenue sharing is payments paid by a third party, often the broker dealer, to the investment advisor, for the relationship and having accounts custody or cleared through that broker dealer. This include Focus Point, Dion, Shelton, and Robare. Robare is currently on appeal to the D.C. Circuit Court, but I recommend reading the Commission opinion. In a nutshell, this case describes the law about the fiduciary duty, as well as the interplay with outside parties in the disclosure process. The Commission found that potential conflicts of interest are material and need to be disclosed. Not just actual conflicts, but *potential* conflicts. Additionally, if an adviser discloses that it "may" receive revenue sharing, but it is receiving revenue sharing, that's not sufficient. Further, if an adviser is relying on a compliance consultant, that is not a defense recognized under the law according to the Commission. Again, this is on appeal, but I think the takeaway is that looking at your business in connection with what form of compensation you're getting, "may" is probably not the best word to describe things that you're actually receiving. In Robare, it was in the form of revenue payments received from a third-party broker-dealer.

Junaid: There are four main issues that the commission focused on, on Robare. The first is materiality. The decision suggests that all potential conflicts of interest are per se material and therefore must be disclosed. The Commission states, because of the fiduciary relationship between an advisor and its client, the percentage or absolute amount of compensation involved is not determinative of materiality. So, there is a qualitative aspect to materiality that goes beyond the quantitative aspect.

The second theme, is the adequacy of the disclosure through their use of the word "may." Andrew already addressed that, so I will skip over that aspect.

The third is reliance on the advice from compliance consultants. Ultimately, the Commission ruled that there was no clear evidence that the respondents sought or obtained advice from compliance consultants for their disclosure obligations. Additionally, the Commission noted that there is no case recognizing a defense of reliance on compliance consultants – I will address that point a little later.

The fourth, which I see a lot on the defense side, despite a clean bill of health and no adverse findings from a recent SEC exam. An exam that results in a No Action Letter in no way guarantees full compliance as evident by the language within the letter itself, and therefore the letter is not a basis for finding that they acted reasonably.

Picking up on a couple of points from an industry standpoint, there's a lot of press around the Robare decision, some of it relates to aspects of the SEC choice to pursue an action against such a small advisor, with only a $150 million of assets under management. The conduct just externally doesn't look super egregious. We were talking about the word "may" versus "do" – but there are a lot of interesting lessons that can be learned from the opinion itself: The first one is to take ownership of your own documents. It doesn't matter if you have lawyers or compliance consultants involved, it's your documents, and having a thorough understanding of your business and the practice associated with your own operation is going to be paramount, and that is going to dictate what goes into those documents. So, carefully review those with of course an extra focus on the word "may." I would do a search on the word, and make sure that you know it really should be "may" and not some other word.

Next, there's a lot of discussion about the use of compliance consultants, outside advisers, attorneys and law firms. The key is, the general use of a compliance consultant or outside counsel in doing a top to bottom overview and evaluation of the compliance policies and procedures in itself is not sufficient. So, the fact that you had someone look at your policies and procedures and they didn't raise this issue by itself is not conclusive, and it's not enough to say that we had a reasonable reliance.

In Robare, the Commission took a very narrow view and went back and discussed the four elements necessary for a reliance defense. One, you have to have a complete disclosure of all relevant facts – all facts to the consultant or the lawyer.

Second, that it sought advice as to the legality of the specific conduct. So, specific advice about a specific issue.

Third, that it received advice that the conduct was legal and appropriate.

Fourth, the firm relied on the advice in good faith. Before the Commission came out with this opinion, the Administrative Law Judge was much more forgiving. The Administrative Law Judge at trial had a different outlook on the use of consultants, and gave a lot of credit for the use of consultants and the evaluation of the policies and procedures from the perspective of good faith. It demonstrated good faith, and rebutted the idea that there was fraud. So, it will be interesting to see how the D.C. Circuit comes out on this.

A couple tips on the use of outside advisers: memorialize the discussions that you're having with outside advisers. If you're going to seek advice, whether telephonically or in person, it's a good practice – especially if you're using outside counsel – to memorialize that advice. Do a memo to file, do an e-mail to yourself, that lays out what was discussed and what the advice was. Because, three or four years down the road when this issue arises, it is very hard. People don't have perfect memories, it becomes a he-said-she-said, and difficult to establish a pure reliance defense.

Thu: I just wanted to add two points – not to beat the word "may" to death. The instructions to Form ADV actually do discuss the use of the word "may". It says, if you in fact do, you shouldn't say "may" because that's not accurate. But also, if you do in some cases but don't in other cases, then describe when you do and when you don't. So, if just provide a clear and comprehensive disclosure, a lot of times you can avoid using the word "may", and don't have to run into this situation entirely. The other point is, from the exam perspective we actually do also look at the Form ADV 2b (the brochure supplement disclosures). In those cases when you're talking about individual reps, "may" seems even less defensible. Those are not filed with us, but in the exam process we will request those and we do review those.

Andrew: Remember, with the Form ADV Part 2bs, even though they are talking about individuals, it's actually the firm's responsibility. If something goes wrong with part 2b, it's on the firm. It's the advisor's disclosure about its associated individuals, not the individual's disclosures to the advisor.

There are many cases from last year dealing with cherry picking. A couple cases to know in that area:

The most recent, and most interesting one, is Tellone. The case dealt with an adviser promising clients they would use a rotation method for assigning who gets what trade. There is nothing wrong with using a rotation method – the problem is, if you are going to use a rotation method, and you tell people you are going to use a rotation method, you need to use a rotation method. The SEC was less concerned with the mechanics of the rotation, but whether or not the rotation was actually carried out.

There was another case called Wellhouse. This case is more egregious than Tellone. Wellhouse dealt with an adviser who was allocating profitable option trades dealing with expired options to his own account over his clients' accounts. Again, when it comes to cherry picking and best execution, if you have a documented procedure, we look for that, and make sure you're following that documented procedure. If you're not following the documented procedure, and there is an exception to the exception, make sure you document the exception to the exception.

The next topic is wrap fee accounts. Wrap fee accounts generate numerous questions and issues both for the advisors as well as for the SEC. As a recap, wrap fee accounts are accounts where one fee covers advisory and execution. The most recent case in this area is Barclays Capital. This was a very large case, dealing with nearly $100 million in penalties and disgorgement. What is important about Barclays, is in the disclosure about its wrap fee program, Barclays said to its clients they would review, look at, investigate, the subadvisors within the account. Barclays didn't do that for a variety of reasons, one was about time, money, and staffing. If you in part of a wrap fee context are going to tell advisers to tell your clients that certain verification and due diligence services will be performed, and those services are not conducted, it shouldn't be surprising that the SEC may issue a fraud charge for that.

In addition to Barclays, there was also the Raymond James case from late 2016. That case dealt with policies and procedures for wrap fee accounts and wrap fee account selection, concerning trading away and sub-advisory accounts. There is a theme to a lot of these cases: there either was a process that was documented and not followed, or the process was never documented so it couldn't be followed. In dealing with cherry picking, I recommend looking at those two cases.

In regards to cross trading, the Morgan Stanley and the SG of Americas are other cases worth looking at. In that case we charged several portfolio managers for engaging in cross trades. Cross trades is identifying one side of trade on one side, making sure another account deals with that trade on the other side, and having them cross for the benefit of one particular account over the other. In that case, disgorgement was received for the added extra expense of the loss to the account.

Another issue in the wrap fee context is the undisclosed use of proprietary products. This issue first came out for the SEC in the JP Morgan Case. In that case, the adviser had a preference and favored JP Morgan products. There is nothing wrong with that, and the Commission understands why an adviser may prefer its own products over an outside party. The problem was that there was never any disclosure to the adviser's clients of this preference. Further, the adviser's products were a little bit more expensive than the third-party products. So, if you have a practice of preferring in-house products or even a particular fund family, it's worthwhile disclosing that to your clients.

Next, false advertising. This shouldn't be a surprise – you can't false advertise. What does that mean? I think you can best analyze this and see what the Commission is thinking is in the series of the F-Squared cases. F-Squared was one of the largest ETF management portfolios in the United States at the time. In those cases, there was an issue regarding whether or not the fund was back tested. F-Squared was promising it was, but it was not. For advisers who recommended F-Squared products to their advisory clients, the problem was that because in their disclosures and their discussion with their clients they attested that they performed a certain amount of due diligence on F-Squared investments. As a whole, these advisers did not do any of that. They recommended a product without performing sufficient due diligence. I recommend one of those cases called Cantella. In Cantella, the adviser failed to have a reasonable basis to believe that the historical performance that was touted by F-Squared and its ETFs was actually true.

EXHIBIT A – REFERENCE MATERIALS

Links to materials discussed at the SEC' Compliance Outreach Program Held in Chicago on June 13, 2017: https://www.sec.gov/info/cco/chro-2017-compliance-outreach-handout-list-061317.pdf

Supplementary SEC Guidance/Releases:

1. OCIE Examination Priorities for FY2017
2. Chairman Clayton Public Statement: "Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers," June 1, 2017
3. IM Guidance Update: Inadvertent Custody, Advisory Contract Versus Custodial Contract Authority, Feb. 2017
4. IM Guidance Update: Robo-Advisers, Feb. 2017
5. IM Guidance Update: Mutual Fund Fee Structures, Dec. 2016
6. NEP Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers, Feb. 7, 2017
7. NEP Risk Alert: Multi-Branch Adviser Initiative, Dec. 12, 2016
8. NEP Risk Alert: Examining Whistleblower Compliance, October 24, 2016
9. NEP Risk Alert: Cybersecurity – Ransomware Alert, May 17, 2017
10. NEP Risk Alert: Examinations of Supervision Practices at Registered Investment Advisers, Sept. 12, 2016
11. NEP Risk Alert: Retirement-Targeted Industry Reviews and Examinations Initiatives, June 22, 2015
12. NEP Risk Alert: OCIE's 2016 Share Class Initiative, July 13, 2016
13. IM Private Fund Adviser Resources web page
14. Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement, by SEC Enforcement Director Andrew Ceresney, May 12, 2016

Materials Referenced During Panel Presentations

Panel 1: SEC's Changing Landscape

15. Items 1 – 14 above
16. In re Barclays Capital, Inc., Advisers Act Release No. 4705 (May 10, 2017) and SEC Press Release No. 2017-98 (May 10, 2017)
17. In re Calvert Investment Management, Inc., Advisers Act Release No. 4577 (Oct. 18, 2016)

18. In re PIMCO, Advisers Act Release No. 4577 (Dec. 1, 2016) and SEC Press Release No. 2016-252

Panel 2: Data Analytics

19. SEC Staff Speech by Marc Wyatt, Director, OCIE, "Inside the National Exam Program in 2016" (Oct. 17, 2016)

20. SEC Spotlight, FINTECH: The Evolving Financial Marketplace

Panel 3: IAIC Examinations: Priorities, Initiatives, Exam Selection, Common Deficiencies, Interplay with Enforcement

21. Items 1 – 14 above; 1 & 2 in particular

Panel 4: Cybersecurity

22. Item 9 above

23. FINRA, Small Firm Cybersecurity Checklist (December 2016)

24. In re Morgan Stanley Smith Barney LLC, Advisers Act Release No. 4415 (June 8, 2016) and SEC Press Release No. 2017-12 (Jan. 13, 2017)

25. In re R.T. Jones Capital Equities Management, Advisers Act Release No. 4204 (September 22, 2015) and SEC Press Release No. 2015-202 (Sept. 22, 2015)

26. NEP Risk Alert: OCIE's 2015 Cybersecurity Examination Initiative, September 15, 2015

27. IM Guidance Update: Cybersecurity Guidance, April 2015

28. NEP Risk Alert: Cybersecurity Examination Sweep Summary, February 3, 2015

29. FINRA Report on Cybersecurity Practices, February 2015

30. NEP Risk Alert: OCIE Launching Cybersecurity Preparedness Initiative, April 15, 2014

31. Other useful resources:
    - Financial Services – Information Sharing and Analysis Center (FS-ISAC)
    - U.S. Department of Commerce - National Institute of Standards and Technology (NIST)

Materials Referenced During Breakout Sessions

Breakout 1A -- Retail Clients & Retirement Funds

32. Items 11 & 12 above

33. In re Credit Suisse (USA) LLC, Advisers Act Release No. 4678 (Apr. 4, 2017)

34. In re Royal Alliance Associates, Inc., Advisers Act Release No. 4351 (Mar. 14, 2016) and SEC Press Release No. 2016-52 (March 14, 2016)

Breakout 1B -- Private Fund Issues*

35. Items 13 & 14 above

36. SEC Staff Speech by Julie Riewe, Co-Chief, Enforcement/AMU, "Conflicts, Conflicts Everywhere" (Feb. 26, 2015)

37. IM Publication of Private Fund Statistics

Breakout 1C – IC Hot Topics*

38. Item 1 above

39. IM Guidance Update: Mutual Fund Fee Structures, December 2016

40. In re Orinda Asset Management, Advisers Act Release No. 4513 (Aug. 25, 2016) and Litigation Release No. 3-17506 (Aug. 25, 2016)

41. In re Calvert Investment Distributors, Advisers Act Release No. 4696 (May 2, 2017) and Litigation Release No. 3-17964 (May 2, 2017)

42. In re William Blair & Co., Advisers Act Release no. 4695 (May 1, 2017) and Litigation Release No. 3-17960 (May 1, 2017)

43. In re Aviva Investors Americas, LLC, Advisers Act Release No. 4534 (Sept. 23, 2016)

Breakout 2A -- Recent Decisions A. Undisclosed Sales Practices, Revenues, Conflicts & Fees

A. Undisclosed Sales Practices, Revenues, Conflicts & Fees

i. Selection of Mutual Fund Share Classes

44. Panel Presentation Items 33 & 34

ii. Undisclosed Revenue/Conflicts

45. In re Voya Financial Advisors, Inc., Advisers Act Release No. 4661 (Mar. 8, 2017)

46. In re Advantage Investment Management, LLC, Advisers Act Release no. 4455 (July 18, 2016)

47. In re Washington Wealth Management, LLC, Advisers Act Release No. 4456 (July 18, 2016)

48. In re The Robare Group Ltd., Advisers Act Release No. 4566 (Commission Dec.) (Nov. 7, 2016)

iii. Overcharging Fees

49. In re Equinox Fund Management, LLC, Advisers Act Release No. 4315 (Jan. 19, 2016) and SEC Press Release No. 2016-11 (Jan. 19, 2016)

50. In re Morgan Stanley Smith Barney, LLC, Advisers Act Release No. 4607 (Jan. 13, 2017)

* This panel was not broadcasted by the SEC.
* This panel was not broadcasted by the SEC.

B. Improper Trade Allocations

51. In re Welhouse & Associates, Inc., Advisers Act Release No. 4231 (Oct. 16, 2015) and SEC Press Release No. 2015-132 (Jun. 29, 2015)

52. In re Tellone Management Group, Inc., Advisers Act Release No. 4701 (May 5, 2017)

53. Structured Portfolio Management, LLC, Advisers Act Release No. 3906 (Aug. 28, 2014)

C. Wrap Fee Account Issues

i. Trading Away Commissions; Failure to Monitor

54. In re Raymond James & Associates, Inc., Advisers Act Release No. 4525 (Sept. 8, 2016)

55. In re Robert W. Baird & Co., Inc., Advisers Act Release No. 4526 (Sept. 8, 2016) and SEC Press Release No. 2016-181 (Sep. 8, 2016)

56. In re Stifel and Nicolaus & Company, Inc., Advisers Act Release No. 4665 (Mar. 13, 2017) and SEC Litigation Release No. 23700 (Dec. 7, 2016)

ii. Failure to Provide Promised Due Diligence and Monitoring Re Third Party Managers

57. In re Barclays Capital, Inc., Advisers Act Release No. 4705 (May 10, 2017) and SEC Press Release No. 2017-98 (May 10, 2017)

58. In re Royal Alliance Associates, Inc., Advisers Act Release No. 4351 (Mar. 14, 2016) and SEC Press Release No. 2016-52 (Mar. 14, 2016)

iii. Principal Trades in Wrap Accounts Without Proper Disclosure or Consent

59. WFG Advisors, LP, Advisers Act Release No. 4441 (June 28, 2016)

D. Unlawful Cross-Trades Via Pre-Arranged Sales/Buybacks with Intermediary (No "Parking")

60. In re Morgan Stanley Investment Management, Inc., Advisers Act Rel. No. 4299 (Dec. 22, 2015) and SEC Press Release No. 2015-287 (Dec. 22, 2015)

61. In re Aviva Investors Americas, LLC, Advisers Act Release No. 4534 (Sept. 23, 2016)

E. Cross-Selling & Undisclosed Financial Conflicts

62. In re J.P. Morgan Chase Bank, N.A., Advisers Act Release No. 4295 (Dec. 18, 2015) and SEC Press Release No. 2015-283 (Dec. 18, 2015)

63. In re Jan Gleisner and Keith D. Pagan, Advisers Act Release No. 4537 (Sept. 28, 2016) and SEC Litigation Release No. 3-17588 (Sep. 28, 2016)

F. False and Misleading Advertising

i. Reliance on Sub-Adviser and Algorithm Provider's Performance Claims

64. In re Cantella & Co., Advisers Act Release No. 4338 (Feb. 23, 2016) and News Article re SEC Fines of Multiple Advisers (Aug. 25, 2016)

ii. Hypothetical, Back-Tested Performance Claims

65. In re Jeffrey Slocum & Associates, Inc., Advisers Act Release No. 4647 (Feb. 8, 2017)

G. Mutual Fund Disclosure and Compliance Issues

i. IC Act 15(c) – Evaluation and Approval of Mutual Fund Advisory Contracts

66. In re Commonwealth Capital Management, LLC, IC Act Release No. 31678 (June 17, 2015) and SEC Press Release No. 2015-124 (Jun. 17, 2015)

H. Use of Fund Assets for sub-TA and 12b-1 Payments

67. Panel Presentation Items 41 & 42

I. Exemptive Order Applications – Material Misrepresentations/Omissions

68. Panel Presentation Item 40

J. Compliance/Annual Review

69. In re Dupree Financial Group, LLC, Advisers Act Release No. 4546 (Oct. 5, 2016)

K. Misrepresentations of Credentials in Form ADV

70. In re Source Financial Advisors, LLC, Advisers Act Release No. 4702 (May 5, 2017)

L. Custody Rule

i. Identify Accounts for Surprise Exam

71. Panel Presentation Item 50

ii. Timely Distribution of Audited Financial Statements

72. In re Sands Brothers Asset Management, LLC, Advisers Act Release No. 4273 (Nov. 19, 2015) and SEC Press Release No. 2015-262 (Nov. 19, 2015)

73. Knelman Asset Management Group, LLC, Advisers Act Release No. 3705 (Oct. 28, 2013) and SEC Press Release No. 2013-230 (Oct. 28, 2013)

M. Accountant/Annual Surprise Exam

74. In re Rodney A. Smith, Advisers Act Release No. 3738 (Dec. 12, 2013)

N. Cybersecurity and Regulation S-P

75. Panel Presentation Items 24 & 25

Breakout 2B -- Newer Registrants: SEC Examination Processes and Tips*

76. Examination Information for Entities Subject to Examination or Inspection by the Commission

* This panel was not broadcasted by the SEC

EXHIBIT B – CASE SUMMARIES

Topic: Self Reporting Violations to the SEC

In re Calvert Investment Management, Inc., Advisers Act Release No. 4577 (Oct. 18, 2016)[36]

Between March 18, 2008 and Oct. 18, 2011, Calvert Investment Management, Inc. ("Calvert" or "Respondent") incorrectly overvalued illiquid securities issued by Toll Road Investors Partnership II, L.P. (the "Toll Road Bonds"). Consequently that mispricing caused certain funds to have the wrong net asset value. Also, because the performance figures were incorrect, Calvert collected inflated fees. Calvert funds acquired Toll Road bonds with a principal amount of $1.2 billion. Calvert relied heavily on a third-party analytical tool to value the bonds, but valued some of the securities at a price that was 65 percent higher than the price assigned to the same bonds by a major industry participant on the same day. Although Calvert eventually marked down the bonds in 2011 when it discovered the mistake, many investors had already paid the higher prices. The SEC found Calvert culpable for not following its own NAV error correction method.

In paragraph 32 of the Order entitled "Calvert's Remedial Efforts" the SEC said: "In determining whether to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff. Calvert enhanced its compliance and fair valuation policies and procedures. Calvert was prompt and responsive in addressing staff inquiries and provided detailed summaries of relevant information."

Topic: Undisclosed Revenue/Conflicts

In re Voya Financial Advisors, Inc., Advisers Act Release No. 4661 (Mar. 8, 2017)[37]

Des Moines, Iowa-based Voya Financial Advisors, Inc., a registered investment adviser, failed to disclose to its advisory clients that it received compensation from a third-party broker-dealer ("Clearing Broker") and the conflicts arising from that compensation. Since at least 2006, Voya participated in a no-transaction fee mutual fund program ("NTF Program") offered by Clearing Broker whereby Clearing Broker agreed to share with Voya a certain percentage of revenues the Clearing Broker received from mutual funds in the NTF Program. Also, since 2014, Voya had a separate arrangement with Clearing Broker whereby Voya agreed to provide certain administrative services in exchange for Clearing Broker's agreement to share a certain percentage of service fees it received from mutual funds on the platform. Payments under both arrangements created conflicts of interest because they provided a financial incentive for Voya to favor the mutual funds in the NTF Program over other investments when giving investment advice to its advisory clients. In its Form ADV, Voya failed to disclose (i) that it was receiving compensation from Clearing Broker and (ii) that this compensation created a conflict of interest. These disclosures were also missing from Voya's advisory contracts. Consequently, Voya violated Sections 206(2), 206(4), and 207 of the Investment Advisors Act of 1940, and Rule 206(4)-7 thereunder. Voya consented to a censure, a cease-and-desist order, and the payment of disgorgement of $2,621,324 plus prejudgment interest of approximately $175,000, and a $300,000 penalty.

[36] https://www.sec.gov/litigation/admin/2016/ia-4554.pdf
[37] https://www.sec.gov/litigation/admin/2017/34-80177.pdf

In re Advantage Investment Management, LLC, Advisers Act Release no. 4455 (July 18, 2016)[38]

Advantage Investment Management, LLC ("AIM"), a Cedar Rapids, Iowa-based registered investment adviser, failed to disclose in its Form ADV or otherwise that (i) it had received more than $3 million in compensation in the form of a forgivable loan made in 2012 by a broker-dealer, and (ii) the conflicts of interest arising from the forgivable loan. AIM was recommending that its clients open accounts, use the service of and purchase research from the broker-dealer that made the loan. In August 2012, AIM entered into an agreement with a third-party broker-dealer under which the broker-dealer would become AIM's new primary broker-dealer, and would provide trade execution, custody, and reporting services for AIM's clients, as well as sponsor several advisory programs offered by AIM. In connection with the agreement, the broker-dealer issued a loan of just over $3 million, forgivable over a five-year period. AIM violated Sections 206(2) and 207 of the Investment Advisers Act of 1940. AIM consented to the SEC's cease and desist order, censure, and the payment of a $60,000 penalty.

In re Washington Wealth Management, LLC, Advisers Act Release No. 4456 (July 18, 2016)[39]

Washington Wealth Management, LLC (WWM), a San Diego, California-based registered investment adviser, failed to disclose its receipt of more than $1.8 million in loans it received between October 2012 and March 2013, from WWM's newly-engaged broker-dealer. In September 2012, WWM entered into an agreement with a broker-dealer to provide trade execution, clearing, custody, and other services for WWM's clients. In connection with this agreement, WWM received a loan of more than $1 million in October 2012 and another loan of more than $66,000 in December 2012. Each of these loans was potentially forgivable over a five-year term provided that WWM maintain its relationship and certain specified asset levels with the broker-dealer. The broker-dealer also made two additional loans to WWM: $485,000 in November 2012 and $277,000 in March 2013. WWM failed to fully and timely disclose the loans in its Form ADV or otherwise until October 2013, as a result of an SEC exam deficiency. WWM violated Sections 206(2) and 207 of the Advisers Act and consented to the entry of the SEC's order censuring it, and requiring it to cease and desist from further violations. WWM paid a $50,000 penalty.

In re The Robare Group Ltd., Advisers Act Release No. 4566 (Commission Dec.) (Nov. 7, 2016)[40]

On appeal by the SEC's Division of Enforcement from an earlier dismissal by an administrative law judge for failure to find scienter, the Commission found that for many years The Robare Group, Ltd. ("TRG"), a registered investment adviser and its principals, Mark Robare (CEO and COO) ("Robare"), and Jack Jones (Robare's son-in-law and owner of TRG) ("Jones"), negligently failed to fully and fairly disclose in TRG's Form ADV the existence of a fee sharing arrangement (the "Arrangement") with Fidelity Investments ("Fidelity") or the potential conflicts of interest arising from the Arrangement.

TRG became an independent registered investment adviser in 2003 and used Fidelity as the custodian of its clients' accounts. TRG also engaged Triad Advisers ("Triad") as its broker-dealer. Robare and Jones were registered representatives of Triad. Pursuant to the initial Arrangement in 2004, Fidelity paid TRG (through Triad) certain "shareholder servicing fees." Effective May of 2013, the Arrangement was modified and Fidelity paid TRG directly (no longer through Triad) for "back-office, administrative, custodial support and clerical services." Between 2005 and 2013, TRG received $400,000 pursuant to the Arrangement (2.5% of

[38] https://www.sec.gov/litigation/admin/2016/ia-4455.pdf
[39] https://www.sec.gov/litigation/admin/2016/ia-4456.pdf
[40] https://www.sec.gov/litigation/opinions/2016/ia-4566.pdf

TRG's gross revenues). As a result of the Arrangement, TRG had a financial incentive to recommend certain Fidelity products over others.

While there were many variations of TRG's disclosure over the years, there was no disclosure of the existence of the Arrangement until late in 2011. Even after disclosing the existence of the Arrangement TRG did not provide details about the nature of the Arrangement or the conflict it presented. For example, in 2005, TRG's Form ADV indicated that "'certain investment adviser representatives of the Robare Group, when acting as registered representatives of a broker-dealer, <u>may</u> receive selling compensation from such broker-dealer as a result of the facilitation of certain securities transaction on Client's behalf through such broker-dealer,' and that these 'arrangements <u>may</u> create a conflict of interest.'"

Fidelity threatened to withhold payments under the Arrangement in late 2011 because it was not satisfied with TRG's disclosure about the Arrangement in its Form ADV. Consequently, TRG added the following paragraph to its Form ADV: "Additionally, we <u>may</u> receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional compensation does not represent additional fees from your account with us."

In June of 2013 TRG added to Item 14 of Part 2A of Form ADV that "the Arrangement <u>may</u> give rise to conflicts of interest, or perceived conflicts of interest, with the Firm's decision to utilize Fidelity as our Custodian."

The Commission noted that Item 14 of Form ADV directs advisers to disclose if anyone "who is not a client provides an economic benefit to you for providing investment or other advisory services to your clients. Advisers must "generally describe the arrangement, explain the conflicts of interest, and describe how you address the conflicts of interest."

The Commission also distilled holdings of several relevant cases and said that: 'A "fundamental purpose of [the Advisers Act] is to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve high standard of business ethics in the securities industry." Accordingly, Section 206 imposes "federal fiduciary standards" on investment adviser, which means they have "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts.'" Because Section 206 was designed to "eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested," the [f]ailure by an investment adviser to disclose potential conflicts of interest to its clients constitutes fraud within the meaning of Sections 206(1) and 2."'

The Commission found that TRG and Robare violated Section 206(2) (acted with negligence) but not 206(1) (which requires a finding of scienter). Jones knew about the failure to disclose the Arrangement and signed the Form ADV and therefore caused the Section 206(2) violation. Consequently, Jones was liable under Section 203(k). The false statements of material fact or material omissions in Form ADV also resulted in the Commission finding that all three Respondents also violated Section 207 of the Advisers Act.

The Commission rejected the Respondents' many claims that they had exercised reasonable care in relying on compliance consultants, that Triad was somehow responsible and that adequate disclosures were made in several documents independent of Form ADV.

Topic: Overcharging Fees

In re Equinox Fund Management, LLC, Advisers Act Release No. 4315 (Jan. 19, 2016)[41]

In a recent enforcement action (In the matter of *Equinox Fund Management, LLC*, Release No. IA 4315, January 19, 2016), the SEC imposed sanctions against a Denver-based registered investment adviser for failing to follow its stated valuation policies (method and frequency) and for overcharging management fees and misleading investors about how it valued certain assets in a registered fund. In order to settle the matter, the adviser agreed to refund investors $5.4 million in excessive management fees plus $600,000 in prejudgment interest. In addition, the adviser agreed to pay to the SEC a $400,000 penalty. The publicly offered series fund managed by the adviser is registered under the Securities Act of 1933, and as such, is filed quarterly and annual disclosure documents on Form 10-Q and 10-K. as These public filings disclosed, among other things, that management fees were based upon the net asset value of each series of the fund. However, the SEC found that the adviser instead used the notional trading value of the assets (i.e., the total amount of assets invested including leverage). That method of calculation resulted in the adviser overcharging the fund $5.4 million in management fees over a seven year period. In addition, various periodic public reports filed with the SEC and provided to investors continued to disclose during this period that the method for valuating certain assets was checked by third party valuations. However, the third party valuations indicated that the adviser had valued such assets substantially higher than the third party valuations for the same assets. The adviser faced willful violations of the anti-fraud provisions under the Securities Act of 1933 and the Securities Exchange Act of 1934 as a result of overcharging management fees and providing misleading material information to fund investors. In addition to the monetary penalties agreed to by the adviser, the adviser also agreed to be censured.

See https://www.sec.gov/news/pressrelease/2015-52.html and related SEC Order for a recent example of an SEC enforcement action against Patriarch Partners and its principal, Lynn Tilton, for failure to follow stated valuation policies in a CLO context.

In re Morgan Stanley Smith Barney, LLC, Advisers Act Release No. 4607 (Jan. 13, 2017)[42]

Morgan Stanley Smith Barney ("MSSB") agreed to pay a $13 million penalty to settle charges that it overbilled investment advisory clients due to coding and other billing system errors. The firm also violated the custody rule pertaining to annual surprise examinations. And it also violated the Advisers Act books and records rule by failing to maintain signed client contracts in an easily accessible place. The SEC found that MSSB overcharged more than 149,000 advisory clients because it failed to adopt and implement compliance policies and procedures reasonably designed to ensure that clients were billed accurately according to the terms of their advisory agreements. MSSB also failed to validate billing rates contained in the firm's billing system against client contracts, fee billing histories, and other documentation. MSSB received more than $16 million in excess fees due to the billing errors that occurred from 2002 to 2016. MSSB reimbursed this full amount plus interest to affected clients.

[41] https://www.sec.gov/litigation/admin/2016/33-10004.pdf

[42] https://www.sec.gov/litigation/admin/2017/34-79794.pdf

Topic: Improper Trade Allocations

In re Welhouse & Associates, Inc., Advisers Act Release No. 4231 (Oct. 16, 2015)[43]

The SEC Enforcement Division has engaged in a data-driven initiative to identify potentially fraudulent trade allocations known as "cherry-picking," and this enforcement action is the first arising from that effort. Working with economists in the agency's Division of Economic and Risk Analysis ("DERA"), enforcement investigators analyze large volumes of investment advisers' trade allocation data and identify instances where it appears an adviser is disproportionately allocating profitable trades to favored accounts. The SEC Enforcement Division found that Mark P. Welhouse (the Firm's sole owner) purchased options in an omnibus or master account for Welhouse & Associates Inc. (the "Firm") and delayed allocation of the purchases to either his or his clients' accounts until later in the day after he saw whether or not the securities appreciated in value. Welhouse allegedly reaped $442,319 in ill-gotten gains by unfairly allocating options trades in an S&P 500 exchange-traded fund named SPY. His personal trades in these options had an average first-day positive return of 6.28 percent while his clients' trades in these options had an average first-day loss of 5.05 percent.

The Firm's Form ADV indicated that it allocated trades among clients on a fair and equitable basis. Its written policies indicated that trades are allocated among clients on a pro rata basis. The Firm's Form ADV indicated that it did not trade for its own account and that it restricted the trading of employees' accounts. Form ADV failed to disclose that Mr. Welhouse invested in the same securities he recommended to clients; it failed to disclose the conflicts arising from such personal trading and failed to disclose how the Firm addressed those conflicts, as required.

It is interesting to note that the Firm's broker-dealer complained to Mr. Welhouse on nine separate occasions about his preferential trade allocations to his own account before firing him. Violations cited include Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as well as Sections 206(1) and (2) of the Advisers Act.

In re Tellone Management Group, Inc., Advisers Act Release No. 4701 (May 5, 2017) [44]

Tellone Management Group, Inc. ("TMG"), a registered investment adviser, and Dean C. Tellone ("Tellone") failed to allocate trades among clients in a manner consistent with TMG's policies and procedures and with disclosures made on TMG's Form ADV. Form ADV indicated that "…TMG will use a rotational method for allocating block trades to a group of client accounts. The rotation method is used to assure that all accounts have roughly equal access to limited trading opportunities over time." TMG allocated certain profitable trades to an account identified as the Day Trade Account. As a result, only the Day Trade Account received risk-free and profitable trades that TMG's other clients did not. TMG and Tellone considered whether allocating only profitable day trades to the Day Trade Account unfairly benefited the Day Trade Account. They concluded that it did not because the account's annual profits were generally consistent with those of other TMG clients. TMG and Tellone failed to consider that TMG's other clients bore all the risk on the Day Trade Account's behalf and that its allocation method in practice was inconsistent with disclosures in its Form ADV. The SEC found that TMG and Tellone violated Sections 206(2) and 207 of the Advisers Act.

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[43] https://www.sec.gov/litigation/admin/2015/34-76175.pdf

[44] https://www.sec.gov/litigation/admin/2017/ia-4701.pdf

Structured Portfolio Management, LLC, Advisers Act Release No. 3906 (Aug. 28, 2014)[45]

The SEC settled administrative proceedings against Structured Portfolio Management, L.L.C. ("Portfolio Management") and its affiliated advisers, SPM Jr., L.L.C. ("SPM Jr.") and SPM IV, L.L.C. ("SPM IV" and together with Portfolio Management and SPM Jr., collectively, "SPM") for (i) failing to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act concerning trade allocations and (ii) failing to review and update fund PPMs with respect to investment objectives and portfolio construction.

Portfolio Management managed Structured Servicing Holdings Master Fund, L.P. ("SSH). And SPM Jr. managed Parmenides Master Fund, L.P. ("Parmenides"). SSH and Parmenides invested in mortgage related securities that were hedged by U.S. Treasuries. Each fund had its own portfolio manager ("PM"). A third trader ("Hedge Trader"), put on hedges for both funds.

SPM IV was created to manage a new liquid fund, Aqueous Master Fund, L.P. ("Aqueous") and Hedge Trader was designated as PM (while still maintaining hedging responsibilities for SSH and Parmenides). Aqueous' investment objective was to provide excess returns by investing primarily in highly liquid U.S. residential and commercial mortgage related securities but could also invest in Treasuries.

The SPM Compliance Manual required trades to be allocated in a fair and equitable manner. Also, trades were to be allocated at the time of trade execution. However, there was no mechanism to ensure that trades actually were allocated upon trade execution and not at some later time (after the trade's success or failure for the day could be determined).

SPM recognized and disclosed that it was a potential conflict of interest for Hedge Trader to trade the same Treasuries across all three fund portfolios but did not modify its policies and procedures to address this conflict. Consequently, Aqueous consistently bought Treasuries at a lower price than the other two funds; and it consistently sold them at a higher price.

Also, contrary to its published investment objective, Aqueous stopped trading mortgage related securities and traded Treasuries almost exclusively for nearly a two year period.

The SEC found that SPM violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder which require registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and related rules. 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.

Topic: Wrap Fee Account Issues

In re Raymond James & Associates, Inc., Advisers Act Release No. 4525 (Sept. 8, 2016)[46]

SEC investigations found that St. Petersburg, Fla.-based Raymond James & Associates failed to establish policies and procedures necessary to determine the amount of commissions their clients were being charged when sub-advisers "traded away" with a broker-dealer outside the wrap fee programs. Without this information, the firms' financial advisors were unable to provide the magnitude of these costs to clients and did not consider these commissions when determining whether the sub-advisers or the wrap fee programs were suitable for clients, leaving certain clients unaware they were paying additional costs

[45] https://www.sec.gov/litigation/admin/2014/ia-3906.pdf

[46] https://www.sec.gov/litigation/admin/2016/ia-4525.pdf

beyond the single wrap fee they paid for bundled investment services. For violations of Adviser Act Section 206(4) (fraudulent, deceptive or manipulative practices) and Rule 206(4)-7 (failure to adopt policies and procedures) thereunder, Raymond James agreed to pay a $600,000 penalty to settle the charges.

In re Robert W. Baird & Co., Inc., Advisers Act Release No. 4526 (Sept. 8, 2016)[47]

SEC investigations found that Milwaukee-based Robert W. Baird & Co. failed to establish policies and procedures necessary to determine the amount of commissions their clients were being charged when sub-advisers "traded away" with a broker-dealer outside the wrap fee programs. Without this information, the firms' financial advisors were unable to provide the magnitude of these costs to clients and did not consider these commissions when determining whether the sub-advisers or the wrap fee programs were suitable for clients, leaving certain clients unaware they were paying additional costs beyond the single wrap fee they paid for bundled investment services. For violations of Adviser Act Section 206(4) (fraudulent, deceptive or manipulative practices) and Rule 206(4)-7 (failure to adopt policies and procedures) thereunder, Baird agreed to pay a $250,000 penalty.

In re Stifel and Nicolaus & Company, Inc., Advisers Act Release No. 4665 (Mar. 13, 2017)[48]

SEC investigations found that St. Louis-based Stifel, Nicolaus & Company, Incorporated ("Stifel") failed to establish policies and procedures necessary to determine the amount of commissions their clients were being charged when sub-advisers "traded away" with a broker-dealer outside the wrap fee programs. Without this information, the firms' financial advisors were unable to provide the magnitude of these costs to clients and did not consider these commissions when determining whether the sub-advisers or the wrap fee programs were suitable for clients, leaving certain clients unaware they were paying additional costs beyond the single wrap fee they paid for bundled investment services. For violations of Adviser Act Section 206(4) (fraudulent, deceptive or manipulative practices) and Rule 206(4)-7 (failure to adopt policies and procedures) thereunder, Stifel agreed to pay a $300,000 penalty.

The companion litigation release referred to in the Reference Materials may be found at https://www.sec.gov/litigation/litreleases/2016/lr23700.htm.

Topic: Failure to Provide Promised Due Diligence and Monitoring Re Third Party Managers

In re Barclays Capital, Inc., Advisers Act Release No. 4705 (May 10, 2017) and SEC Press Release[49]

From September 2010 through December 2015, Barclays Capital, then a dually-registered investment adviser and broker-dealer, improperly charged certain advisory clients of its wealth and investment management business, overcharging them almost $50 million in advisory fees. Barclays Capital violated Section 207 of the Advisers Act by falsely representing in its Form ADV, Part 2A, Appendix 1 wrap fee brochure to advisory clients that it was performing ongoing due diligence and monitoring of certain third-party managers who managed advisory clients' assets using certain investment strategies, when Barclays Capital was not performing such due diligence. Barclays also violated Section 206(2) of the Advisers Act, Section 206(4) and Rule 206(4)-7 thereunder. Barclays also violated Sections 17(a)(2) and (3) of the

[47] https://www.sec.gov/litigation/admin/2016/ia-4526.pdf
[48] https://www.sec.gov/litigation/admin/2017/ia-4665.pdf
[49] https://www.sec.gov/litigation/admin/2017/33-10355.pdf and https://www.sec.gov/news/press-release/2017-98

Securities Act. Barclays was required to disgorge approximately $50 million and pay prejudgment interest of just under $14 million as well as a penalty of $30 million.

__In re Royal Alliance Associates, Inc.__, Advisers Act Release No. 4351 (Mar. 14, 2016)[50]

Respondents, three AIG affiliates, failed to disclose in their Forms ADV or otherwise that they had a conflict of interest due to a financial incentive to place non-qualified advisory clients in higher-fee mutual fund share classes. As a result, Respondents breached their fiduciary duties as investment advisers to certain of their advisory clients by investing them in higher-fee mutual fund share classes. Respondents also failed to follow their own compliance policies which required them to monitor advisory accounts quarterly for inactivity or "reverse churning" to ensure that fee-based wrap accounts remained in the best interest of clients that seldom traded. Respondents were required to hire an independent compliance consultant, disgorge approximately $2 million and pay a penalty of $7.5 million.

Topic: Principal Trades in Wrap Accounts without Proper Disclosure or Consent

__WFG Advisors, LP__, Advisers Act Release No. 4441 (June 28, 2016)[51]

This matter arises from improper fee and trading practices and related compliance and reporting failures at WFG Advisors, L.P. ("WFGA"), a Dallas based registered investment adviser. WFGA overcharged clients in one of its advisory wrap account programs contrary to its disclosures to these clients. WFGA represented to clients participating in a wrap account program that they would be charged a commission in connection with the purchase of interests in certain alternative investment products, but that the wrap account advisory fee would not be assessed on the value of such interests. Contrary to these disclosures, from at least January 2011 through August 2013, WFGA in certain instances improperly charged its clients both the commission and the advisory fee in connection with these clients' purchases of interests in alternative investment products. In addition, WFGA falsely stated in its Forms ADV Part 2 and Wrap Fee Program Brochures filed with the Commission that clients participating in its wrap account program would not be charged commissions in connection with transactions in their accounts. WFGA failed to adopt policies and procedures reasonably designed to ensure that its advisory clients' fees were calculated as represented, and failed to implement its policies regarding appropriate disclosure to and consent from its clients with respect to transactions effected on a principal basis.

Topic: Unlawful Cross-Trades via Pre-Arranged Sales/Buybacks with Intermediary (No "Parking")

__In re Morgan Stanley Investment Management, Inc.__, Advisers Act Rel. No. 4299 (Dec. 22, 2015)[52]

Morgan Stanley agreed to pay $8.8 million to settle charges that one of its portfolio managers, Sheila Huang, unlawfully conducted prearranged trading known as "parking" that resulted in the undisclosed favorable treatment of certain clients over others. As part of this scheme, Huang, effected cross trades that violated internal policies as well as several antifraud securities provisions. Morgan Stanley policies prohibited cross trades involving ERISA accounts under any circumstances and required all other cross trades to comply with Rule 17a-7 of the Investment Company Act (regardless of whether the accounts

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[50] https://www.sec.gov/litigation/admin/2016/34-77362.pdf

[51] https://www.sec.gov/litigation/admin/2016/34-78189.pdf

[52] https://www.sec.gov/litigation/admin/2015/33-9998.pdf and https://www.sec.gov/news/pressrelease/2015-287.html

were registered investment companies). To evidence best execution, Morgan Stanley internal policies required two comparable dealer quotes. When Huang did not have these she, along with an accomplice, just made them up and then lied about their source! Policies and procedures were ineffective as was supervision of Huang's trading activity.

Aviva Investors Americas, LLC, Advisers Act Rel. No. 4534 (Sept. 23, 2016)[53]

Aviva Investors Americas, LLC ("Aviva") is a Chicago-based investment adviser and a successor entity to Aviva Investors North America, Inc. ("AINA") as of 2012. The illicit cross trades that are the subject of this proceeding took place between March of 2010 and December of 2011. About 137 cross trades were effected between AINA's registered investment company clients ("RICs") and certain of AINA's other clients who were affiliated persons of a RIC or affiliated persons of an affiliated person of a RIC, including insurance companies owned by AINA's parent company, Aviva plc ("AINA Insurance Clients"), and pooled vehicles not owned by AINA or its parent ("Private Fund Clients").

Because AINA's parent was a 100% owner of the AINA Insurance Clients, AINA was acting as principal with respect to cross trades between AINA Insurance Clients and Private Fund Clients. Section 206(3) of the Advisers Act requires written disclosure to and consent from the clients for principal transactions which was not obtained in this case.

AINA's written policies with respect to cross trades were consistent with Sections 17(a)(1) and (2) of the Investment Company Act and prohibited transactions involving RICs and affiliated persons of RICs, absent an exemptive order issued by the SEC. Rule 17a-7 under the Investment Company Act provides an exemption for certain trades if the rules governing determining "current market price" are followed. The transactions in question were not suitable for relief under Rule 17a-7 because the affiliations between the parties made them ineligible, the adviser paid a brokerage commission and because the pricing convention required by the rule was not followed.

It is interesting to note that AINA's policies and procedures required that sale/buyback trades occurring within a three day window be monitored. The underqualified junior compliance person reviewing trades only looked for same day trades and therefore missed the trades done on an overnight basis that were the subject of this proceeding. AVIVA was required to pay a penalty of $250,000.

Topic: Cross-Selling & Undisclosed Financial Conflicts

In re J.P. Morgan Chase Bank, N.A., Advisers Act Release No. 4295 (Dec. 18, 2015)[54]

An SEC investigation found that JPMorgan Chase & Co.'s (the "Firm's") investment advisory business J.P. Morgan Securities LLC ("JPMS") and nationally chartered bank JPMorgan Chase Bank N.A. ("JPMCB") preferred to invest clients in the firm's own proprietary investment products without properly disclosing this preference. This preference impacted two fundamental aspects of money management – asset allocation and the selection of fund managers – and deprived JPMorgan's clients of information they needed to make fully informed investment decisions. "Firms have an obligation to communicate all conflicts so a client can fairly judge the investment advice they are receiving," said Andrew J. Ceresney, Director of the SEC Enforcement Division. "These J.P. Morgan subsidiaries failed to disclose that they

[53] https://www.sec.gov/litigation/admin/2016/ia-4534.pdf

[54] https://www.sec.gov/litigation/admin/2016/ia-4534.pdf and https://www.sec.gov/news/pressrelease/2015-283.html

preferred to invest client money in firm-managed mutual funds and hedge funds, and clients were denied all the facts to determine why investment decisions were being made by their investment advisers."

Form ADV Part 2A failed to adequately disclose conflicts, including that: JPMS preferred J.P. Morgan managed mutual funds for certain retail accounts (at one point Form ADV indicated they "may" have a preference); JPMS obtained certain services from its affiliates based on the amount of assets invested in the Firm's proprietary products; and certain less expensive share classes were available (that would generate less revenue for the Firm).

Violations cited by the order include that JPMS willfully violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any practice which operates as a fraud or deceit upon any client or prospective client. JPMS willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder which requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. JPMS willfully violated Section 207 of the Advisers Act which makes it unlawful for any person to willfully (i) make an untrue statement of a material fact in any registration or report filed with the SEC or (ii) omit to state any material fact. JPMCB also violated Sections 17(a)(2) and (3) of the Securities Act of 1933.

Respondents were required to disgorge $127.5 million and pay a penalty of the same amount as well prejudgment interest of just under $12 million. They were also required to pay the CFTC a $40 million penalty in a parallel action.

In re Jan Gleisner and Keith D. Pagan, Advisers Act Release No. 4537 (Sept. 28, 2016)[55]

According to the SEC's order, two principals of Belvedere Asset Management, LLC ("Belvedere") settled charges that they failed to tell clients about material conflicts of interest arising from Belvedere's investments of client assets into an affiliated mutual fund.

Jan Gleisner, Belvedere's former president, managing director, and 40% indirect owner, invested client assets in Belvedere Alternative Income Fund ("BAIF"), a mutual fund formed and advised by Belvedere. Belvedere client assets accounted for more than 75% of BAIF's total investments. Based on an agreement with BAIF, Belvedere had to reimburse BAIF for its expenses exceeding 2.95% of its net asset value. As a result, the Belvedere client investments in BAIF ultimately decreased the amount Belvedere had to reimburse BAIF. In addition, Belvedere's clients paid double management fees on money invested in BAIF: the management fees clients paid directly to Belvedere and the fees investors paid to BAIF that benefitted Belvedere. Belvedere and Gleisner failed to tell clients about these conflicts of interest. Keith Pagan, Belvedere's CEO, CCO, and 45% indirect owner, caused these disclosure failures. Pagan was solely responsible for Belvedere's compliance and operations functions, and was aware that Gleisner had invested client assets in BAIF. A compliance consultant also advised Pagan that he should give Belvedere's clients a Form ADV to disclose material conflicts, but he did not. Belvedere's refusal to heed its compliance consultant's advice in this matter is all the more peculiar because it identified the disclosure of this particular conflict with respect to the mutual fund as a material change to Form ADV. In addition, Pagan failed to implement policies and procedures reasonably designed to prevent violations of the securities laws.

[55] https://www.sec.gov/litigation/admin/2016/ia-4537.pdf and https://www.sec.gov/litigation/admin/2016/ia-4537-s.pdf

Between July 2013 and January 2014 Gleisner separately provided some clients a disclosure that Belvedere may invest clients' assets in affiliated funds and charge additional fees and that this may create a conflict. The SEC made clear that this is inadequate disclosure once an actual conflict exists.

Topic: False and Misleading Advertising

In re Cantella & Co., Advisers Act Release No. 4338 (Feb. 23, 2016)[56]

An SEC investigation found that Cantella & Co. ("Cantella") a Boston-based registered investment adviser and broker-dealer negligently relied on the inflated, and hypothetical and back-tested, performance track record provided by F-Squared Investments, Inc. ("F-Squared"). Cantella passed those false performance claims on to Cantella's own clients without obtaining sufficient documentation that substantiated F-Squared's advertising claims.

Cantella violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder by publishing, circulating and distributing advertisements that contained untrue statements of material fact. Cantella also did not make and keep true, accurate and current records necessary to demonstrate the calculation of the performance that it distributed as required by Section 204(a) of the Advisers Act and Rule 204-2(a)(16) thereunder. Without admitting or denying the findings, Cantella agreed to pay a $100,000 penalty. Incidentally, Cantella was one of thirteen advisers that negligently relied on F-Squared performance numbers.

In re Jeffrey Slocum & Associates, Inc., Advisers Act Release No. 4647 (Feb. 8, 2017)[57]

The SEC's order instituting a settled administrative proceeding found that Jeffrey Slocum & Associates, Inc. ("JSA") disseminated marketing materials containing misleading performance data, misstatements regarding JSA's acceptance of items of value from investment managers, and misstatements about JSA's enforcement of its Code of Ethics. The order found that JSA's majority owner, Jeffrey C. Slocum ("Slocum") was a cause of the compliance violations and certain misstatements. JSA and Slocum agreed to the issuance of the order without admitting or denying its findings.

JSA's provided investment consulting services to institutional clients and included recommending investment managers to its clients that JSA had vetted and placed on its "Approved List." In its marketing materials JSA claimed: "Our firm has never, not once, taken even so much as a nickel from an investment manager, under any guise." Contrary to the "never, not once" claim, JSA's Code of Ethics permitted gifts of not more than $100. With preclearance from JSA's CCO, JSA employees could attend a sporting event if the value of tickets was greater than $100 if it was reasonable and both the giver and the employee were present. In 2012, two JSA employees received preclearance and attended the Masters Golf Tournament as the guests of an investment manager. In 2013, four employees accepted ticket worth greater than $100 with obtaining preclearance from the CCO. The CCO wanted the four to reimburse the manager but Slocum overruled the CCO and the four were not formally disciplined.

The performance data compiled by JSA on managers on the Approved List was not based on actual performance. It was hypothetical and back-tested and JSA did not keep books and records substantiating the performance disseminated. JSA did develop certain footnotes about the nature of the performance

56 https://www.sec.gov/litigation/admin/2016/ia-4338.pdf
57 https://www.sec.gov/litigation/admin/2017/ia-4647.pdf

record but these disclosures were not uniformly used. Also, JSA had no writtenpolicies and procedures regarding the review of marketing materials or the use of performance data in marketing materials.

Topic: Mutual Fund Disclosure and Compliance Issues

In the Matter of Commonwealth Capital Management, LLC, Investment Company Act Release No. 31678 (Jun. 17, 2017)[58]

The SEC charged a mutual fund adviser, its principal, and three mutual fund board members with failing to satisfy their statutory obligations (Section 15(c) of the Investment Company Act) in connection with the evaluation and approval of mutual fund advisory contracts. Also violated was the shareholder reporting requirement found in Section 30(e) of the Investment Company Act and Rule 30e-1 thereunder.

Topic: Compliance/Annual Review

In re Dupree Financial Group, LLC, Advisers Act Release No. 4546 (Oct. 5, 2016)[59]

These proceedings arise out of the failure of Dupree Financial, a registered investment adviser, to conduct annual compliance reviews over a multi-year period. Pursuant to Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, it is unlawful for a registered investment adviser to provide investment advice to clients unless the adviser completes annual reviews of the adequacy of its compliance policies and procedures and the effectiveness of their implementation. From the time Dupree Financial registered with the Commission in June 2010 through 2014, it failed to perform annual compliance reviews. Based on these actions, Dupree Financial willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

Topic: Misrepresentations of Credentials in Form ADV

In re Source Financial Advisors, LLC, Advisers Act Release No. 4702 (May 5, 2017)[60]

These proceedings concern material misrepresentations by Michelle M. Smith ("Smith") and Source Financial Advisors, LLC ("Source"), the registered investment adviser Smith founded. Source misrepresented on its Form ADV brochure supplement that Smith earned a college degree (she never graduated) and that she had earned a Certified Financial Planner credential; she took courses but did not earn the credential. Smith corrected the statements after being contacted by the SEC in 2016.

[58] https://www.sec.gov/litigation/admin/2015/ic-31678.pdf and https://www.sec.gov/news/pressrelease/2015-124.html

[59] https://www.sec.gov/litigation/admin/2016/ia-4546.pdf

[60] https://www.sec.gov/litigation/admin/2017/ia-4702.pdf

Topic: Custody Rule

In re Sands Brothers Asset Management, LLC, Advisers Act Release No. 4273 (Nov. 19, 2015)[61]

The SEC hammered repeat offender Sands Brothers Asset Management LLC ("SBAM") for failure to timely deliver audited financial statements to its investors. Audited financial statements were late from 40 days to 8 months because SBAM did not provide valuation information to its auditors supporting SBAM's valuation of nonperforming loans. SBAM and its principals were required to pay penalty of $1 million and were prevented from raising new capital for one year.

In re Knelman Asset Management Group, LLC, Advisers Act Release No. 3705 (Oct. 28, 2013)[62]

First, the SEC sanctioned Knelman Asset Management Group, LLC ("KAMG") and its CCO for failure to arrange for a surprise audit or annual GAAP audit for a private equity fund Rancho Partners I, LLC ("Rancho"). Second, Irving P. Knelman ("Knelman"), KAMG's CEO and CCO, violated Rancho's PPM in making certain cash distributions to some of Rancho's members. Third, KAMG and Kelman failed to conduct annual compliance reviews and by failing to implement controls to safeguard Rancho's assets. Fourth, KAMG failed to maintain required books and records. Fifth, KAMG filed a false Form ADV that claimed it did not have custody of client assets.

Topic: Accountant/Annual Surprise Exam

In re Rodney A. Smith, Advisers Act Release No. 3738 (Dec. 12, 2013)[63]

This matter involves improper professional misconduct by Rodney A. Smith, Michael Santicchia, CPA, and Stephen D. Cheaney, CPA (collectively "Respondents") in not completing surprise exams they were engaged and paid to do pursuant to Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (the "Custody Rule"). The Repondents completely dropped the ball over several years and did not do the work they were hired to do, including filing Form ADV-E with the SEC.

Other Notable Cases

In re Everhart Fin. Group, Inc., et al., Investment Advisers Act Release No. 4314 (Jan. 14, 2016)[64]

Everhart Financial Group ("EFG"), a registered investment advisor, principally invested its clients in the mutual funds offered by a single family of mutual funds ("Mutual Fund Complex"), which offers two share classes to investment advisors with the only meaningful difference being that one share class charges 12b-1 fees and the other does not. Despite significantly higher fees, some advisor reps at EFG "nearly always" invested non-retirement individual advisory accounts in shares that charged a 12b-1 fee, which was paid to EFG's principal owners, who also were licensed registered broker-dealer reps. Receipt of 12b-1 fees not only created a conflict of interest that was not adequately disclosed to EFG's clients, but favoring 12b-1 funds over others was inconsistent with EFG's duty to seek best execution for its clients. In addition, EFG

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[61] https://www.sec.gov/litigation/admin/2015/ia-4273.pdf and https://www.sec.gov/news/pressrelease/2015-262.html

[62] https://www.sec.gov/litigation/admin/2013/ia-3705.pdf and https://www.sec.gov/news/press-release/2013-230

[63] https://www.sec.gov/litigation/admin/2013/34-71070.pdf

[64] https://www.sec.gov/litigation/admin/2016/34-76897.pdf

had several compliance failures, including the lack of annual compliance reviews for several years, and also issued insufficient disclosures regarding the receipt of 12b-1 fees. The firm also failed to file and deliver an accurate Form ADV. The SEC has also required the advisory firm to retain an independent compliance consultant, notify all advisory clients of the enforcement order, and pay fines and disgorgement. The agency also found that ESG's founder, Everhart, did not perform required annual compliance reviews from 2008 through 2011 and in 2013 and 2014.

In the Matter of Credit Suisse Securities (USA) LLC, Adm. Proc. File No. 3-17899 (April 4, 2017)[65]

Credit Suisse Securities ("Credit Suisse") and one of its former investment adviser representatives, Michael Katz, agreed to pay almost $8 million to settle charges they improperly invested clients in more expensive "Class A" shares of mutual funds rather than less expensive "institutional" shares for which they were eligible. The respondents breached their fiduciary duties and failed to adequately disclose the conflict of interest created by such investments as they enriched themselves at their clients' expense. Class A shares are generally more expensive than institutional shares of the same fund because they charge investors marketing and distribution expenses known as 12b-1 fees that are paid out of the assets of the mutual fund. In this case, the 12b-1 fees were paid by the mutual funds to Credit Suisse, which then shared a portion of those fees with Katz. According to the SEC's orders, Credit Suisse collected approximately $3.2 million in avoidable 12b-1 fees from 2009 to 2014, and approximately $2.5 million of that amount was generated from Katz's advisory clients. Credit Suisse also failed to implement policies and procedures to prevent these fiduciary breaches.

In re William Blair & Co., Advisers Act Release no. 4695 (May 1, 2017)[66]

Chicago-based William Blair & Company agreed to pay a $4.5 million penalty for negligently using mutual fund assets to pay for the distribution and marketing of fund shares outside of a written, board-approved Rule 12b-1 plan and that it failed to fully disclose that it would retain a fee for providing shareholder administration services to certain funds. Payments for distribution-related services can only come from fund assets pursuant to a written Rule 12b-1 plan that is approved by a fund's board. These payments totaled approximately $1.25 million and rendered certain of William Blair Funds' ("Funds") disclosures concerning payments for distribution and sub-TA services inaccurate. As a result of this conduct, William Blair violated Section 206(2) of the Advisers Act and Section 34(b) of the Investment Company Act, and caused the Funds to violate Section 12(b) of the Investment Company Act and Rule 12b-1 thereunder. William Blair also failed to fully disclose to the Funds' Board of Trustees ("Board") that William Blair (and not a third-party service provider) would retain a fee for providing shareholder administration services to the Funds under a shareholder administration services agreement between certain of the Funds and William Blair.

[65] https://www.sec.gov/news/pressrelease/2016-69.html
[66] https://www.sec.gov/litigation/admin/2017/ia-4695.pdf