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SEC Enforcement Action Implies Broad Application of Investment Adviser Compliance Rule

A recent enforcement action by the Securities and Exchange Commission (SEC) appears to represent a significant expansion of the reach of Rule 206(4)-7 under the Investment Advisers Act of 1940 (Advisers Act), sometimes referred to as the Compliance Program Rule.[1] Specifically, the SEC settled an administrative proceeding against First Western Capital Management Company (FWCM), a registered investment adviser, in connection with the adviser's allocation of purchases of restricted securities made pursuant to Rule 144A under the Securities Act of 1933 (1933 Act) to clients that were not qualified institutional buyers (QIBs) under that rule.[2] Rule 206(4)-7, on its face, requires adoption of written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, but not Rule 144A or other rules under the 1933 Act. The SEC settlement order against FWCM (Order) nonetheless stated that FWCM violated Rule 206(4)-7 by not adopting reasonably designed policies and procedures.

The Purchases Under Rule 144A

The 1933 Act requires all offers and sales of securities to be registered with the SEC unless an exemption from registration is available. Rule 144A provides a non-exclusive safe harbor from the registration requirements of the 1933 Act when persons other than issuers sell restricted securities to QIBs, or persons that they reasonably believe are QIBs, and certain other requirements are met.[3]

FCWM is a Colorado-based registered investment adviser with over $900 million of assets under management as of Dec. 31, 2019. During the period from October 2010 through July 2017, FWCM purchased restricted securities sold in reliance on Rule 144A, and its investment adviser representatives (IARs) allocated the securities to all client accounts managed within certain of the firm's strategies, regardless of whether those clients were QIBs. As a result, Rule 144A securities were acquired by 81 client accounts that were not QIBs. During this period, the Order stated, FWCM did not adopt supervisory policies and procedures specifically addressing Rule 144A securities, nor did it require training or adopt any other process to educate its IARs and supervisors about Rule 144A.

The SEC Enforcement Action

The SEC found that FWCM willfully violated Section 206(4) of the Advisers Act, which authorizes prophylactic rules to prevent fraudulent practices, and Rule 206(4)-7, which was adopted thereunder. As the SEC said twice in the Order, Rule 206(4)-7 requires a registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. Although the SEC found that FWCM failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder by the adviser and its supervised persons, the SEC did not explain in what respect FWCM had fallen short.[4]

The SEC also found that FWCM failed to reasonably supervise its IARs, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing its IARs' violations of Section 17(a)(3) of the 1933 Act. Section 203(e)(6) authorizes the SEC to impose various sanctions on an investment adviser that has failed reasonably to supervise another person who violates the federal securities laws if the other person is subject to its supervision. However, an adviser may not be deemed to have failed reasonably to supervise another person, if the adviser has established and complied with procedures that would reasonably be expected to prevent and detect, insofar as practicable, any such violation by the other person. The SEC found that FWCM had supervisory policies and procedures, but did not adopt supervisory policies and procedures specifically addressing Rule 144A securities.

The SEC ordered FWCM to cease and desist from committing or causing any violations of Rule 206(4)-7, censured it, and ordered it to pay a civil money penalty in the amount of $200,000. FWCM consented to the Order without admitting or denying its findings. The Order did not name any of FWCM's IARs or other personnel.

Implications of the Enforcement Action

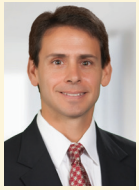
The Order does not mention any violation, or even potential violation, of the Advisers Act, even though Rule 206(4)-7, on its face, only requires policies and procedures to prevent violations of the Advisers Act and the rules thereunder.[5] The only other Advisers Act provision discussed in the Order is Section 203(e)(6), which on its face cannot be violated since it merely authorizes enforcement actions. However, the SEC's administrative summary of the proceeding (though not the Order itself) states that "FWCM violated Sections 203(e)(6) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder."[6] Section 203(e)(6) does extend to 1933 Act violations like the one in this case. The enforcement action could be read as the SEC taking the position that, despite its explicit language, Rule 206(4)-7 requires policies and procedures to prevent violations of all the statutes and rules addressed in Section 203(e)(6). In addition to the Advisers Act, these statutes and rules include the 1940 Act, the 1933 Act, the Securities Exchange Act of 1934 (1934 Act), the Commodity Exchange Act, the respective rules thereunder, and the rules of the Municipal Securities Rulemaking Board.

The enforcement action is also significant for its approach to enforcing the accuracy of purchaser certifications under Rule 144A. As a safe harbor for sellers, Rule 144A cannot be violated by a purchaser. The SEC addressed this by taking the position that the IARs had uncharged violations of Section 17(a)(3) of the 1933 Act, which prohibits transactions, practices, or courses of business which operate or would operate as a fraud or deceit upon the purchaser.[7] A violation of Section 17(a)(3) does not require the SEC to show scienter (a mental state embracing intent to deceive, manipulate, or defraud). However, the SEC has held that isolated deceptions do not violate Section 17(a)(3); the provision requires a practice or course of business, or a transactional deception that results in the receipt of money or property.[8] Isolated misrepresentations by purchasers in Rule 144A certifications presumably would require the SEC to proceed under a different theory of liability, such as Rule 10b-5 under the 1934 Act, which requires a showing of scienter.

Conclusion

As the Order is only one settled proceeding, it is not clear if the SEC is advancing a new position that Rule 206(4)-7 requires an investment adviser to adopt and implement policies and procedures related to federal securities laws other than the Advisers Act. Registered investment advisers should, therefore, not immediately jump to this conclusion. Advisers should, however, be cognizant that the investment services they provide may implicate federal securities laws other than the Advisers Act and take steps to identify the requirements of such laws and rules thereunder. In any case, investment advisers that engage in Rule 144A purchases should ensure that

For more information, contact:



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their supervisory policies and procedures specifically address Rule 144A securities in order to avoid failure-to-supervise liability under Section 203(e)(6).

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[1] Rule 206(4)-7 requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

[2] *First Western Capital Management Co.*, Release No. IA-5543 (July 16, 2020), https://www.sec.gov/litigation/admin/2020/ia-5543.pdf.

[3] A QIB generally is one of various enumerated entities, acting for its own account or the accounts of other QIBs, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities. Individuals do not qualify to be QIBs, nor do entities that are not among the enumerated entities or that fail to meet the applicable financial threshold.

[4] The language of the SEC's findings concerning the lack of reasonably designed policies and procedures to prevent Advisers Act violations, by itself, leaves open the possibility that the finding was unrelated to the Rule 144A purchases. However, the finding was in the middle of a discussion of the Rule 144A purchases and the adviser's failure to address Rule 144A securities in its supervisory policies and procedures.

[5] In contrast, Rule 38a-1 under the Investment Company Act of 1940 (1940 Act), which was adopted at the same time as Rule 206(4)-7 and imposes a similar compliance obligation on registered investment companies, encompasses a much broader group of federal securities laws, including the 1933 Act and rules thereunder.

[6] SEC Charges Investment Adviser with Supervisory and Compliance Failures (July 16, 2020), https://www.sec.gov/enforce/ia-5543-s.

[7] The SEC did not specify who, if anyone, were the defrauded purchasers.

[8] *See John P. Flannery*, Release Nos. 33-9689, 34-73840, IA-3981, IC-31374, at 26 (Dec. 15, 2014), https://www.sec.gov/litigation/opinions/2014/33-9689.pdf, vacated on other grounds, 810 F.3d 1 (1st Cir. 2015).