STRADLEY RONON

Fund Alert

A Publication of the Stradley Ronon Investment Management Group

WWW.STRADLEY.COM

MARCH 2019

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SEC Enforcement Developments of Note for Mutual Funds and Their Advisers: The Year in Review and a Look Ahead

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[A] vigorous enforcement program is at the heart of the Commission's work to protect investors and maintain the integrity of the securities markets. . . . Successful enforcement actions impose meaningful sanctions on securities law violators, deter wrongdoing and, most important, have the maximum impact of returning dollars to harmed investors, especially Main Street investors, as well as preventing harm to those investors in the first instance.[1]

– SEC Chairman Walter J. "Jay" Clayton, June 5, 2018.

Introduction

Fiscal Year 2018 marked the first full year of Chairman Clayton's leadership of the SEC.[2] Although there may have been some uncertainty about how the SEC's enforcement program would fare at the outset of the Trump presidency, Chairman Clayton's support of enforcement, and his focus on protecting retail investors, quickly became apparent and continues to guide the Commission today. In this Alert, we will outline how the SEC's commitment to enforcement has been translated into specific priorities by the Commission's Division of Enforcement. We will also review the program's accomplishments during the past year, which have reinforced those priorities, and comment briefly on what FY 2019 might hold for SEC enforcement.

Enforcement Priorities

The SEC's Strategic Plan. The Commission released its Strategic Plan for 2018 through 2022 in October 2018.[3] In the Strategic Plan, Chairman Clayton identified three goals for the agency: (1) "Focus on the long-term interests of our Main Street investors;" (2) "Recognize significant developments and trends in our evolving capital markets and adjust our efforts to ensure we are effectively allocating our resources;" and (3) "Elevate the SEC's performance by enhancing our analytical capabilities and human capital development."[4]

Each of these three goals impacts the priorities of the Division of Enforcement. To protect the long-term interests of Main Street investors, the Strategic Plan directs the Commission to "pursue enforcement and examination initiatives focused on identifying and addressing misconduct that impacts retail investors."[5] Among the significant developments and trends in the capital markets is a directive to "focus on ensuring that the market participants [the SEC] regulate[s] are actively and effectively engaged in managing cybersecurity risks and that these participants . . . are appropriately informing investors and other market participants of these risks and incidents."[6] Finally, with respect to improving the performance of the Commission, the plan calls for the agency to "enhance our analytics of market and industry data to prevent, detect, and prosecute improper behavior."[7]

Chairman Clayton's Recent Testimony. Chairman Clayton has made the protection of Main Street investors a significant point of emphasis for the Commission. Most recently, in testimony before Congress on December 11, 2018, Chairman Clayton pointed to four initiatives that support his commitment to investor protection: "(1) the Retail Strategy Task Force; (2) the Cyber Unit; (3) the Share Class Selection Disclosure Initiative; and (4) Enforcement's work in returning funds to harmed investors."[8] He also noted the importance of the Office of Compliance Inspections and Examinations' ("OCIE") to the SEC's mission to protect Main Street investors by focusing on "products and services offered to retail investors, the disclosures they receive about those investments and the financial services professionals who serve them."[9]

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The Division of Enforcement. Consistent with the Commission's and Chairman Clayton's goals and initiatives, the Co-Directors of the Division of Enforcement, Stephanie Avakian and Steven Peikin, have articulated five principles that guide the Division's decision-making: "(1) focus on the Main Street investor; (2) focus on individual accountability; (3) keep pace with technological change; (4) impose sanctions that most effectively further enforcement goals; and (5) constantly assess the allocation of our resources."[10] The Co-Directors see "vigorous enforcement efforts across the markets" as a continuing priority for the Division of Enforcement and do not believe there is a "binary choice between protecting Main Street and policing Wall Street."[11] Holding individuals accountable is "critical" for Enforcement, as is pursuing wrongdoing "at the highest corporate levels supported by the evidence."[12] To keep pace with technological change, the Division formed the Cyber Unit in September 2017, with the goal of focusing on cyber-related misconduct (including violations involving digital assets).[13] Enforcement also has made the compensation of harmed investors a point of emphasis in both its actions and how it reports on its efforts.[14] The Share Class Selection Disclosure Initiative ("SCSDI") (discussed in more detail below) is an example of how the Division is looking for efficient methods it can deploy to return money to a significant number of retail investors at a modest investment of its own resources.

Enforcement in the Past Year

This has been a strong year for the Division of Enforcement. But you do not need to take my word for it. The nature and quality of the SEC's enforcement actions during the last year speak for themselves – they addressed a wide array of conduct and spanned a broad landscape. We renewed our focus on Main Street investors and, at the same time, continued to pursue and bring cases against large corporations, financial institutions, "Wall Street" firms, investment advisers, Ponzi schemers, offering fraudsters, insider traders, and other market participants who violate the federal securities laws.

– Co-Director Stephanie Avakian, September 20, 2018.[15]

Enforcement Statistics. The SEC filed 821 enforcement actions and obtained orders exceeding $3.945 billion in monetary sanctions in FY 2018.[16] Both totals represented a year-over-year increase from FY 2017 (754 enforcement actions and $3.7 billion in sanctions), but did not reach records set in earlier years. The number of independent actions (i.e., enforcement actions other than those against issuers for delinquent SEC filings and follow-on administrative proceedings seeking bars against individuals based on criminal convictions, civil injunctions, or other orders) rose more sharply. In FY 2018, the Commission filed 490 such actions, an increase of almost 10% over FY 2017 (but about 10% lower than FY 2016's total of 548). In its press release announcing the statistics, the Division of Enforcement noted that it had returned "almost $800 million to harmed investors."[17]

Coordination with OCIE. OCIE has now put more resources than ever before into examining registered investment companies and their advisers. In FY 2018, OCIE completed over 3,150 examinations, a 10% increase over FY 2017.[18] OCIE examined approximately 17% of SEC-registered investment advisers, up from approximately 15% the previous year. OCIE also increased its examinations of investment companies by 45% from FY 2017. Interestingly, the increase in the number of OCIE examinations has not led to more referrals to the Division of Enforcement. In its FY 2017 Annual Performance Report, the Commission disclosed that OCIE made a referral to the Division of Enforcement in 7% of its examinations, compared with 9% in FY 2016, 11% in FY 2015, 12% in FY 2014, and 13% in FY 2013.[19] Similar trends exist with respect to the percentage of examinations that identify deficiencies or result in a "significant finding," which have declined year-over-year as the rate of examinations have increased.[20]

No matter which way these statistics cut on balance, the ongoing coordination between the Division of Enforcement and OCIE (as perhaps best illustrated by the Commission's continuing practice of acknowledging OCIE's assistance in its press releases announcing significant enforcement actions)[21] suggests that registrants should continue to, among other things, pay close attention to OCIE's examination priorities. For 2019, these priorities are aimed at six perceived risks directly related to mutual fund and ETF advisers: (1) index funds that track customized or bespoke indexes; (2) smaller ETFs and/or ETFs with little secondary market trading volume; (3) funds with higher allocations to certain securitized assets; (4) funds with aberrational underperformance relative to their peer groups; (5) advisers who are relatively new to managing registered investment companies; and (6) advisers who provide advice to both mutual funds and private funds that employ similar strategies and/or are managed by the same portfolio managers.[22] A Risk Alert issued by OCIE in November 2018 noted that OCIE would tailor its examination scope and focus areas to address the business practices, risks, and conflicts applicable to each topic and provided additional detail concerning the planned testing to examine each of these six risks.[23]

Retail Investors. The Division of Enforcement has taken to heart Chairman Clayton's emphasis on serving and protecting Main Street investors. Examples of enforcement actions in FY 2018 to protect retail investors include those involving (1) the sale of structured financial products without appropriate disclosures;[24] (2) the suitability of products like inverse exchange-traded funds;[25] and (3) wrap fees, churning, and excessive trading.[26]

Enforcement's efforts to protect Main Street investors have included leveraging its Retail Strategy Task Force ("RSTF"), which the Division formed in FY 2017. According to Co-Director Avakian, the mission of the RSTF is straightforward: "to develop effective strategies and techniques to identify, punish, and deter misconduct that most affects everyday investors."[27] The RSTF will conduct proactive, targeted initiatives intended to identify misconduct impacting retail investors and will leverage data analytics and technology to identify large-scale misconduct affecting retail investors. The RSTF also conducts its own investigations.[28]

Although Chairman Clayton's Commission has placed particular emphasis on the protection of retail investors, previous Commissions and their staff have also focused on investor protection. For example, in July 2016, OCIE launched a Share Class Initiative.[29] In the Risk Alert publicizing the initiative, OCIE indicated it would focus on advisers' practices related to share class recommendations and compliance oversight of the process.

In February 2018, the Division of Enforcement built on the OCIE Initiative by announcing the SCSDI.[30] The SCDSI "enabled investment advisory firms to avoid financial penalties if they timely self-reported undisclosed conflicts of interest, agreed to compensate harmed clients, and undertook to review and correct their relevant disclosure documents."[31] On March 11, 2019, the Commission announced settlements with 79 investment advisers who participated in the SCSDI and returned more than $125 million to clients.[32] The SEC is continuing to evaluate self-reports received from investment advisers prior to the Initiative's cut-off date.

Since the announcement of the SCSDI and prior to the announcement of the settlements on March 11, 2019, the Division of Enforcement settled eight enforcement actions with investment advisers outside of the initiative.[33] One of these settlements also involved the majority owner of the adviser, and all of them required the payment of a civil monetary figure (as high as six figures in five of the eight actions). Moreover, the Division has reportedly commenced an enforcement sweep aimed at the share class selection practices of those investment advisers who did not self-report as part of the SCSDI.[34] These developments highlight the potential risk accompanying a decision to forgo participation in a similar Enforcement initiative in the future.

Individual Accountability. The statistics continue to demonstrate the SEC's continuing commitment to holding individuals accountable as part of its enforcement program. In FY 2018, the Commission charged individuals in connection with 72% of its standalone actions, approximately the same percentage as in FY 2018 (73%).[35] The Commission obtained judgments or orders for disgorgement and/or penalties from over 500 individuals, an increase of 9% over FY 2017. Enforcement actions resulted in nearly 550 bars and suspensions of wrongdoers in FY 2018.[36]

Keeping Pace with Technological Change. In FY 2018, the Division of Enforcement's Cyber Unit became fully operational and brought numerous actions in the digital asset space involving fraud, registration, and touting violations.[37] For example, in September 2018, the Commission settled an administrative proceeding against a hedge fund manager and its sole principal for offering a fund formed to invest in digital assets that operated as an unregistered investment company while falsely marketing it as the "first regulated crypto asset fund in the United States."[38]

The SEC brought several landmark cases related to cybersecurity in FY 2018. Perhaps most notably for advisers to registered funds, in September 2018, the Commission settled its first enforcement action charging violations of the Identity Theft Red Flags Rule (Reg S-ID), as well as violations of the Safeguards Rule (Reg S-P), which are designed to protect confidential customer information and to protect customers from the risk of identity theft.[39] The Commission found that cyber intruders had impersonated contractors of a dual registrant broker-dealer and investment adviser by calling a support line and requesting the contractors' passwords be reset. The intruders then used the passwords to gain access to the personal information of the firm's customers, allowing them to create new online customer profiles and obtain unauthorized access to account documents for three customers. The firm agreed to retain an independent compliance consultant and to pay a $1 million civil monetary penalty.

Whistleblowers. The Commission paid more than $168 million to 13 whistleblowers in FY 2018, setting not only a new year-over-year record for the program, but exceeding the sum of all payments made by the program over its lifetime.[40] As of March 4, total payouts under the whistleblower program stood at roughly $326 million paid to 59 whistleblowers in enforcement actions that resulted in more than $1.7 billion in financial remedies.[41]

In February 2018, the Supreme Court handed down its decision in *Digital Realty Trust, Inc. v. Somers*.[42] In a unanimous decision, the Court resolved a Circuit Court split and held that to qualify for the anti-retaliation provisions of Dodd-Frank, an individual first must report a possible securities law violation to the Commission. The decision invalidated the Commission's rule interpreting that Dodd Frank's anti-retaliation protections applied regardless of whether a report of possible securities law violations was made to the Commission, to a different government agency, or internally to an employer. In June, the Commission proposed amendments to the whistleblower program that would conform eligibility for anti-retaliation protection to the holding of the Court.[43]

Credit for Cooperation. In October 2001, the Commission issued a Report of Investigation and a Statement (the "*Seaboard* Report") indicating that it would not take action against a public company it had investigated for financial statement irregularities due to the company's self-policing, self-reporting, remediation, and cooperation, and laying out an analytical framework that the Commission would deploy to evaluate cooperation in the future.[44] The SCSDI represents the SEC's most recent and comprehensive effort to apply the *Seaboard* factors through the creation of a transparent framework for an adviser's disclosure of its share class selection practices to the Commission and to clarify the standardized settlement terms the Division of Enforcement will recommend in connection with such a self-report.

In addition to the SCSDI, on at least two occasions in FY 2018, the Commission publicly stated that it had waived civil money penalties where entities took significant steps to comply with the *Seaboard* factors. In September 2018, the Commission settled with a registered investment adviser, its former president, and the former Chief Financial Officer for a breach of fiduciary duty with respect to a conflict of interest and improperly adjusting the reported returns for some of the private funds it managed.[45] In its press release, the Division of Enforcement noted that it had determined not to recommend charges against the parent to the adviser, which "promptly self-reported its executives' misconduct following a review initiated by its board of directors, thoroughly remediated the harm caused to investors, and provided extraordinary cooperation with the agency's investigation."[46] In February 2019, a company agreed to settle with the SEC for conducting an unregistered ICO.[47] The company self-reported its conduct to the Division of Enforcement, took prompt remedial steps to return funds to investors, and cooperated with the Commission's investigation. The Commission elected not to impose a penalty because of these steps.[48] On the other two occasions in FY 2018, public companies self-reported misconduct by executives to the Commission, cooperated with the SEC's investigation, and made thorough remediation, including an internal investigation of the misconduct.[49]

We also note that, in connection with five of the seven matters we discuss in the section on "Specific Enforcement Actions Related to Mutual Funds and Advisers" below, the Commission gave credit to the respondent investment adviser for its self-reporting, remediation, and/or cooperation with the investigation.

Remedies. In 2017, the Supreme Court in *Kokesh v. SEC* held that Commission claims for disgorgement are subject to a five-year statute of limitations.[50] As of November 2018, the Division of Enforcement estimates that *Kokesh* has forced the Commission to forgo up to approximately $900 million in disgorgement.[51] As a result of *Kokesh*, the Division of Enforcement appears to be more aggressively seeking tolling agreements in connection with its investigations.

Out of Fashion? In our March 2017 Alert, we mentioned that the era of "broken windows" looked to be at an end.[52] Two years later, we are comfortable agreeing with Commissioner Hester M. Peirce (who has publicly dated the "broken windows" era to 2013 to 2016) and declaring it dead.[53] The SEC's past emphasis on admissions of wrongdoing seems to be on the verge of becoming another casualty of the new leadership at the Commission and in the Division of Enforcement. Consistent with public statements from Co-Director Peikin expressing skepticism about the Commission's admissions policy,[54] the SEC obtained just one admission of wrongdoing in connection with a settled administrative enforcement action in FY 2018 and a single admission in connection with what had been a litigated proceeding.[55]

Specific Actions Related to Mutual Funds and Advisers

Failure to Disclose Conflict of Interest. In March 2018, the SEC brought and settled an administrative proceeding against a registered investment adviser and its subsidiary, a registered investment adviser/broker-dealer, for making misleading disclosures to investors and failing to disclose conflicts of interest in connection with its securities lending practices.[56] The respondent served as an adviser to insurance-dedicated mutual funds. The Commission found that the adviser structured its securities lending program so that it would lend the shares to the funds and then recall them in advance of the dividend record date, allowing certain insurance companies affiliated with the adviser to take a tax deduction while the funds lost securities lending income. The respondents failed to identify and disclose these practices to the funds' board or to disclose in the funds' prospectuses that the practice would benefit affiliates while depriving the funds of income.

The Commission found the respondent to have violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The respondent agreed to a cease-and-desist order, a censure, disgorgement of approximately $2.635 million, prejudgment interest of approximately $510,000, and a $500,000 civil money penalty. In determining to accept the settlement, the Commission noted its consideration of the respondent's cooperation with its investigation and the completion of certain undisclosed remedial acts.

Failure to Detect or Prevent Misappropriation of Client Funds. In June 2018, the Commission brought and settled an administrative proceeding against a registered investment adviser/broker-dealer for failure to adopt policies and procedures reasonably designed to prevent personnel from misusing and/or misappropriating funds in client accounts.[57] Although the respondent's policies provided for certain reviews of disbursement requests, the reviews were not reasonably designed to detect or prevent such potential misconduct. These insufficiencies contributed to the respondent's failure to detect or prevent one of its advisory representatives from misusing or misappropriating approximately $7 million out of four advisory clients' accounts in approximately 110 unauthorized transactions conducted over a period of nearly a year.

When a representative of one of the defrauded clients raised questions concerning certain of the transactions, the investment adviser promptly conducted an internal investigation, terminated the advisory representative, and reported the fraud to the Commission and other law enforcement agencies. The investment adviser also fully repaid the clients for the misused and/or misappropriated funds with interest. Finally, the adviser developed significant enhancements to its policies, procedures, systems, and controls. The Commission indicated that it considered this remediation and the cooperation with its investigation in making the decision to accept a settlement with the adviser.

The Commission found the respondent to have violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The respondent also failed to reasonably supervise the advisory representative within the meaning of Section 203(e)(6). The respondent agreed to a cease-and-desist order, a censure, and a civil money penalty of $3.6 million.

Failure to Adequately Test and Disclose Investment Model. In August 2018, the Commission brought and settled an administrative proceeding against four affiliated registered entities (two investment advisers, an investment adviser/broker-dealer, and a broker-dealer) for various violations of the federal securities laws in connection with offering, selling, and managing 15 quantitative model-based mutual funds, variable life insurance investment portfolios, and variable annuity investment portfolios and separately managed account strategies.[58] The respondents marketed the products and account strategies as "managed using a proprietary quant model." However, the respondents marketed the models without confirming that the models worked as intended and did not disclose any recognized risks associated with using the models. Upon learning that errors impacted the operation of certain of the models, the respondents stopped using, running, or relying on at least one of the models, but did not disclose the decision to the funds' boards. The respondents also failed to disclose to investors and or the funds' boards

that an inexperienced quantitative analyst acted as the day-to-day manager for certain of the models. In addition, for one fund, the respondents advertised a monthly dividend without confirming the fund's holdings could support the disclosed yield range and did not calculate the dividend based on the disclosed methodology.[59]

The investment adviser/broker-dealer also negligently relied upon and distributed to their advisory clients marketing materials to advisory clients that misrepresented the use of the econometric models described above as well as the use of three investment strategies for separately managed accounts developed by F-Squared.[60]

In determining to accept the settlements with the respondents, the Commission noted its consideration of the "substantial cooperation" afforded to the Commission's staff during the investigation and that the respondents' efforts assisted the Commission in the collection of evidence that might not otherwise have been available to its staff. The Commission also noted that the respondents had voluntarily retained a compliance consultant to conduct a comprehensive independent review of their policies and procedures, internal controls, and related practices. Finally, the Commission noted that the respondents had begun revising and improving their compliance and due diligence policies and procedures related to the use of models and the creation and use of marketing communications, product development, and investment management.

As a consequence of the foregoing conduct, the Commission found each respondent to have violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. One or more of the respondents also violated each of the following: Section 204 of the Advisers Act and/or Rules 204-2(a)(16), 206(4)-1(a)(5), 206(4)-8 of the Advisers Act, Section 17(a)(2) of the Securities Act, and Section 15(c) of the Investment Company Act. The respondents agreed to cease-and-desist orders, censures, $61.3 million in disgorgement and prejudgment interest, and $36.3 million in civil money penalties. The Commission also found that two senior members of management (the Chief Investment Officer and Director of New Initiatives, respectively) were causes of some of the violations, and they were required to pay $65,000 and $25,000, respectively, in separate proceedings.[61]

Improper Cross-trades. The Commission settled three administrative proceedings for improper cross-trades in FY 2018. In August 2018, the Commission brought and settled the first of the three proceedings against a registered investment adviser for engaging in cross-trading that favored certain advisory client accounts over others.[62] The investment adviser engaged in over 15,000 cross-trades that were arranged to be executed at the securities' bid price, instead of the mid-point between the bid and the ask price, resulting in the undisclosed allocation of all market savings on the trades to the purchasing clients. The investment adviser also persuaded certain broker-dealers to adjust their price quotations for municipal bonds held in client portfolios to levels substantially above where the bonds had most recently traded in the market without documenting any rationale for these upward adjustments. The investment adviser subsequently executed approximately 21 cross-trades in these bonds at the inflated levels, causing the buying advisory clients in these transactions to overpay for the bonds.

The Commission found the investment adviser violated Sections 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. The adviser agreed to a censure and cease-and-desist order, as well as to reimburse $609,172, plus interest, to its affected clients, and to pay a $900,000 civil money penalty. The Commission noted that, in determining to accept the settlement, it had considered the cooperation the adviser afforded to its staff during the investigation and remedial acts undertaken by the adviser, including voluntary payments to affected clients and enhancements to the advisers' policies, procedures, controls, and disclosures regarding cross-trading and security valuation.

The following month, the Commission brought and settled another administrative proceeding against a registered investment adviser in connection with two undisclosed cross-trades done on behalf of a hedge fund it managed with a closed-end fund and open-end fund it also managed.[63] The investment adviser consulted with counsel on how to structure the trades, however it failed to provide its traders with the necessary details on how to implement the instructions it received from counsel. The investment adviser crossed the transaction by selling the securities to a broker on an agency basis and then repurchasing the securities through a different broker in a transaction characterized as a "private" trade. As a result, the clients incurred brokerage fees of approximately $125,000 in connection with the trades. The Commission found the investment adviser had caused its hedge fund client to violate Section 17(a)(1) of the Investment Company Act. The adviser agreed to a cease-and-desist order and to pay a $100,000 civil money penalty.

Later in September, the Commission brought and settled yet another administrative proceeding against a registered investment adviser and one of its portfolio managers in connection with improper cross-trades.[64] Rather than sell the

securities to market, the portfolio manager pre-arranged with broker-dealers to temporarily sell the securities and repurchase them at a small mark-up, with the repurchase usually handled on the next business day. The majority of these cross-trades took place between registered investment companies or between registered investment companies and registered investment company-affiliated accounts. Because the portfolio manager pre-arranged to execute the cross-trades at the bid, rather than at an average between the highest current independent bid and the lowest current independent offer, the buyers were favored in the transactions over the sellers.

After the portfolio manager disclosed his conduct to the investment adviser, the adviser terminated him, retained outside counsel to investigate, and self-reported the suspect misconduct and the result of the internal investigation. The adviser also placed approximately $1,095,000 in escrow to compensate harmed clients. The Commission noted that it had considered these remedial acts and the adviser's cooperation with its investigation in its determination to accept a settlement with the adviser.

This course of conduct by the investment adviser and portfolio manager caused certain advisory accounts to violate Sections 17(a)(1) and 17(a)(2) of the Investment Company Act. The investment adviser also violated Sections 206(2), 206(4), and 207 (and Rule 206(4)-7) of the Advisers Act and failed to supervise the portfolio manager within the meaning of Section 203(e)(6). The portfolio manager caused the violation of Section 206(2) of the Advisers Act. The investment adviser agreed to a cease-and-desist order and a civil money penalty of $1 million. The portfolio manager agreed to a cease-and-desist order, a nine-month suspension, and a civil money penalty of $50,000.

Advertising. In August 2018, the Commission brought and settled an administrative proceeding against a registered investment adviser for material misstatements and omissions made to certain of its advisory clients and others concerning hypothetical stock returns associated with its blended stock ratings.[65] For roughly nine years, the adviser advertised using a hypothetical portfolio of stocks to illustrate the validity of its claim that blending fundamental and quantitative stock ratings could yield better returns than either type of ratings alone. These advertisements were materially misleading because the materials failed to disclose that some of the quantitative ratings used to create the hypothetical portfolio were determined using a retroactive, backtested application of the investment adviser's quantitative model. The misleading advertisements were due in part to a failure to adopt and implement policies and procedures reasonably designed to prevent the publication, circulation, or distribution of inaccurate advertisements.

The Commission found the adviser violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-1(a)(5) and 206(4)-7 thereunder. The investment adviser agreed to a cease-and-desist order, a censure, and the payment of a $1.9 million civil money penalty.

Conclusion

The SEC faced two headwinds in FY 2018 and early FY 2019, one expected and the other an unpleasant and protracted surprise. First, turnover and attrition continued, with the number of staff still below its FY 2014 level,[66] the departure of at least six Regional Directors[67] and an unfilled vacancy due to expiration of Commissioner Kara Stein's term.[68] Second, beginning in December 2018, the government shut down for 35 days. Setting aside the SCSDI, since the end of the shutdown, the Commission has brought only 43 settled administrative proceedings.[69] Only 13 of these settled administrative proceedings involved violations of the Investment Advisers Act of 1940 and 12 of these 13 settlements either follow up on a civil action brought by the SEC or a criminal action brought by other authorities. None of the 43 settled administrative proceedings implicated a violation of the Investment Company Act of 1940. As a consequence, the overall pace of enforcement activity will likely slow in FY 2019 (although the number of individual actions associated with the SCSDI will significantly offset the effect of the shutdown in the final statistics). But while the eventual end-of-year may be down from FY 2018, the reduction will not be attributable to a lack of vigor in the SEC's enforcement program, which we expect to continue to aggressively protect the interests of retail investors. In addition, the SCSDI demonstrates that the Commission is unafraid to experiment with its enforcement techniques to obtain greater results with fewer resources, and we may see it deploy a similar approach to tackling perceived industry-wide issues going forward.

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[1] Chairman Jay Clayton, *Testimony before the Financial Services and General Government Subcommittee of the Senate Committee on Appropriations* (Jun. 5, 2018), https://www.sec.gov/news/testimony/testimony-financial-services-and-general-government-subcommittee-senate-committee ("June 5 Testimony").

[2] FY 2018 is the 12-month period ended Sept. 30, 2018.
[3] *See* U.S. Securities and Exchange Commission, Strategic Plan Fiscal Years 2018-2022, https://www.sec.gov/files/SEC_Strategic_Plan_FY18-FY 22_FINAL.pdf.
[4] *Id.* at 4.
[5] *Id.* at 6.
[6] *Id.* at 8.
[7] *Id.* at 10.
[8] *See* Chairman Jay Clayton, *Testimony on "Oversight of the U.S. Securities and Exchange Commission"* (Dec. 11, 2018), https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission-0.
[9] *Id.* Chairman Clayton also identified several other areas of heightened risks being addressed by OCIE, which included "the continued growth of cryptocurrencies and ICOs" (often referred to as "digital assets").
[10] Stephanie Avakian, *Measuring the Impact of the SEC's Enforcement Program* (Sept. 20, 2018), https://www.sec.gov/news/speech/speech-avakian-092018 ("Sept. 20 Avakian Speech").
[11] *See* Stephanie Avakian and Steven Peikin, *Oversight of the SEC's Division of Enforcement* (May 16, 2018), https://www.sec.gov/news/testimony/testimony-oversight-secs-division-enforcement.
[12] *Id.*
[13] *See* Press Release 2017-176, *SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors* (Sept. 25, 2017), https://www.sec.gov/news/press-release/2017-176 ("Press Release 2017-176").
[14] *See* Press Release 2018-250, *SEC Enforcement Division Issues Report on FY 2018 Results* (Nov. 2, 2018), https://www.sec.gov/news/press-release/2018-250.
[15] Sept. 20 Avakian Speech.
[16] *See* U.S. Securities and Exchange Commission Division of Enforcement, *Annual Report*, at p. 5, https://www.sec.gov/files/enforcement-annual-report-2018.pdf ("Enforcement 2018 Annual Report").
[17] *See* Press Release 2018-250, *SEC Enforcement Division Issues Report on FY 2018 Results* (Nov. 2, 2018), https://www.sec.gov/news/press-release/2018-250.
[18] *See* U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, *2019 Examination Priorities*, at p. 1, https://www.sec.gov/files/OCIE%202019%20Priorities.pdf ("OCIE 2019 Examination Priorities").
[19] *See* U.S. Securities and Exchange Commission, *Fiscal Year 2019 Congressional Budget Justification Annual Performance Plan and Fiscal Year 2017 Annual Performance Report*, at p. 107, https://www.sec.gov/files/secfy19congbudgjust.pdf ("FY 2017 Annual Performance Report").
[20] *C.f.* 80% of examinations in FY 2012 identifying deficiencies with 72% of examinations in FY 2017. FY 2017 Annual Performance Report, at p. 106.
[21] *See* Press Release 2018-213, *SEC Charges Firm With Deficient Cybersecurity Procedures* (Sept. 26, 2018), https://www.sec.gov/news/press-release/2018-213 ("Press Release 2018-213").
[22] OCIE 2019 Examination Priorities at p. 8.
[23] *See* U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, *Risk-Based Examination Initiatives Focused on Registered Investment Companies* (Nov. 8, 2018), https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20RIC%20Initiatives_0.pdf.
[24] *See* I*n the Matter of Wells Fargo Advisors, LLC* (Jun. 25, 2018), https://www.sec.gov/litigation/admin/2018/33-10511.pdf.
[25] *See In the Matter of Cadaret, Grant & Co., Inc., Arthur Grant, Beda Lee Johnson, and Eugene Long* (Sept. 11, 2018), https://www.sec.gov/litigation/admin/2018/33-10542.pdf.
[26] *See, e.g., In the Matter of BB&T Securities LLC* (Sept. 7, 2018), https://www.sec.gov/litigation/admin/2018/ia-5002.pdf; *In the Matter of Alexander Capital, L.P.* (June 29, 2018), https://www.sec.gov/litigation/admin/2018/34-83562.pdf; Press Release 2018-183, *SEC Charges Two Brokers With Defrauding Customers*, https://www.sec.gov/news/press-release/2018-183.
[27] Stephanie Avakian and Steven Peikin, *Testimony Before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets Securities, and Investment concerning Oversight of the SEC's Division of Enforcement* (May 16, 2018), https://www.sec.gov/news/testimony/testimony-oversight-secs-division-enforcement.
[28] *See, e.g.,* Press Release 2018-283, *SEC Charges Former New York Investment Advisor and Daughter With Conducting a Ponzi Scheme*, https://www.sec.gov/news/press-release/2018-283; Press Release 2018-172 , *SEC Charges Buffalo Advisory Firm and Principal With Fraud Relating to Association With Barred Adviser* (Aug. 30, 2018), https://www.sec.gov/news/press-release/2018-172.

[29] *See* U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations, *OCIE's 2016 Share Class Initiative* (July 13, 2016), https://www.sec.gov/files/ocie-risk-alert-2016-share-class-initiative.pdf.
[30] *See* Press Release 2018-15, *SEC Launches Share Class Selection Disclosure Initiative to Encourage Self-Reporting and the Prompt Return of Funds to Investors*, https://www.sec.gov/news/press-release/2018-15.
[31] Press Release 2019-28, *SEC Share Class Initiative Returning More Than $125 Million to Investors* (March 11, 2019), https://www.sec.gov/news/press-release/2019-28.
[32] In each of the settled enforcement actions discussed in this Alert, the respondent(s) neither admitted nor denied the findings, except with respect to the Commission's jurisdiction over them and the subject matter of the proceedings.
[33] *See, e.g., In the Matter of Ameriprise Financial Services, Inc.* (Feb. 28, 2018), https://www.sec.gov/litigation/admin/2018/33-10462.pdf; *In the Matter of Geneos Wealth Management, Inc.* (April 6, 2018), https://www.sec.gov/litigation/admin/2018/34-83003.pdf; *In the Matter of PNC Investments LLC* (April 6, 2018), https://www.sec.gov/litigation/admin/2018/34-83004.pdf; *In the Matter of Securities America Advisors, Inc.* (April 6, 2018), https://www.sec.gov/litigation/admin/2018/34-83004.pdf; *In the Matter of Harbour Investments, Inc.* (Sept. 13, 2018), https://www.sec.gov/litigation/admin/2018/34-84115.pdf; *In the Matter of Capital Analysts, LLC* (Sept. 14, 2018), https://www.sec.gov/litigation/admin/2018/ia-5009.pdf; *In the Matter of American Portfolio Advisors* (Dec. 20, 2018), https://www.sec.gov/litigation/admin/2018/ia-5083.pdf; *In the Matter of PPS Advisors, Inc. and Lawrence Nicholas Passaretti* (Dec. 20, 2018), https://www.sec.gov/litigation/admin/2018/ia-5084.pdf.
[34] *See* Hardin Compliance Consulting, LLC, *The Real Nightmare before Christmas: SEC Gets Tough on Firms that Did Not Self-Report during SCSD Initiative* (Dec. 16, 2018), https://www.hardincompliance.com/blog/the-real-nightmare-before-christmas-sec-gets-tough-on-firms-that-did-not-self-report-during-scsd-initiative/.
[35] *See* Enforcement 2018 Annual Report at p. 12.
[36] *See id.* at p. 3.
[37] *See, e.g.*, Litigation Release No. 24078, *SEC Charges Former Bitcoin-Denominated Exchange and Operator with Fraud* (Feb. 21, 2018), https://www.sec.gov/litigation/litreleases/2018/lr24078.htm; *In the Matter of Tokenlot, LLC, Lenny Kugel and Eli L. Lewitt* (Sept. 11, 2018), https://www.sec.gov/litigation/admin/2018/33-10543.pdf; *In the Matter of Floyd Mayweather Jr.* (Nov. 29, 2018), https://www.sec.gov/litigation/admin/2018/33-10578.pdf.
[38] *See In the Matter of Crypto Asset Management, LP and Timothy Enneking* (Sept. 11, 2018), https://www.sec.gov/litigation/admin/2018/33-10544.pdf.
[39] *See* Press Release 2018-213.
[40] *See* U.S. Securities and Exchange Commission, 2018 Annual Report to Congress Whistleblower Program, at p. 1, https://www.sec.gov/sec-2018-annual-report-whistleblower-program.pdf ("2018 Whistleblower Program Report"). The Commission's FY 2018 awards included a record $82 million award, consisting of $49 million for two individuals who voluntarily provided a tip that became the focus of the staff's investigation and a $33 million award to a third individual who provided information previously unknown to the staff handling the investigation that led the staff to launch a second, separate investigation to investigate the alleged misconduct. *See* Press Release 2018-44, *SEC Announces Its Largest-Ever Whistleblower Awards* (March 19, 2018), https://www.sec.gov/news/press-release/2018-44. The Commission also made an award of $54 million to two whistleblowers, with one individual receiving $39 million for voluntarily providing information to the Commission and the other receiving $15 million when they learned of information after being interviewed by another federal agency and promptly reported that information to both the Commission and another federal agency when they did not have a legal obligation to do so. *See* Press Release 2018-179, *SEC Awards More Than $54 Million to Two Whistleblowers* (Sept. 6, 2018), https://www.sec.gov/news/press-release/2018-179.
[41] 2018 Whistleblower Program Report, at p. 1.
[42] *See Digital Realty Trust, Inc. v. Somers*, 583 U.S. ___, 138 S. Ct. 767, 200 L. Ed. 2d 15, (2018).
[43] *See* Press Release 2018-120, *SEC Proposes Whistleblower Rule Amendments* (June 28, 2018), https://www.sec.gov/news/press-release/2018-120. The proposed amendments also provide the Commission with additional discretion in making whistleblower awards and seek to increase efficiency in the claims review process.
[44] *See* U.S. Securities and Exchange Commission, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions* (Oct. 23, 2001).
[45] *See In the Matter of Lending Club Asset Management, LLC, f/k/a LC Advisors, LLC, Renaud LaPlanche, and Carrie Dolan* (Sept. 28, 2018), https://www.sec.gov/litigation/admin/2018/ia-5054.pdf.
[46] Press Release 2018-223, *SEC Charges LendingClub Asset Management and Former Executives With Misleading Investors and Breaching Fiduciary Duty* (Sept. 28, 2018), https://www.sec.gov/news/press-release/2018-223.

[47] *In the Matter of Gladius Network LLC* (Feb. 20, 2019), https://www.sec.gov/litigation/admin/2019/33-10608.pdf.
[48] *See* Press Release 2019-15, *Company Settles Unregistered ICO Charges After Self-Reporting to SEC* (Feb. 20, 2019), https://www.sec.gov/news/press-release/2019-15.
[49] *See* Press Release 2017-229*, SEC Charges Biopharmaceutical Company With Failing to Properly Disclose Perks for Executives* (Dec. 12, 2017), available at https://www.sec.gov/news/press-release/2017-229; Press Release 2018-221, *SEC Charges Salix Pharmaceuticals and Former CFO With Lying About Distribution Channel* (Sept. 28, 2018), available at https://www.sec.gov/news/press-release/2018-221.
[50] *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).
[51] Enforcement 2018 Annual Report at p. 12.
[52] *See* Gregory D. DiMeglio and Peter Bogdasarian, *SEC Enforcement Developments of Note for Mutual Funds and Their Advisers: The Year in Review and a Look Ahead* (March 17, 2017), https://www.stradley.com/insights/publications/2017/03/fund-alert-march-17-2017.
[53] *See* Commissioner Hester M. Peirce, "The Why Behind the No: Remarks at the 50th Annual Rocky Mountain Securities Conference" (May 11, 2018), https://www.sec.gov/news/speech/peirce-why-behind-no-051118.
[54] *See* Dave Michaels, *SEC Signals Pullback From Prosecutorial Approach to Enforcement*, Wall Street Journal (Oct. 26, 2017), https://www.wsj.com/articles/sec-signals-pullback-from-prosecutorial-approach-to-enforcement-1509055200.
[55] *See* Press Release 2018-108, *Merrill Lynch Admits to Misleading Customers about Trading Venues* (June 19, 2018), https://www.sec.gov/news/press-release/2018-108; Litigation Release No. 24023, *Former Transition Management Executive Agrees to Securities Industry Bar and is Ordered to Pay Over $975,000 to Settle Fraud Charges*, https://www.sec.gov/litigation/litreleases/2018/lr24023.htm.
[56] *See In the Matter of Voya Investments, LLC and Directed Services LLC* (Mar. 8, 2018), https://www.sec.gov/litigation/admin/2018/34-82837.pdf.
[57] *See In the Matter of Morgan Stanley Smithy Barney LLC* (June 29, 2018), https://www.sec.gov/litigation/admin/2018/34-83571.pdf.
[58] *See In the Matter of AEGON USA Investment Management, LLC, Transamerica Asset Management, Inc., Transamerica Capital, Inc. and Transamerica Financial Advisors, Inc.* (Aug. 27, 2018), https://www.sec.gov/litigation/admin/2018/33-10539.pdf.
[59] The respondents also committed certain additional violations with respect to volatility guidelines added to the variable life insurance and variable annuity investment portfolios. The respondents added the guidelines without disclosing to the investors or the board of trustees how they would control and determine the portfolios' asset allocations and the fact that, in certain market conditions, the guidelines could reduce the exposure to the equity markets below the stated target percentages. The respondents also failed to check the accuracy of the guidelines and, upon discovering errors, failed to disclose them to investors or to the board of trustees.
[60] For more information on F-Squared, please see Press Release 2014-289, *SEC Charges Investment Manager F-Squared and Former CEO With Making False Performance Claims* (Dec. 22, 2014), https://www.sec.gov/news/pressrelease/2014-289.html; Press Release 2016-167, *Investment Advisers Paying Penalties for Advertising False Performance Claims* (Aug. 25, 2016), https://www.sec.gov/news/pressrelease/2016-167.html.
[61] *See In the Matter of Bradley J. Beman* (Aug. 27, 2018), https://www.sec.gov/litigation/admin/2018/ia-4997.pdf; *In the Matter of Kevin A. Giles* (Aug. 27, 2018), https://www.sec.gov/litigation/admin/2018/ia-4998.pdf.
[62] *See In the Matter of Hamlin Capital Management, LLC* (Aug. 10, 2018), https://www.sec.gov/litigation/admin/2018/ia-4983.pdf.
[63] *See In the Matter of Cushing Asset Management, LP* (Sept. 14, 2018), https://www.sec.gov/litigation/admin/2018/ic-33226.pdf.
[64] *See In the Matter of Putnam Investment Management, LLC and Zachary Harrison* (Sept. 27, 2018), https://www.sec.gov/litigation/admin/2018/ia-5050.pdf.
[65] *See In the Matter of Massachusetts Financial Services Company* (Aug. 31, 2018), https://www.sec.gov/litigation/admin/2018/ia-4999.pdf.
[66] *See* June 5 Testimony.
[67] *See* Press Release 2017-179, *Andrew Calamari, Regional Director of the SEC's New York Office, to Leave the Agency After 17 Years of Service* (Sept. 28, 2017), https://www.sec.gov/news/press-release/2017-179; Press Release 2017-191, *Walter Jospin, Regional Director of the SEC's Atlanta Office, to Leave the Agency* (Oct. 10, 2017), https://www.sec.gov/news/press-release/2017-191; Press Release 2017-2015, *David Glockner, Regional Director of Chicago Office, to Leave SEC* (Nov. 1, 2017), https://www.sec.gov/news/press-release/2017-205; Press Release 2018-139, *Julie Lutz, Regional Director of the Denver Regional Office, to Leave SEC After More Than 40 Years Serving Investors* (July 23, 2018), https://www.sec.

gov/news/press-release/2018-139; Press Release 2018-267, *Jina L. Choi, Regional Director of the SEC's San Francisco Office, to Leave the Agency After Over 16 Years of Service* (Nov. 29, 2018), https://www.sec.gov/news/press-release/2018-267; Press Release 2019-4, *Shamoil T. Shipchandler, Regional Director of the SEC's Fort Worth Regional Office, Has Left the Agency* (Jan. 28, 2019), https://www.sec.gov/news/press-release/2019-4.

[68] *See* U.S. Securities and Exchange Commission, SEC Historical Summary of Chairmen and Commissioners, https://www.sec.gov/about/sechistoricalsummary.htm.

[69] *See* generally U.S. Securities and Exchange Commission, *Administrative Proceedings*, https://www.sec.gov/litigation/admin.shtml.