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SEC Exams and Enforcement 2022

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OVERVIEW

- Examination Trends
 - 2022 Exam Priorities for Private Fund Managers
 - 2023 Predicted Focus Areas
- Enforcement Trends
 - Crypto Enforcement and Litigation
 - ESG
 - Electronic Communications and Related Recordkeeping





EXAMINATION TRENDS



2022 EXAM PRIORITIES – COMMON FEATURES OF RESILIENT COMPLIANCE PROGRAMS

1. **Inclusivity** – Compliance function and staff across a firm work together to aid in development of compliance program and design of effective controls.
2. **Monitoring and Updating** – Compliance program is sufficiently flexible to accommodate business and market changes.
3. **Reviews and Testing** – In addition to annual compliance reviews, “testing is critical” to ensure adequacy and effectiveness.



FY 2022 – SEC EXAM PRIORITIES IMPACTING PRIVATE FUNDS

- Fees and Expenses
- Preferential Liquidity – Gates, Suspensions, and Withdrawals
- Custody Rule Compliance
- Cross and Principal Trades
- GP-Led Secondaries
- Disclosures of Investment Risks
- Controls around MNPI



OTHER KEY 2022 PRIORITIES

- ESG Investing
 - Accuracy of disclosures; greenwashing
- Information Security
 - Safeguarding of information; vendors and service provider oversight; intrusion detection; incident response; Red Flags (Reg S-ID); remote work risks
- Emerging Technologies and Crypto Assets
 - Focus on duty of care, suitability, disclosures and product risks
 - Compliance (wallet reviews, custody, valuation)



NATIONAL EXAM PROGRAM: RISK ALERTS*

- Marketing Rule (Sept. 19, 2022)
- MNPI Compliance Issues (April 26, 2022)
- Private Fund Advisers (January 27, 2022)
- Advisers' Fee Calculations (November 10, 2021)
- Electronic Advice (November 9, 2021)
- ESG Investing (April 9, 2021)
- Digital Asset Securities (February 26, 2021)
- Large Trader Obligations (December 16, 2020)
- Compliance Programs (November 19, 2020)
- Supervision, Compliance and Multiple Branch Offices (November 9, 2020)
- Safeguarding Client Accounts against Credential Compromise (September 15, 2020)
- Private Fund Advisers (June 23, 2020)

** Partial list*



2023 EXPECTED EXAMINATION PRIORITIES

- Continued Focus on Private Funds Core Compliance Areas
- Crypto regulation
 - Crypto industry will not have immunity from the “application of well-established regulations and precedents”
 - SEC maintains “vast majority” of crypto assets are securities that fall within federal securities regulations
- Cybersecurity disclosures—material incidents and policies and procedures
- Adviser marketing
 - Compliance date for new marketing rule was November 4, 2022
 - Initial sweeps will likely focus on ensuring that examined advisers are aware of the rule and engaging in good faith efforts to comply
- ESG
 - Accurate disclosures
 - Policies and procedures





ENFORCEMENT STATISTICS, TRENDS, AND IMPORTANT ACTIONS



SEC ENFORCEMENT STATISTICS - 2021

- 697 total enforcement actions in FY 2021
 - 434 new enforcement actions
 - 7% increase from FY 2020
 - 70% involved at least one individual defendant or respondent
 - 120 actions against issuers delinquent in required SEC filings
 - 143 “follow-on” administrative proceedings seeking individual bars based on criminal convictions, civil injunctions, or other orders



SEC ENFORCEMENT STATISTICS - 2022

- FY 2022 enforcement statistics announced November 15
- SEC filed 760 total enforcement actions, marking a **9% increase** over 2021
 - 462 new, or "stand alone," enforcement actions (**6.5% increase** over 2021)
 - 129 actions relating to delinquent SEC filings
 - 169 "follow-on" administrative proceedings seeking to bar or suspend individuals from certain functions in the securities markets based on criminal convictions, civil injunctions, or other orders
- **\$6.439 billion** in money ordered, *the most on record in SEC history*
 - Civil penalties, disgorgement, and pre-judgment interest
 - Up from \$3.852 billion in FY 2021



SEC ENFORCEMENT STATISTICS

- In its most recent annual budget request, the SEC seeks a budget of \$2.15 billion for FY 2023, which is almost \$240 million more than it sought for FY 2022
- SEC practically doubles the size of the Division of Enforcement's Crypto Assets and Cyber Unit



ENFORCEMENT-RELATED LITIGATION DEVELOPMENTS

- New 10-year statute of limitations for disgorgement in fraud actions
 - Court decisions generally find it to be retroactive
- Disgorgement – new Supreme Court and Congressional action affirming the remedy and imposing limitations
 - *Lui* – Disgorgement permitted but limited to violator’s net profits (June 2020)
 - NDAA - Grants the SEC explicit authority to seek disgorgement and the federal courts express authority to order disgorgement in any action or proceeding brought by the SEC under the securities laws (January 2021)





ENFORCEMENT-RELATED DEVELOPMENTS

- Wells process – SEC is empowering front-line enforcement staff, including limiting meetings with senior officials in the Wells process
- Resolutions
 - 15 cases tried in federal court in 2022 — the most since 2015
 - Aggressive litigation timelines and postures
 - Early self-reporting and remediation efforts considered when determining penalties





ENFORCEMENT – TONE FROM THE TOP

- “[W]e go after misconduct wherever we find it in the financial system, holding individuals and companies accountable, without fear or favor...” – *SEC Chair Gary Gensler, November 18, 2021*
- “Robust enforcement requires the [SEC’s] Division [of Enforcement] to be the cop on the beat and cover the entire securities waterfront, investigating and litigating every type of case within our remit with a sense of urgency.” – *SEC Director of Division of Enforcement Gurbir S. Grewal, July 21, 2022*





Selected Enforcement Actions



ENFORCEMENT SWEEPS

- Violations of Custody Rule and related Form ADV reporting obligations (Sept. 2022)
 - Six private fund advisers charged with failing to deliver audited financials to private fund investors and/or to amend Form ADV accordingly

Takeaway: Crucial to update Form ADV to Confirm Receipt of Unqualified Audit Opinion. Item 7.B.(1).23

Yes No

(g) Are the *private fund's* audited financial statements for the most recently completed fiscal year distributed to the *private fund's* investors?

(h) Do all of the reports prepared by the auditing firm for the *private fund* since your last *annual updating amendment* contain unqualified opinions?

Yes No Report Not Yet Received

If you check "Report Not Yet Received," you must promptly file an amendment to your Form ADV to update your response when the report is available.



ENFORCEMENT SWEEPS

- Recordkeeping failures associated with off-channel communications (September 2022)
 - 16 firms charged with failing to maintain employees' business-related text messages over “off-channel” mediums—i.e., personal text messaging, personal email accounts, and applications such as WhatsApp and Signal
 - \$1.1 billion in penalties, and settled C&D Orders with admissions
 - SEC Chair Gensler stated that the SEC’s “investigation is ongoing”

Takeaway: Crucial to evaluate – and enforce - policies pertaining to electronic records preservation and the use of unauthorized communication channels and implement measures to preserve and/or flag off-channel communications



ENFORCEMENT SWEEPS

- Noncompliance with Form CRS obligations (July 2021 - February 2022)
 - 42 firms charged with failures to file and deliver Forms CRS to investors by the required deadline
- Pay-to-play violations (September 2022)
 - Four advisers charged with violating Rule 206(4)-5 by continuing to receive management fees from government entities following campaign contributions



CONFLICTS OF INTEREST

- *SEC v. Cambridge Inv. Research Advisers, Inc.* (March 1, 2022)
 - SEC charged adviser with failing to disclose material conflicts of interest and breaching its duty of care by investing client assets in mutual funds and money market sweep funds that generated millions of dollars in revenue sharing payments for an affiliated broker-dealer, rather than investing in lower-cost share classes and investment options with little to no revenue sharing.
 - Case still pending



VALUATION

- *In the Matter of AlphaCentric Advisors LLC* (June 3, 2022)
 - SEC claims that a mutual fund's adviser failed to implement its policies and procedures related to the valuation of the fund's securities, and failed to adopt and implement policies and procedures designed to oversee the role of the fund's sub-adviser and portfolio manager in the valuation process.
 - Settled via cease-and-desist order, with civil penalty of \$300,000.
- *SEC v. Velissaris* (February 17, 2022)
 - SEC claims portfolio manager engaged in a fraudulent scheme to overvalue mutual fund and private fund assets by manipulating a third-party pricing service's code and altering inputs used for valuation. Also alleges that the portfolio manager altered documents to obstruct SEC's investigation.
 - In litigation – SEC is seeking permanent injunctive relief, disgorgement, civil penalties, and an officer and director bar. Criminal and CFTC actions also filed.
 - Funds' assets liquidated and subject to SEC-approved distribution plan.



MISSTATEMENTS AND OMISSIONS

- *In the Matter of Allianz Global Investors U.S. LLC* (May 17, 2022)
 - Adviser and three portfolio managers charged with fraudulent scheme to conceal substantial downside risks of a complex options trading strategy called “Structured Alpha,” which lost billions of dollars after the COVID-19 market crash.
 - SEC alleged that the portfolio managers manipulated numerous financial reports and other investor disclosures to conceal the magnitude of risk.
 - AGI US admitted to misconduct and agreed to a cease-and-desist order, payment of \$315.2 million in disgorgement, \$34 million in prejudgment interest, and \$675 million civil penalty.
 - AGI US disqualified from providing advisory services to US registered investment funds for the next 10 years.



MISSTATEMENTS AND OMISSIONS

- *In re BNY Mellon Investment Adviser, Inc.* (May 23, 2022)
 - SEC settled charges against a mutual fund adviser for material misstatements and omissions made concerning the consideration of ESG principles in making investment decisions.
 - Some funds incorporated ESG considerations into investment decisions, but did not have a specific mandate to follow ESG principles for investment
 - SEC alleged that the adviser falsely disclosed in various statements, including prospectuses, that all investments in certain mutual funds had undergone an ESG review as part of the investment selection process.
 - SEC also claimed that the adviser lacked written policies and procedures reasonably designed to prevent inaccurate or materially incomplete statements about the use of ESG quality reviews when selecting investments.



VENTURE MANAGER/ERAS NOT IMMUNE

- *In the Alumni Ventures Group, LLC and Michael Collins (March 4, 2022)*
 - SEC's action against exempt reporting adviser involved allegations of materially misleading statements regarding its management fee and improper inter-fund loans and cash transfers.
 - Adviser misrepresented that its fees were in line with "industry standard" and, in violation of fund operating documents, commingled fund assets.
 - Settled in cease-and-desist order action with adviser agreeing to pay \$700,000 civil money penalty and the adviser's CEO and founder agreeing to pay \$100,000 civil money penalty.



MISALLOCATION OF EXPENSES AMONG FUND AND CO-INVESTORS

- *In re Energy Capital Partners Management, LP (June 14, 2022)*
 - SEC charged private equity adviser in connection with take-private transaction that was financed in part by a fund that it advised and by a group of co-investors.
 - The pre-closing co-investors refused to bear expenses related to a credit facility use to finance the transaction. Adviser then changed course and allocated its fund more than its pro rata share to cover the fees that were not paid by the co-investors.
 - The SEC determined that this allocation was inconsistent with the language in fund documents that stated that fees would be allocated based on relative investments or equitably, as a result the adviser should not have allocated to its fund more than its proportional share of such expenses.
 - Adviser consented to an order finding a negligent violation of Section 206(2) and 206(4) of the Advisers Act, paid a \$1 million penalty, and returned disproportionately allocated fees to the fund.



SEC CHARGES REAL ESTATE DEVELOPER WITH SECURITIES FRAUD

- *SEC v. Robert Brian Watson and WDC Holdings LLC d/b/a Northstar Commercial* (D. Colo. Filed August 22, 2022)
 - The SEC's complaint alleges that sponsor of real estate development funds told investors that they would personally invest 4% to 5% of the equity needed for the projects when they actually invested only a small fraction of this amount. The SEC alleges that the false and misleading statements the sponsor's stake in the projects, or "skin in the game," were critical to investors.
 - The SEC's complaint, filed in federal district court in Denver, Colorado, charges the sponsors with violating the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.



CRYPTO ENFORCEMENT

- Staffing increases – in May 2022, 20 additional positions were added to the Crypto Assets and Cyber Unit
- Investigatory focus on:
 - Digital asset offerings, digital asset exchanges, digital asset lending and staking products
 - Decentralized finance platforms, non-fungible tokens (NFTs), and stablecoins



CRYPTO ENFORCEMENT

- Crypto exchange FTX and its affiliated trading firm, Alameda Research, announced Chapter 11 bankruptcy filings last Friday.
- Collapse of these mammoth crypto companies, which follows the struggles of other crypto-related companies (Voyager Digital, Celsius), will likely enhance government scrutiny.
- Just one day before the bankruptcy announcement, SEC Chair Gensler stated that the crypto industry is a space where “investors need better protection,” and he highlighted enforcement as a means of providing such protection.



REGULATION THROUGH ENFORCEMENT: CRYPTO ASSETS

- While the SEC has not introduced rulemaking to address funds' and advisers' use of crypto assets, it has not shied from taking an aggressive enforcement stance
- “Some in the crypto industry have called for greater ‘guidance’ with respect to crypto tokens. For the past five years, though, the [SEC] has spoken with a pretty clear voice here: through the DAO Report, the Munchee Order, and dozens of [e]nforcement actions...”

- SEC Chair Gary Gensler, September 8, 2022



REGULATION THROUGH ENFORCEMENT: CRYPTO ASSETS

- Sampling of regulation by enforcement
 - *SEC v. Wahi* – In a July 21, 2022 complaint regarding insider trading allegations against a Coinbase Global, Inc. employee and two others, the SEC declared that the crypto assets traded were “securities”
 - Determined the subject crypto assets to be “securities” beyond an action taken against the issuer of the assets or the platform on which they were traded
 - *In re Kimberly Kardashian* – On October 3, 2022, the SEC announced that it settled charges brought against Kim Kardashian for “touting” on social media a crypto asset – which the SEC determined was a “security” - without disclosing that she received a payment for that promotion
 - Similar to *Wahi*, the SEC used the matter as an opportunity to declare a crypto asset (EMAX tokens) to be a “security” without taking action against the issuer of the asset



REGULATION THROUGH ENFORCEMENT: CRYPTO ASSETS

- Sampling of regulation by enforcement
 - *In re BlockFi Lending LLC* - In February 2022, the SEC claimed BlockFi failed to register the offer and sale of BlockFi Interest Accounts under the Securities Act of 1933, and that BlockFi was an unregistered “investment company”
 - SEC determined that the BIAs were securities and that BlockFi acted as an issuer without filing a registration statement or qualifying for an exemption
 - SEC also determined that BlockFi owned “investment securities” (as defined by Section 3(a)(2) of the Investment Company Act), including loans of crypto assets, investments in crypto asset trusts and funds, exceeding 40% of the value of BlockFi’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis, thereby causing BlockFi to fall under the definition of “investment company”
 - BlockFi did not register as an investment company with the SEC, did not meet any statutory exemptions or exclusions from the definition of an investment company, and did not seek an order from the SEC
 - SEC did not believe that BlockFi could rely on the exclusion from the definition of “investment company” provided for “market intermediaries”

