

The top half of the slide features a background image of a city at night with a glowing blue world map overlay. The map is composed of a grid of dots. Overlaid on the map are several financial charts, including candlestick charts and line graphs. Specific data points are highlighted with labels: '334 +7.09%' in the top left, '56 +1.13%' on the left side, '178 +3.28%' in the lower center, '206 +1.12%' in the upper center, '281 +1.07%' in the top right, and '566 +2.08%' on the right side. The K&L GATES logo is prominently displayed in the top left corner, with 'K&L' in white on an orange square and 'GATES' in white on a dark blue square.

# K&L GATES

Session VI

## Enforcement and Examinations

Moderator:

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# AGENDA

- SEC Enforcement Statistics and Trends
- SEC Exam Priorities and Risk Alerts
- Enforcement Updates
  - Sweeps
  - Legal Developments
  - Selected SEC Enforcement Actions Pertaining to the Asset Management and Investment Funds industry
- Mutual Fund Litigation Update







# SEC Enforcement Statistics and Trends



## SEC ENFORCEMENT STATISTICS (FY 2021)

- 697 total enforcement actions in FY 2021
  - 434 new enforcement actions
    - Seven percent increase from FY 2020
    - 70 percent 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
  - Three percent decrease over the total actions filed in FY 2020
- FY 2022 enforcement statistics expected to be released by the SEC in the coming weeks





# SEC ENFORCEMENT STATISTICS (FY 2021)

Enforcement Summary Chart for FY 2021 by Primary Classification							
Primary Classification	Civil Actions	Standalone AP	Follow-On AP	Delinquent Filings	Total	% of Total Actions	% of Civil and Standalone APs
Broker Dealer	10 (23)	26 (32)	74 (77)	0 (0)	110 (132)	16%	8%
Delinquent Filings	0 (0)	0 (0)	0 (0)	120 (120)	120 (120)	17%	0%
Foreign Corrupt Practices Act	0 (0)	5 (8)	0 (0)	0 (0)	5 (8)	1%	1%
Insider Trading	19 (37)	9 (10)	0 (0)	0 (0)	28 (47)	4%	6%
Investment Advisers / Investment Companies	33 (85)	87 (108)	39 (40)	0 (0)	159 (233)	23%	28%
Issuer Reporting / Audit & Accounting	11 (26)	42 (61)	17 (17)	0 (0)	70 (104)	10%	12%
Market Manipulation	23 (71)	3 (6)	5 (5)	0 (0)	31 (82)	4%	6%
Miscellaneous	3 (3)	4 (5)	0 (0)	0 (0)	7 (8)	1%	2%
NRSRO	1 (1)	1 (1)	0 (0)	0 (0)	2 (2)	0%	0%
Public Finance Abuse	2 (3)	10 (12)	0 (0)	0 (0)	12 (15)	2%	3%
Securities Offering	123 (398)	19 (32)	8 (8)	0 (0)	150 (438)	22%	33%
SRO / Exchange	0 (0)	1 (1)	0 (0)	0 (0)	1 (1)	0%	0%
Transfer Agent	1 (2)	1 (1)	0 (0)	0 (0)	2 (3)	0%	0%
<b>Total</b>	<b>226 (649)</b>	<b>208 (277)</b>	<b>143 (147)</b>	<b>120 (120)</b>	<b>697 (1,193)</b>	<b>100%</b>	<b>100%</b>

Each action initiated has been included in only one category listed above, even though many actions involved multiple allegations and may fall under more than one category. The number of defendants and respondents is noted parenthetically.



## SEC ENFORCEMENT STATISTICS (FY 2021)

- Some enforcement actions highlighted by the SEC:
  - Charged investment advisers and their portfolio managers with misleading investors about their risk management practices over funds that lost more than \$1 billion in two trading days.
  - Charged a fund manager with making misrepresentations as to the fund's strategy and investments, failing to eliminate or disclose conflicts of interest, misappropriating assets, and misrepresenting that the fund would be audited annually.
  - The Division of Enforcement's Exchange-Traded Products Initiative, which utilizes trading data analytics to try to detect unsuitable sales of (mostly) volatility-linked ETPs to be held for long periods despite warnings by the issuers.



# SEC ENFORCEMENT TRENDS

- Whistleblower trends
  - Record-breaking year for SEC Whistleblower Program
  - Increase in number and amount of awards issued in 2021 resulting in \$564 million in total awards issued to 108 individuals
  - Program surpassed \$1 billion in awards over the life of the program
  - Gave the highest awards in the program's history
    - \$114 million award in October 2020
    - \$110 million award in September 2021
  - Charged individuals with violating whistleblower protection rules relating to retaliation and impeding whistleblowers from communicating with the SEC







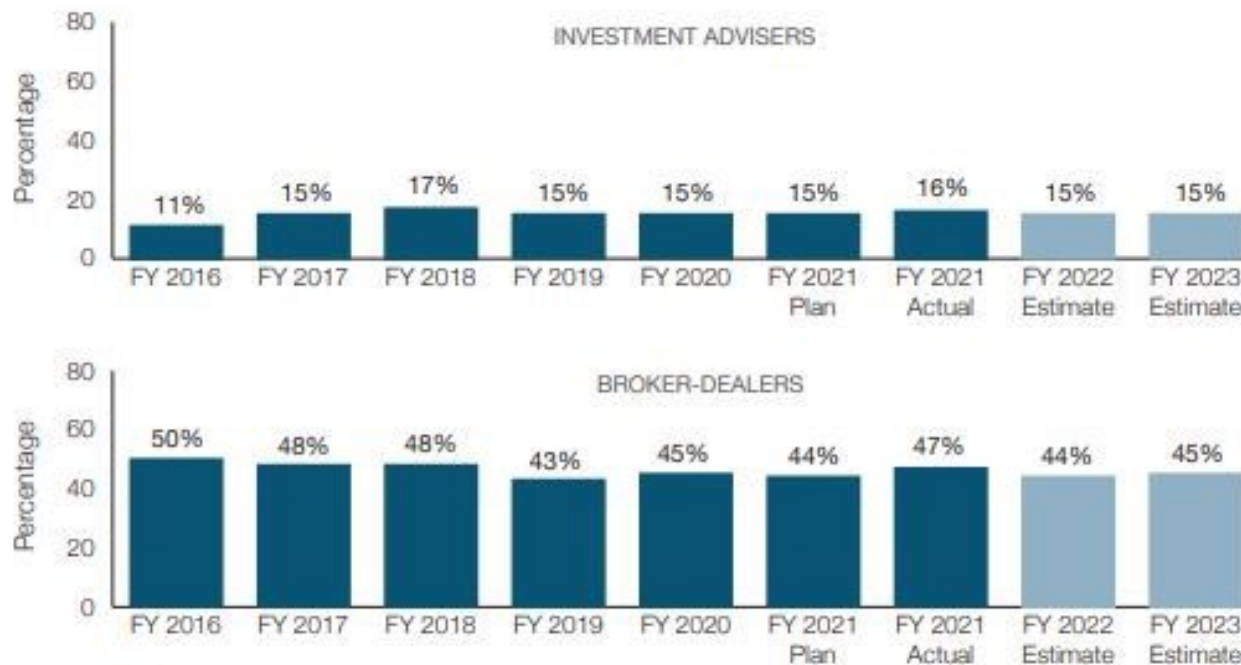
# 2022-2023 Expected Exam Priorities





# SEC EXAMINATION TRENDS

- Percentage of investment advisers, investment companies, and broker-dealers examined during the year:



# FY 2022 SEC EXAMINATION PRIORITIES

- Private funds
  - Continued focus on RIAs to private funds, including with respect to disclosures, compliance programs, and controls around MNPI.
- ESG Investing
  - Attention to ESG-related advisory services and investment products and accuracy of ESG disclosures.
- Fiduciary Duty, Reg BI, Form CRS
  - RIA-specific focus on revenue sharing arrangements, share class selections, wrap fee account recommendations, and proprietary product recommendations.
  - BD-specific focus on compensation structures and sales practices surrounding, among other things, SPACs, leveraged and inverse exchange traded products, REITs, and private placements.



# FY 2022 SEC EXAMINATION PRIORITIES

- Information Security and Operational Resiliency
  - Review of practices to prevent interruptions to critical services and to protect investor information (e.g., preventing account intrusions, overseeing vendors, addressing malicious e-mail activities, responding to incidents, detecting red flags related to identity theft, and managing operational risk associated with remote work).
- Emerging Technology and Crypto-Assets
  - Attention to use of digital investment advice or “robo-advisers” and offering of digital engagement services/products such as “Finfluencers” or fractional shares.
  - Custody arrangements of marketing participants engaged with crypto-assets.





# NATIONAL EXAM PROGRAM: RISK ALERTS

- Observations from Examinations in the Registered Investment Company Initiatives (Oct. 26, 2021)
  - Observed failures to establish or tailor compliance programs concerning several business practices, including portfolio management, valuation, trading, conflicts of interest, fees and expenses, and advertising.
  - Noted disclosure deficiencies in fund filings, advertisements, sales literature, and/or other shareholder communications.
- Observations from Examinations of Advisers that Provide Electronic Advice (Nov. 9, 2021)
  - Identified deficiencies with respect to (1) compliance programs, (2) portfolio management consistent with fiduciary duty to provide advice in client's best interest, and (3) adequacy of statements and disclosures in marketing or advertising.
  - Observed advisers relying on, but not satisfying the requirements of, the Internet adviser exemption and Company Act Rule 3a-4.



# NATIONAL EXAM PROGRAM: RISK ALERTS

- Division of Examinations Observations: Investment Advisers' Fee Calculations (Nov. 10, 2021)
  - Noted several deficiencies, including advisers charging advisory fees inaccurately and failing to refund prepaid fees on terminated accounts or not assessing fees for new accounts on a pro-rata basis.
  - Observed false, misleading or omitted disclosures, missing or inadequate policies and procedures addressing advisory fee billing, monitoring of fee calculations and billing, or both, and inaccurate financial statements with respect to advisory fees.
- Observations from Examinations of Private Fund Advisers (Jan. 27, 2022)
  - Identified failures to act consistently with disclosures and use of misleading disclosures regarding performance and marketing.
  - Observed deficiencies with respect to due diligence processes and practices as to potential investments or service providers.
  - Noted use of potentially misleading “hedge clauses.”



# NATIONAL EXAM PROGRAM: RISK ALERTS

- Investment Adviser MNPI Compliance Issues (Apr. 26, 2022)
  - Identified noncompliance with Section 204A of the IAA based on policy/procedure deficiencies concerning use of alternative data, identification of “value-add investors,” and discussions with “expert networks.”
  - Noted deficiencies under Rule 204A-1, the Code of Ethics Rule, related to identification of access persons, investment pre-approvals for access persons, personal securities transactions and holdings, and written acknowledgement of receipt of the code and any amendments.
- Examinations Focused on the New Investment Adviser Marketing Rule (Sep. 19, 2022)
  - Compliance date for the Marketing Rule is November 4, 2022.
  - Examinations will focus on compliance with the Marketing Rule, including with respect to Marketing Rule policies and procedures, the substantiation requirement, performance advertising requirements, and the amended Books and Records Rule.







# Enforcement Updates



# ENFORCEMENT SWEEPS

- Recordkeeping failures associated with off-channel communications (Sept. 2022)
  - 16 firms charged with failing to maintain employees' business-related text messages on their personal devices.
  - \$1.1 billion in penalties.
  - Settled C&D Orders with admissions.
- Violations of Custody Rule and related Form ADV reporting obligations (Sept. 2022)
  - 6 private fund advisers charged with failing to deliver audited financials to private fund investors and/or to amend Form ADV accordingly



# ENFORCEMENT SWEEPS

- Noncompliance with Form CRS obligations (July 2021-Feb. 2022)
  - 42 firms charged with failures to file and deliver Forms CRS to investors by the required deadline.
- EPS Initiative is ongoing





## ENFORCEMENT-RELATED 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*
  - NDAA



# SELECTED ENFORCEMENT ACTIONS: CONFLICTS OF INTEREST

- *SEC v. Cambridge Inv. Research Advisers, Inc.* (Mar. 1, 2022).
  - Alleged that adviser invested client assets in certain 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.
  
- *In the Matter of RiverSource Distributors, Inc.* (Mar. 25, 2022).
  - SEC's first-ever enforcement proceeding under Section 11 of the 1940 Act.
  - Alleged that certain RiverSource Distributors ("RDI") employees implemented a sales practice that caused exchange offers to be made to variable annuities holders to switch from one variable annuity to another, thereby increasing sales commissions.
  - RDI consented to a cease-and-desist order, with \$5 million civil penalty.



# SELECTED ENFORCEMENT ACTIONS: VALUATION

- *In the Matter of AlphaCentric Advisors LLC* (June 3, 2022).
  - AlphaCentric Advisors LLC, a Puerto Rico-based registered investment adviser, allegedly failed to implement policies and procedures related to the valuation of the Fund's securities and designed to oversee the Fund's portfolio management.
  - Settled via cease-and-desist order, with civil penalty of \$300,000.
- *SEC v. Velissaris* (Feb. 17, 2022).
  - SEC charged portfolio manager with fraudulent scheme to overvalue assets held by registered mutual fund and related private fund, by manipulating a third-party pricing service's code and altering inputs used to value assets. Also alleged altering of documents to frustrate SEC's investigation and cover-up scheme.
  - In litigation – SEC is seeking permanent injunctive relief, disgorgement, civil penalties, and an officer and director bar. Criminal and CFTC actions also filed.
  - Remaining fund assets have been liquidated and subject to SEC-approved distribution plan.





# SELECTED ENFORCEMENT ACTIONS: MISSTATEMENTS AND OMISSIONS

- *In the Matter of Allianz Global Investors U.S. LLC* (May 17, 2022).
  - Adviser and three portfolio managers charged with alleged 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 information provided to investors to conceal the magnitude of risk.
  - AGI US admitted to its misconduct and agreed to a cease-and-desist order, with a payment of \$315.2 million in disgorgement, \$34 million in prejudgment interest, and \$675 million in civil penalty.
  
- *In the Matter of BNY Mellon Inv. Adviser, Inc.* (May 23, 2022).
  - Alleged misstatements and omissions regarding investments in mutual funds receiving ESG review, finding that several investments lacked ESG quality review scores at the time of investment.
  - Settled in cease-and-desist order action with \$1.5 million penalty.



# SELECTED ENFORCEMENT ACTIONS: MISSTATEMENTS AND OMISSIONS

- Other misstatement and omission cases:
  - Settled cease-and-desist action against investment advisers for failure to disclose that their internal analyses showed that their manner of allocating client funds (particularly to cash) would, under most market conditions, be less profitable while taking on the same amount of risk.
    - Also involved allegation that adviser swept cash balances to affiliated bank, which created revenue for the bank affiliate.
  - Settled cease-and-desist action against advisory firm related to alleged failure to adequately train and oversee advisers regarding a complex investment strategy.
  - Settled cease-and-desist action against variable annuity provider, alleging account statements were provided to investors with misleading statements and omissions regarding investor fees.





# Litigation Update





## SECTION 36(b) LITIGATION

- Since the Supreme Court's decision in *Jones v. Harris Assocs. L.P.* in 2010, 40 actions have been brought under Section 36(b) of the ICA.
  - Cases named 26 different advisers as defendants.
  - Cases were filed in 16 different U.S. district courts.
  - The vast majority of cases were brought by just 5 law firms (sometimes working in collaboration).
- Filings peaked in 2014-2015, following initial successes in avoiding dismissal.
- Defendants and the courts have now landed what may be some knock-out blows.
- But SEC Director of Investment Management Birdthistle has given additional attention to this area...



## NATURE OF THE RIGHT OF ACTION UNDER SECTION 36(b) OF THE ICA

- Section 36(b) of the ICA imposes upon an investment adviser a fiduciary duty “with respect to [its] receipt of compensation for services, or of payments of a material nature” made by a registered investment company.
  - Shareholders may sue for breach of this duty, i.e., an adviser’s receipt of an allegedly “excessive fee.”
  - A claim may be brought only against an investment adviser or affiliated person receiving such compensation (not a fund board).



# THE STANDARD FOR LIABILITY UNDER SECTION 36(b)

- The standard for liability is an exacting one:

“[A]n investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”

*Jones v. Harris Assocs. L.P.*, 559 U.S. 335, 346 (2010).

- In making this determination, courts take into account all relevant circumstances, including those identified in a Second Circuit decision (*Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*), endorsed in *Jones*.





# THE STANDARD FOR LIABILITY UNDER SECTION 36(b)

- The *Gartenberg* factors include:
  1. the independence, expertise, care, and conscientiousness of the independent members of the fund board in evaluating and approving the advisory fee;
  2. the nature and quality of the services provided to the fund and its shareholders;
  3. the profitability to the adviser of its relationship with the fund;
  4. whether economies of scale, if any, are shared with investors;
  5. comparative fee structures; and
  6. “fall-out” benefits to the adviser.



## SECTION 36(b) SCORECARD

- Historically, Plaintiffs usually prevailed on motions to dismiss and then survived summary judgment due to perceived issues of fact.
  - This risk incentivized defendants to settle.
- The scorecard has since changed dramatically.
  - *Summary judgment*: Of nine motions for summary judgment resolved since 2018, five have been granted in full, three have been granted in part, and only one has been denied.
  - *Trial*: Defendants have prevailed in every case that has ever gone to trial in the 50 years since the enactment of Section 36(b), including 4 trials conducted since 2018.



## SECTION 36(b) SCORECARD

- Potential knockout punch:
  - District of Colorado recently sanctioned plaintiff's counsel (in an amount up to \$1.5 million) for “recklessly pursu[ing] their claims through trial despite the fact that they were lacking merit,” noting their expert's analysis was “fundamentally flawed” and entitled to no weight, and that the litigation was “inherently lawyer driven.”





## WHAT DOES THE FUTURE HOLD?

- As a consequence of the unbroken chain of defeats, Section 36(b) litigation has dried up.
  - No new cases filed in several years.
  - The recent sanctions award only increases risk to plaintiffs' bar.
- But, we can't expect the plaintiffs' bar to completely lose interest, and there is potential for new waves based on new theories.
- The SEC can also enforce Section 36(b), which so far it has not done. But, statements earlier this year from Division of Investment Management Director Birdthistle appear to open the door.



# WHAT DOES THE FUTURE HOLD?

- Director Birdthistle Remarks at ICI Investment Management Conference (March 28, 2022):

*“The Commission can always enforce a breach of fiduciary duty by a fund adviser. In addition, the Investment Company Amendments Act of 1970 also added Section 36(b), which as you know specifies that a registered fund’s adviser has a fiduciary duty with respect to the receipt of compensation for services or material payments from the fund or its shareholders. To enforce this duty, fund shareholders or the Commission may bring an action under this subsection. No plaintiff has yet won a 36(b) case, but if no adviser can ever lose one – and none has, so far – one wonders whether the duty enacted in the statute is truly being honored.”*



## OTHER LITIGATION

- Effort to extend Section 36(b) in private action against SPACs
  - Centered on theory that SPAC is acting as an unregistered investment company in violation of the ICA and IAA.
- Continuation of “proprietary funds” ERISA litigation
  - Broad interpretation of duties owed by plan fiduciaries, plus lucrative settlements, have fueled additional litigation.



## OTHER LITIGATION

- '33 Act and '34 Act claims based upon allegedly false and misleading representations in prospectuses, public filings, and marketing materials
  - Broad range of asserted misrepresentations, including as to fund investment objectives, misrepresentation of investment risks, and failures to disclose events adversely affecting operations.
- Breach of fiduciary duty claims
  - Typically brought in state court against fund board members, although the adviser may also be named as an “aider and abettor” of asserted breaches of fiduciary duty.





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