

2019 Annual Convention



MARCH 5-8 • THE DIPLOMAT BEACH RESORT • HOLLYWOOD, FLORIDA

SEC and FINRA: 2019 Regulatory Priorities and Enforcement Trends



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Agenda

- SEC/OCIE
 - 2018 Enforcement / Examination Stats Update
 - 2019 Examination Priorities
 - Notable 2018 Risk Alerts
 - Notable 2018 Enforcement Actions
- FINRA
 - 2019 Risk Monitoring and Exam Priorities
 - Other Notable Developments
 - Cybersecurity Focus 2019
- NASAA Enforcement Activity & Priorities





Enforcement Update – FY2018 Results

- Filed **821 enforcement actions** in FY 2018 (compared to 754 in FY17 and 868 in FY16)
- Obtained orders totaling more than **\$3.945 billion** in disgorgement and penalties (compared to \$3.79B in FY17 and \$4B in FY16)
- Returned a record **\$794 million** to harmed investors (down from \$1.07B in FY17)
- Barred or suspended **550 individuals** (down from 625 in FY17)
- **108** actions against investment advisers and investment companies (up from 82 in FY17)
- **56** individuals prosecuted for Insider Trading





SEC OCIE 2019 Examination Priorities: Industry Participants

- 13,200 Investment Advisers
- 10,000 Mutual Funds and ETFs
- 3,800 B/Ds
- 330 Transfer Agents
- 7 Clearing Agencies
- 21 National Securities Exchanges
- 600 Municipal Advisors
- FINRA, MSRB, SIPC, PCAOB



2018 Examination Statistics

- Number of IA/IC exams has continued to increase
 - FY 2016 – exams achieved coverage of 11% of advisers
 - FY 2017 – # of exams increased 40% to achieve coverage of 15% of advisers
 - > Highest percentage of coverage in over 10 years
 - FY 2018 – # of exams increased 10% to achieve a 17% examination coverage ratio
- “...nearly 35 percent of all registered investment advisers have never been examined...Significant additional resources are critical to the examination program in order to improve the examination coverage of these entities.”



SEC OCIE 2019 Examination Priorities

- Release 2018-299 (Dec. 20, 2018)
- Heightened Investor Risk and Capital Market Integrity
- Three Key Areas of Focus:
 - Digital Assets
 - Cybersecurity
 - Retail Investor Issues
 - > Fees
 - > Expenses
 - > Conflicts of Interest



SEC OCIE 2019 Examination Priorities

- Six thematic areas:
 - Retail investors, including seniors and those saving for retirement
 - Compliance and risks in critical market infrastructure
 - FINRA and MSRB
 - Digital assets (*new*)
 - Cybersecurity
 - Anti-money laundering programs



Theme #1: Protecting retail investors

- Disclosure of the Costs of Investing
 - Proper disclosure of fees, expenses and other charges to investors
 - > E.g., Form ADV, investment advisory contracts, PPM/LPAs
- Share Class Selection
 - Evaluate financial incentives that may influence selection of particular share classes
- Wrap Fee Programs
 - Reviewing to see if firms associated with wrap fee programs are acting in a manner consistent with their fiduciary duty



Theme #1: Protecting retail investors (Cont.)

■ Conflicts of Interest

- Review policies and procedures addressing (i) use of affiliated service providers and products, (ii) securities-backed non-purpose loans and lines of credit, and (iii) borrowing from fund clients

■ Senior Investors and Retirement Accounts and Products

- Appropriateness of certain investment recommendations to seniors
- Supervision by firms of their employees and independent representatives

■ Portfolio Management and Trading

- Best Execution
- Investment allocation



Theme #1: Protecting retail investors (Cont.)

■ Never-Before Examined RIAs

- Newly registered RIAs and RIAs that have not been examined in some time
- Risk-based determinations but no clear formula
 - > Factors may include change in strategy, significant drop in AUM, newsworthy events

■ Mutual Funds and Exchange Traded Funds (ETFs)

- Index funds that track custom-built or bespoke indices
- ETFs with little secondary market trading volume and smaller AUM
- Funds with aberrational underperformance relative to peer groups
- Funds managed by advisers that are relatively new to managing registered investment companies

■ Municipal Advisors

- Never-before examined
- Compliance with recently-effective MSRB rules



Theme #2: Compliance and Risks in Critical Market Infrastructure

- Clearing Agencies
 - Annual reviews of those deemed 'systematically important' and risk-based reviews of others
- Transfer Agents
 - Play a critical role in the settlement of securities transactions
 - > Examiners will focus on transfer agent operations, including transfers, recordkeeping, and the safeguarding of funds and securities
- Regulation Systems Compliance and Integrity (SCI) Entities
 - Examiners will continue to review SCI entities and assess the effectiveness of their written policies and procedures as relates to Regulation SCI



Theme #3: FINRA and MSRB

■ FINRA

- OCIE examinations of FINRA will focus on operations and regulatory programs, including the quality of broker-dealer and municipal advisor examinations

■ MSRB

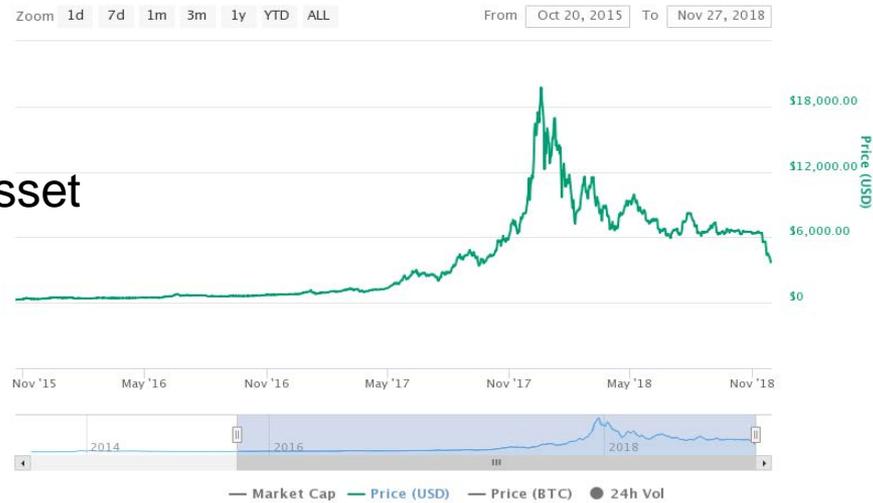
- OCIE examinations of MSRB will focus on the effectiveness of MSRB's operational and internal policies, procedures, and controls



Theme #4: Digital Assets

- Monitor the offerings, sales, trading and management
 - Where the products are securities, examine for regulatory compliance
- For firms actively engaged in the digital asset market, OCIE will focus on
 - Portfolio management
 - Trading
 - Pricing
 - Safety of client assets
 - Compliance and internal controls

Bitcoin Charts





Theme #5: Cybersecurity

Focus Areas Include:

- Proper configuration of networks
- Information security governance
- Policies and procedures
- Access rights and controls
- Vendor management
- Training
- Data loss prevention





Theme #6: Anti-Money Laundering Programs

- The Bank Secrecy Act requires certain financial institutions to establish anti-money laundering programs
 - RIAs do not explicitly fall within this remit, but broker-dealers and mutual funds do
 - AML programs require customer identification, account monitoring, and suspicious activity reporting (SAR)
- Examiners will continue to prioritize examining broker-dealers for compliance with applicable anti-money laundering requirements, with a focus on the compliance and testing of these firms' AML programs
 - No update on the proposed AML rule for advisers



SEC OCIE 2018 Risk Alerts

- Best Execution
- Fees and Expenses
- Cash Solicitation Rule
- Electronic Communications (best practices)



SEC OCIE 2018 Risk Alerts

- Compliance Issues Related to Best Execution
 - The Risk Alert reflects issues identified in deficiency letters from more than 1,500 adviser examinations
 - Advisers may wish to amend their disclosures regarding best execution or soft dollar arrangements, revise their compliance policies and procedures, or otherwise change their practices regarding best execution or soft dollar arrangements
 - Advisers may also wish to assess their supervisory, compliance and/or other risk management systems and make changes to strengthen such systems



SEC OCIE 2018 Risk Alerts

- Compliance Issues Related to Best Execution
 - Most frequent best execution issues cited in adviser exams
 - > Not performing best execution reviews
 - > Not considering relevant factors during best execution reviews
 - > Not seeking comparisons from other broker-dealers
 - > Disclosure issues
 - > Soft dollar issues
 - > Weak policies and procedures



SEC OCIE 2018 Risk Alerts

■ Compliance Issues Related to Best Execution

- Not performing best execution reviews
 - > Advisers must be able to demonstrate that they periodically and systematically evaluate the performance of broker-dealers used to execute trades, and document it
- Not considering materially relevant factors during best execution reviews
 - > Advisers must evaluate any qualitative factors relating to a broker-dealer, including but not limited to the broker-dealer's: (i) execution capability; (ii) financial responsibility; and (iii) responsiveness
 - > Advisers must solicit and review input from traders and portfolio managers



SEC OCIE 2018 Risk Alerts

- Compliance Issues Related to Best Execution
 - Not seeking comparisons from other broker-dealers
 - > Advisers must seek comparisons from competing broker-dealers initially and/or on an ongoing basis to assess their chosen broker-dealer's execution performance
 - > Advisers must not rely solely on cursory reviews of broker-dealer policies and priced when choosing to rely on only one or a limited pool of broker-dealers
 - > Advisers must not rely solely on a broker-dealer's brief summary of its services without seeking comparisons



SEC OCIE 2018 Risk Alerts

- Compliance Issues Related to Best Execution
 - Not fully disclosing best execution practices
 - > Advisers must fully disclose best execution practices
 - > Advisers must disclose, if applicable, that certain types of client accounts trade after other client accounts and the potential impact of this practice on execution prices
 - > Best execution practices must align with disclosures in brochures



SEC OCIE 2018 Risk Alerts

- Compliance Issues Related to Best Execution
 - Not disclosing soft dollar arrangements
 - > Advisers must adequately disclose soft dollar arrangements
 - > Advisers must disclose, if applicable, that certain clients may bear more of the cost of soft dollar arrangements than other clients
 - > Advisers must provide more detailed disclosure of soft dollar arrangements when the products or services they receive do not qualify for the Section 28(e) safe harbor



SEC OCIE 2018 Risk Alerts

- Compliance Issues Related to Best Execution
 - Not properly administering mixed use allocations
 - > Advisers must make a reasonable allocation of the cost of a mixed use product or service according to its use
 - > Advisers must produce document the rationale for mixed use allocations
 - Inadequate policies and procedures relating to best execution
 - > Advisers must have policies relating to best execution
 - > Advisers must have sufficient internal controls to monitor execution performance
 - > Advisers' policies must take into account the current business of the advisers



SEC OCIE 2018 Risk Alerts

- Compliance Issues Related to Best Execution
 - Not following best execution policies and procedures
 - > Advisers must follow their policies regarding best execution review
 - > Advisers must allocate soft dollar expenses in accordance with their policies
 - > Advisers must follow internal policies regarding the ongoing monitoring of execution price, research and responsiveness of broker-dealers



SEC OCIE 2018 Risk Alerts

- Advisory Fees and Expenses
 - Covers six areas of most frequent advisory fee and expense compliance issues
 - > Fee billing based on incorrect account valuations
 - > Billing fees in advance or with improper frequency
 - > Applying incorrect fee rates
 - > Adviser expense misallocations
 - > Omitting rebates and applying discounts incorrectly
 - > Disclosure issues involving advisory fees



SEC OCIE 2018 Risk Alerts

■ Advisory Fees and Expenses

> Fee billing based on incorrect account valuations

- Valuing clients' accounts using a different metric from that which is outlined in the advisory agreement
 - » Valuation of illiquid assets using original cost versus FMV
- Valuing clients' accounts using a process that differs from the process outlined in the advisory agreement
 - » Market value at the end of the billing cycle versus average daily balance of account assets
 - » Assets excluded for purposes of the fee calculation



SEC OCIE 2018 Risk Alerts

- Advisory Fees and Expenses
 - Billing fees in advance or with improper frequency
 - > Frequency of fees inconsistent with advisory agreement and Form ADV
 - > Billing in advance, despite the advisory agreement stating that the client would be billed in arrears
 - > Failure to pro-rate fees for clients whose advisory services began mid-billing cycle
 - > Failure to reimburse clients whose advisory services ended mid-billing cycle, as outlined in the Form ADV



SEC OCIE 2018 Risk Alerts

- Advisory Fees and Expenses
 - Applying incorrect fee rates
 - > Charging a higher fee rate than agreed upon in the advisory agreement or double-billing clients
 - > Charging non-qualified clients performance fees based on a percentage of capital gains
 - Adviser expense misallocations
 - > Allocating of distribution and marketing, regulatory filing fees, and travel expenses to clients



SEC OCIE 2018 Risk Alerts

■ Advisory Fees and Expenses

- Omitting rebates and applying discounts incorrectly
 - Failing to aggregate client account values for households, as described in the advisory agreement or Form ADV
 - Failing to reduce a client's fee rate when the client's account value reached a certain level, as described in the advisory agreement or Form ADV
 - Charging clients brokerage fees for transactions that qualify under a wrap fee program



SEC OCIE 2018 Risk Alerts

- Advisory Fees and Expenses
 - Disclosure issues involving advisory fees
 - > Engaging in business practices that are inconsistent with disclosures in Form ADV
 - Client advisory fees exceeding maximum fees stated in Form ADV
 - Failing to disclose additional fees or markups in addition to advisory fees
 - > Collecting expenses in excess of actual fees
 - > Earning additional compensation or participating in fee sharing arrangements



SEC OCIE 2018 Risk Alerts

- Investment Adviser Compliance Issues Related to the Cash Solicitation Rule
 - Advisers must make sure that solicitor disclosure documents include:
 - > The nature of the adviser and solicitor's relationship
 - > The terms of the compensation arrangement
 - > The actual compensation terms agreed to (avoid vague or hypothetical terms)
 - > The additional cost the client is charged in addition to the advisory fee
 - Advisers must make sure that they receive, before or at the time of entering the advisory agreement, signed and dated client acknowledgments for deliveries of adviser brochures and solicitor disclosure documents



SEC OCIE 2018 Risk Alerts

- Investment Adviser Compliance Issues Related to the Cash Solicitation Rule
 - Advisers must make sure the written solicitation agreements with third party solicitors include:
 - > An undertaking by the solicitor to perform its duties under the solicitation agreement in a manner consistent with the adviser's instructions
 - > A description of the solicitor's activities and the compensation to be paid
 - > Requirements for solicitors to provide clients with the adviser's brochure and solicitor disclosure document
 - Advisers must be able to describe the bona fide efforts taken to ascertain whether third-party solicitors complied with solicitation agreements



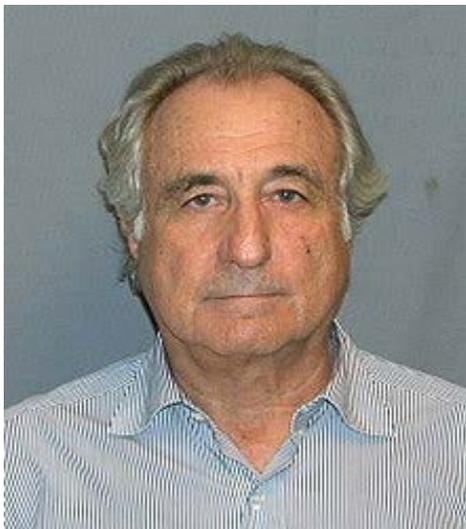
SEC OCIE 2018 Risk Alerts

- Observations from Investment Adviser Examinations Relating to Electronic Messaging
 - Covers electronic messaging other than email (text, apps, social media)
 - Provides observations in the following areas
 - Policies and procedures – be thoughtful about the forms of electronic communication you permit, as they must be able to be used in a manner that allows you to meet your books and records compliance obligations
 - Training and Attestations – provide initial and ongoing training on policies and procedures, collect attestations of compliance, and solicit feedback from personnel to keep abreast of developments
 - Supervisory Review – monitor for unauthorized use of social media, etc.
 - Control over Devices – centralize device management to protect against cyber threats



Notable 2018 SEC Enforcement Actions

■ 2008:



■ 2018:





Notable 2018 SEC Enforcement Actions

- *In re Floyd Mayweather and DJ Khaled*
 - Failed to disclose payments received for promoting ICO investments
 - First SEC cases charging touting violations involving ICOs
 - Mayweather failed to disclose \$300K in promotional payments from three ICO issuers
 - DJ Khaled received \$50K payment from one of same ICO issuers
- Mayweather: \$300K disgorgement; \$300K penalty; \$15K prejudgment interest
- DJ Khaled: \$50K disgorgement; \$100K penalty; \$2700 interest



Notable 2018 SEC Enforcement Actions

- “Share Class Selection Disclosure Initiative” started 2/18
- In re American Portfolio Advisers, Inc., PPS Advisers, Inc. and Lawrence Nicholas Passaretti
 - Invested advisory clients in MF share classes that paid 12b-1 fees even though less expensive share classes of same funds were available
 - Failed to disclose COIs; violated duty to seek best execution; failed to implement policies designed to prevent violations of federal securities laws
 - Expressly misled clients in disclosures about receipt of 12b-1 fees
 - APA paid \$895K disgorgement + \$250K penalty;
 - PPS & Passaretti paid \$631K disgorgement + \$75k penalty



Notable 2018 SEC Enforcement Actions

- Improper Handling of American Depository Receipts
- JP Morgan agreed to pay \$135 million to settle charges of improper handling of “pre-released” ADRs—failure to confirm sufficient collateral being held at corresponding foreign depository bank
- Resulted in inflating total number of shares of foreign issuer’s tradable securities, resulting in abusive sales practices like inappropriate short selling and dividend arbitrage
- 8th action against bank or broker as part of SEC ongoing investigation into abusive ADR pre-release practices



FINRA 2019 Risk Monitoring and Exam Priorities

- Annual Priorities Letter skips for first time the usual ongoing areas of focus—firms should just assume FINRA will review for compliance with these “usual” areas:
 - Suitability determinations
 - Recommendations for complex products, VAs, use of margin
 - OBAs, PSTs and Private Placements
 - Communications with the public
 - AML
 - Best Execution
 - Fraud, market manipulation, insider trading



FINRA 2019 Risk Monitoring and Exam Priorities

- Ongoing Areas of Focus, ctd.
 - Trade and order reporting
 - Recordkeeping
 - Recidivist Advisors
 - Cybersecurity programs



Highlighted Priorities--FINRA 2019

- Use of online distribution platforms in effort to insulate from liability for selling or recommending securities
 - Firms still obligated to fulfill R. 2111 reasonable-basis and customer-specific suitability;
 - supervise communications with customers & public
 - Satisfy AML obligations
- Fixed income markup/markdown disclosure
- Regulatory Technology
 - Are the tools being implemented sufficiently up to the jobs for which they are being deployed?



Highlighted Priorities--FINRA 2019

- Sales Practice Risks
 - Suitability
 - Senior Investors
 - OBAs and PSTs

- Operational Risks
 - Supervision of Digital Assets Business
 - Customer Due Diligence and SARs



Highlighted Priorities--FINRA 2019

- Market Risks
 - Best Execution
 - Market Manipulation
 - Market Access
 - Short Sales
 - Short Tenders
- Financial Risks
 - Credit Risk
 - Funding & Liquidity



Other Notable FINRA Developments

- October 2018: Consolidation of Examination and Risk Monitoring Programs
- January 2019: Self-Reporting of 529 Savings Plan Violations



FINRA Cybersecurity Focus 2019

- Inadequate Branch Controls
- Branch-Level WSPs
- Asset Inventory
- Technical Controls
- Branch Review Program
- Phishing
- Insider Threats
- Data Loss Prevention (DLP)
- Penetration Testing
- Mobile Devices



NASAA Enforcement Activity & Priorities

- 2017 year-end stats:
 - 4790 investigations
 - 2105 enforcement actions
 - \$486 million in restitution ordered
 - 4500 license sanctions
- “Operation Cryptosweep”
 - US/Canadian provincial joint initiative
 - Sweep of promoters and issuers and of illegal crypto offerings
 - More than 200 inquiries and investigations
 - More than 50 operations shut down



QUESTIONS?