May 20, 2019

ACA COMPLIANCE GROUP

ACA Insight

The weekly news source for investment management legal and compliance professionals

"Are there other appropriate responses in lieu of an enforcement action, such as a rulemaking, interpretive guidance, or an educational bulletin for investors?"

Peirce Calls for 'Reasonableness' in SEC Regulation and Enforcement

SEC Commissioner **Hester Peirce** wants the SEC to be more reasonable in how it regulates and enforces, arguing that two recent developments – the agency's Share Class Disclosure Initiative and the Supreme Court's *Lorenzo* decision – give her concern.

The agency, she said in a May 8 speech at **Rutgers Law School** in New Jersey, needs to put on its "reasonableness pants," borrowing a term from a judge in a recent court case. Peirce said that she is "not a fan of the so-called 'broken windows' philosophy,

continued on page 2

Associations Support FSOC Financial Institution Evaluation Changes

Asset management associations this month issued letters of strong support for proposed guidance from the Financial Stability Oversight Council (FSOC) that would alter the way the Council evaluates non-bank financial institutions – a group that includes investment advisers, investment companies and broker-dealers – in terms of their systemic risk to the country's financial stability.

Both the **Investment Adviser Association**, which represents SEC-registered advisers, and the **Investment Council Institute**, which represents regulated funds, in let-

continued on page 4

Put Best Practices in Place to Ensure Branch Office Compliance

Branch office compliance practices have long been high on the SEC's radar. Its Office of Compliance Inspections and Examinations has listed branch offices among its priorities for several years running and issued a risk alert to let advisers know what its examiners found. But ensuring compliance at branch offices, particularly new branch offices following an acquisition, takes considerable time and effort.

"There's been record-breaking merger and acquisition activity in the advisory space," said **Pasquarello Fink & Haddad** partner **William Haddad**, in explaining part of the reason behind the SEC attention. "Firms are buying up other firms with branches. As

continued on page 6

Peirce

continued from page 1

a more-is-always-better, punish-the-small-violations approach to enforcement."

"Instead, I assess, when reviewing an enforcement recommendation from our staff, whether the recommendation is using our enforcement resources wisely," she said. "I ask, was there a meaningful violation? Is this a matter that could have been handled by our exam program? Are there other appropriate responses in lieu of an enforcement action, such as a rulemaking, interpretive guidance, or an educational bulletin for investors?"

Whether due process is being followed must also be a consideration in enforcement actions, "for example by asking whether an action would constitute rulemaking by enforcement, push the bounds of the SEC's authority, punish unduly aged conduct, or be based on an inappropriately induced waiver of attorney-client privilege," Peirce said. She added that she also tries to consider any unintended consequences that might result from enforcement actions, such as their effect on chief compliance officers or added costs to shareholders.

In terms of the Division of Enforcement's Share Class Disclosure Initiative, and what the SEC will do now that the Supreme Court's *Lorenzo* decision has potentially increased the agency's enforcement options, "I would like to ask whether we are wearing our reasonableness pants."

"The Commissioner recognizes that the SEC is 'not an enforcement agency, but rather a regulatory agency that uses enforcement as one tool,'" said **Greenberg Traurig** partner **Robert Long**. "Having more than one tool in the SEC toolbox is important, because if its only tool is the enforcement hammer, then, as the saying goes, everything is a nail."

Peirce's approach to enforcement is "encouraging," he said. "Rather than advocating a 'broken windows' philosophy, her approach is grounded in reasonableness, due process and a focus on particular facts – not one-size fits all initiatives. Although she doesn't control the Commission, she is a vote, so the staff will likely take note of her views. After all, enforcement actions are typically voted on by the Commission."

"Peirce has (again) expressed her concern about the SEC 'overstepping' as a regulator and becoming an enforcement agency," said **Tesser Ryan** senior counsel **Alexandra Lyras**. "Her solution to this problem is for legislation to be more clearly written and the SEC to offer more rulemaking and interpretive guidance, which is great in theory. She reinforces her cautionary message by expressing dissatisfaction with the expansion of liability resulting from the Share Class Disclosure Initiative and the *Lorenzo* decision."

"Peirce's position, however, is a tight rope to walk," she said. "The SEC clearly needs to protect investors from unscrupulous advisers. The trick is how to give the SEC enough power (and resources) as a watchdog to root out the predators without leaving the predominantly honest players in the industry in a state of fear and uncertainty. I think taking the time to distinguish the bad from the good players (that is, less sweeping initiatives) and more rulemaking and guidance would be a 'reasonable' place to start."

Share Class Disclosure Initiative

Under the Share Class Disclosure Initiative, launched in February 2018 (*ACA Insight*, 2/26/18), advisers that had placed clients in certain mutual fund share classes when lower-fee share classes of those same investments were available could self-report to the SEC and avoid civil money penalties. They would still face possible censure and have to pay disgorgement.

The initiative was not the first time the agency's Division of Enforcement had cracked down on advisers that placed clients in more expensive share classes, with the additional expense typically tied to payment of 12b-1 fees, and not disclosing the existence of lower-cost share classes to the clients. It had made several settlements with advisers involving this violation in years prior to the initiative.

What the initiative did, however, was to empower the Division with a way to conserve limited resources by offering such advisers settlements that would not involve having to investigate each case individually. While some defense attorneys questioned the value of the proposed arrangement, quite a few apparently encouraged their clients to take it, as in March of this year 79 advisory firms chose to self-report share class disclosure violations, agreeing to pay more than $125 million in disgorgement and interest (*ACA Insight*, 3/18/19).

"I do not view this initiative as a high point in the Commission's history," said Peirce. While acknowledging that the aggregation of cases "helped to preserve precious staff resources and perhaps the participating advisers' reputations," she said, these benefits "came at a great cost to the individual consideration these cases deserve."

Peirce argued that by grouping the cases together for the public, "important distinctions" were "obscured." She noted that "some of these firms affirmatively lied; they accepted Rule 12b-1 fees, even though they said they did not. Other firms had disclosures that we deemed to be subpar, but, at least in broad strokes, disclosed the conflict at issue. These are two very different types of violations, but they were lumped together and presented to the public as if they were cut from the same cloth. More generally, an initiative like this one by its nature obscures the different facts and circumstances of each participant and emphasizes the similarities."

More fundamentally, Peirce said, the fact that so many advisers participated in the initiative "suggests that the SEC has fallen down on its job as a regulator." While the advisers themselves have a fiduciary duty and must act on it, she said, "the SEC also has a duty. Our duty is to be clear with registrants about our interpretation of the fiduciary duty. If we see a widescale departure from the fiduciary duty as we interpret it occurring over numerous years, we owe it to the firms we regulate and – more importantly – the investors whom we are charged with protecting to be very clear that there is a problem."

"A regulator wearing its reasonableness pants tells the firms it regulates what their regulatory objections are," Peirce said. In cases where the agency sees a widespread problem, the Commission should issue guidance or promulgate a rule. Doing so, she said, is "respectful of the due process of the firms we regulate by giving them notice of what the SEC expects from them."

"Sadly, that is not what happened" with the Share Class Disclosure Initiative, Peirce said. "We spotted a problem and let it fester without a definitive reaction from the Commission for five plus years."

The Lorenzo decision

The Supreme Court, in its March 2018 ruling in *Lorenzo v. Securities and Exchange Commission*, likely enabled the SEC and private parties to bring fraud charges in more cases and assess more sanctions. In most cases, these additional charges would be against individuals at asset management firms accused of sending false statements that others wrote (*ACA Insight*, 4/15/19).

The high court's ruling centered on the application of Advisers Act Rule 10b-5 and its three parts. The Court said that an individual or firm found to have made an untrue statement under Rule 10b-5(b), regardless of whether that individual or firm was the creator of the untrue statement and was simply distributing it, may also be charged with the other two parts of the Rule, (a) and (c), meaning involvement in a fraud scheme. Under part (b) alone, the party could be charged only with making an untrue statement.

Peirce, in her speech, took issue with the high court ruling, quoting arguments from the dissent, written by Justice **Clarence Thomas**, from the majority opinion.

In terms of "reasonableness pants," she said "it is awfully tempting for the SEC to read and attempt to apply *Lorenzo* as broadly as possible. I hope we will instead keep in mind how unseemly it is when a regulator stretches its authority to its outer limits or beyond. Even in the wake of a Supreme Court win, restraint is the better approach. Reasonableness pants are always well-fitting, not stretched beyond decency."

"We must exercise the provisions at issue in *Lorenzo* with wise discretion," Peirce said. "We must respect the proper line between what primary and aiding-and-abetting liability is. . . . It is important for us and the courts not to ascribe primary liability to every violation and thus write aiding and abetting out of the statute. Instead, we have to think carefully about where the line between primary and secondary liability lies in particular cases. Even substantial conduct may not qualify as a primary violation. With that in mind, let us keep our reasonableness pants on and be judicious in how we exercise our authority to bring enforcement actions in the wake of *Lorenzo*."

Associations Support

continued from page 1

ters commenting on FSOC's March proposed guidance (*ACA Insight*, 4/15/19), spoke highly of the proposal's main element, evaluating non-bank financial companies based on activity, rather than on an institutional basis.

"We strongly support the Council's proposed activities-based approach to identifying, assessing and addressing potential risks and threats to U.S. financial stability, as well as a more transparent and rigorous determination process in the unlikely event that a potential risk or threat cannot be addressed through an activities-based approach," the IAA said in its 10-page May 10 comment letter.

The ICI, in a 28-page, May 13 comment letter, also backed the proposal. "We strongly support the proposal, which thoughtfully outlines the Council's intended use going forward of its various authorities to identify and address potential risks to U.S. financial stability, and we urge its prompt adoption."

In addition to strongly backing much of the Council's proposed guidance, both organizations also recommended some further changes.

Why the change

FSOC's shift in how it proposes to evaluate non-bank financial institutions is significant. Created following the 2008 financial crisis as part of the Dodd-Frank Act in July 2010, the Council brought together diverse regulators, including the SEC, the CFTC, the Treasury Department and more in one body. It was charged, according to the Treasury Department, with "identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system."

Its authority included designating institutions that it found to pose such risks as "Systemically Important Financial Institutions (SIFIs)," more colloquially known as "too big to fail." This was a designation that almost all financial firms sought to avoid, as it would impose additional requirements upon them.

The Council ran into headwinds from the asset management community, in that it was perceived as seeking to regulate advisory firms and others in ways similar to how banks are regulated. This type of "prudential regulation" did not sit well with much of the industry. The IAA, in its comment letter to FSOC in regard to the latest proposal, reiterated its point that "the fundamental nature of asset managers does not pose systemic risk."

It went on to say that the reason why asset managers are fundamentally not a source of systemic risk is "because asset management is an agency business in which an asset manager's core function is to manage assets as an agent on behalf of others. An asset manager is neither a counterparty to nor a guarantor of its clients' investment risks. Asset managers are also separate legal entities from the funds and separate accounts they manage and there is no recourse to the asset manager in the event of losses in the funds or separate accounts."

"Whether the adoption of the FSOC proposal is a good or bad thing can be debated, but it seems to represent a withdrawal of FSOC from efforts it made after the financial crisis to address systemic risk outside of the banking space," said **Proskauer** partner and former SEC Division of Investment Management Deputy Director **Robert Plaze**. "This part of the Dodd-Frank Act was clunky from the start, and I always thought that it would not survive the passage of time as memories of the financial crisis faded. The governmental energy and political capital that it took just to write the rules and then designate a few non-bank SIFIs was enormous."

"FSOC's current approach, with its focus on market actors, may be both over-inclusive and under-inclusive," said **Sidley Austin** counsel **William Shirley**. "Over-inclusive because it highlights certain market actors only as rough proxies for their activities (and not because the actors' failure would alone cause market distress); under-inclusive because it misses the full range of interconnections within our financial markets. FSOC now proposes to focus more on market activities, separate and apart from market actors. That would be a welcome change in FSOC's oversight model."

IAA recommendations

The IAA, in its comment letter, while supporting other parts of the FSOC proposed guidance, also made a number of recommendations. One of these was that asset managers "be exempted as a class from Systemically Important Financial Institution (SIFI) designation."

The IAA justified this recommendation by noting that there already exists a regulatory regime for asset managers, one that has continued to develop, noting recent requirements for advisers, including for liquidity management and leverage, enhanced data reporting, and stress testing.

"Asset management is a highly regulated business, subject to numerous specific rules and interpretive guidance, most of which are derived from the overarching fiduciary duty asset managers owe their clients," the agency said.

The IAA strongly supported another part of the FSOC proposed guidance, allowing the relevant existing regulatory agencies to address any potential risks discovered by the Council. So, for instance, FSOC would involve the SEC in situations where such risks were discovered at advisory firms.

Other recommendations made by the adviser association included:

- **Encourage regulators "not to take a 'one-size-fits-all' approach, but rather to appropriately tailor regulations or guidance to the unique attributes of the regulated businesses."** FSOC should also encourage regulators to consider the "cumulative effect" of all regulations on regulated entities of all size on an ongoing basis," the IAA said.
- **Focus its activities-based review on "those products, activities and practices that have potentially/likely systemic impact."** This review would be based on four "framing questions" the Council proposed when evaluating a product, activity or practice: how a potential risk could be triggered, how its adverse effects might be transmitted to financial markets and participants, its possible impact on the financial system, and the potential for harm to the non-financial sector. In regard to these four framing questions, the IAA recommended four areas that it said FSOC should focus on: 1) activities, products or markets that are new, untested and unregulated; 2) fundamental changes in existing products, markets or activities, and key service providers or market participants; 3) cross-jurisdictional risks that may result in products or activities that are not adequately monitored or regulated; and 4) historical sources of financial disruptions.
- **Focus on the likelihood, rather than the possibility**, of triggering potential risk, transmitting adverse effects to financial markets or market participants, impact on the financial system, and impairing the financial system in a manner that could harm the non-financial sector of the U.S. economy.

ICI recommendations

The ICI praised the FSOC proposal, noting that the changes in it "represent a giant step forward." In particular, the association said that the changes in the proposed guidance provide for:

- More analytical rigor and attention to actual experience,
- Evaluation of benefits and costs and assessment of the likelihood of a company's material financial distress,
- Earlier and more extensive engagement with a company being considered for possible designation,
- Enhanced engagement with the company's primary financial regulatory agency,
- A clear 'off-ramp' for designated companies, and
- Greater transparency and accountability.

ACA COMPLIANCE GROUP

The ICI did have some recommendations, many of them dealing with the details of risk analysis and determining the systemic risks that might occur through various transmission channels. Other recommendations include the following:

- FSOC should make explicit in its guidance its intention to consult primary regulators when assessing a company's potential financial distress,
- The requirement of a vote by FSOC principals when making a decision to review an individual company,
- Codify in the proposed guidance that the Council intends to grant a company's timely request for an oral hearing, and
- Codify in the proposed guidance that the Council would grant that a company's timely request for an oral hearing be conducted by members of the Council, rather than the staff.

Put Best Practices in Place

continued from page 1

branches are snapped up, promises are often made to those in the branches that everything will be the same, but then chief compliance officers from the acquiring firm often tell the acquired branches that they cannot keep doing certain things they used to do, whether involving advertising, signage or the kinds of deals they have been making."

A lot depends on the type of advisers at each branch office and how the firm's compliance infrastructure works, said **Morrison & Foerster** of counsel **Kelley Howes**. "Some businesses might be mainstream, others might focus on alternative assets or manage different types of accounts. Different types of work are going to need different types of compliance help."

This extends to cybersecurity. In its 2019 examination priorities list, OCIE said that it "will emphasize cybersecurity practices at investment advisers with multiple branch offices, including those that have recently merged with other investment advisers, and continue to focus on, among other things, governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response."

In its 2017 priorities, OCIE said it would "continue to focus on registered investment advisers that provide advisory services from multiple locations. The use of a branch office model can pose unique risks and challenges to advisers, particularly in the design and implementation of a compliance program and the oversight of advisory services provided at branch offices." In its 2016 priorities, it said that it would review supervision of both advisory firm and broker-dealer representatives at branch offices in regard to potentially inappropriate trading.

OCIE's December 2016 Risk Alert (*ACA Insight*, 1/2/17), said that examiners would be focusing on advisers with multiple locations, and "evaluating the design and effectiveness of advisers' compliance programs with respect to their oversight of advisory services provided at remote locations."

The agency's scrutiny is not likely to abate, both because of new mergers and acquisitions, and simply because supervision over a distance will always raise compliance issues. "The more branch offices that a registered investment adviser has, the more difficult it becomes to be sure that compliance policies and procedures are effectively implemented across all locations," said **Pepper Hamilton** partner **John Falco**.

Specific challenges, he said, include the following:

- Consistent firm-wide policies and procedures across many locations;
- Branch-specific risks, in terms of identifying them, assessing their likely impact, and then addressing them;
- How compliance responsibilities between the home office and branch offices should be allocated;
- Development of effective branch compliance reviews and tests;
- Development of effective privacy cybersecurity practices;

- Identification and addressing of branch office conflicts of interest;
- Maintenance of books and records at branch offices; and
- Maintenance of accurate and consistent disclosures across branches.

CCOs should always keep in mind the "remoteness factor" and the "cultural factor," said Haddad. While the remoteness factor – the actual distance between the home office and the branch offices, which can be considerable after an acquisition of out-of-state advisers or branches – may have declined a bit due to the abilities the Internet and electronic communication provide, they are no substitute for being onsite, where a professional compliance officer can learn firsthand how things work, where the problems are, and directly communicate with staff.

The cultural factor – the "compliance tone" at different locations and the way staff operate – can be more difficult to address, he said. "If you have, say, 15 branches nationwide, you can send them policies and procedures, you can call them, you can go out and visit them. You can send them the book, but that doesn't mean they get the book," as in understanding it and living it.

"There is a difference when the compliance officer is just down the hall," said Howes. "Some branch offices may be so small that there are no compliance officers at that branch."

Meanwhile, the home office CCO is most likely deep into compliance issues and operational issues at that home office, but must make time for compliance at the branches, even if that is a new responsibility. "The CCO cannot get so involved at the corporate level that he or she loses touch with the branches," she said.

Best practices

With that in mind, consider the following best practices when supervising compliance at branch offices:

- **Conduct a risk assessment of each branch.** "Look at disciplinary history, whether there is a need for heightened supervision, personal securities history, whether there has been cherry-picking or other activities that are not allowed," said Haddad. "Conduct daily trade checks, look at fee disclosure, do email monitoring." Above all, he said, "Do not fall into the trap of saying to branch employees, 'Nothing will change.' Transitions can take months."

- **Develop a compliance review and testing plan.** These should be specific to each branch office and be based on the risk assessment from each office, Falco said. The compliance review and testing, which should make use of technology, should involve interviewing branch office employees and contractors "with senior compliance personnel conducting the branch reviews," he said. Some of the testing and reviews should be unannounced, and address areas of SEC concern, including those concerns listed in the OCIE Risk Alert, including fees and expenses, code of ethics, advertising, cybersecurity and custody.
- **Visit branch offices.** Telephone calls and emails are not enough. Initial visits should be followed up by once-a-year, twice-a-year or three-times-a-year inspections, as necessary, said Haddad. "There is no perfect solution as to the number of visits that are needed. Do what is necessary. Rinse and repeat. Make sure that you send a trained professional who knows what to look for. If you find some insufficient policy initiatives that cause problems, elevate them to the priorities list."
- **Consider having branch employees visit the home office.** One of the advantages to this is that the branch employees will, for the length of their visit, be immersed in the home office compliance culture, see how compliance works in the home office, then take that experience back to their branches. The downside is that such visits can be expensive, Haddad said. Howes suggested inviting all branch office compliance officers to the home office for an annual risk assessment. "Local branch people may see different risks than those in the home office and vice versa," she said, and that is information the chief compliance officer should know. ☙

Note to Readers

The next issue of *ACA Insight* will be dated June 3, 2019. We wish you all a happy and safe Memorial Day weekend. ☙

ACA COMPLIANCE GROUP

ACA Insight

The weekly news source for investment management legal and compliance professionals

Published by:
ACA Compliance Group
(301) 495-7850
(301) 495-7857 (fax)
service@acainsight.com

Editor/Publisher:
Robert Sperber
(301) 502-8718
rsperber@acacompliancegroup.com

To Subscribe:
(800) 508-4140
subscribe@acainsight.com
Annual subscriptions (46 electronic issues, web access, and breaking news alerts) are $1,295.
Multi-user site licenses are available.

Customer Service:
(800) 508-4140
service@acainsight.com

On the Web:
www.acainsight.com