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SEC Regulatory and Enforcement Trends: How to Prepare for the SEC in 2020

North America Financial Regulation & Enforcement Practice | January 14, 2020



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THE SEC AND ITS CHICAGO REGIONAL OFFICE

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SEC REGULATORY TRENDS AND RECENT DEVELOPMENTS

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SEC ENFORCEMENT TRENDS AND RECENT DEVELOPMENTS

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The SEC and its Chicago Regional Office

SEC Leadership: Chair and Commissioners

Lessening Regulatory Burden on Raising of Corporate Capital While Increasing Regulatory and Enforcement Focus On Financial Industry Practices



Allison Herren Lee
Commissioner
Since 2019



Jay Clayton
Chair of SEC
Since 2017



Elad L. Roisman
Commissioner
Since 2018



Robert J. Jackson Jr.
Commissioner
Since 2018



Hester M. Peirce
Commissioner
Since 2018

The SEC's Chicago Regional Office

Significant Influence and Impact

- CHRO oversees examinations and enforcement investigations with a nexus to the Midwest
- Recent retirement of CHRO Co-Head of Enforcement
- Heads of CHRO BD Exam and IA/IC Exam are both former Enforcement attorneys
- Close coordination between CHRO examination and enforcement staff
- Current CHRO Regional Director was former senior official at the US Attorney's Office in Chicago
- Many Enforcement Units, including Asset Management Unit, have teams embedded at CHRO
- Current Director of OCIE was former CHRO Assistant Regional Director and former CHRO enforcement attorney

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SEC Regulatory Trends and Recent Developments

SEC Trends and Recent Developments

Rulemaking and OCIE Priorities & Risk Alerts Maintain Wide Scope

- **Protecting Retail Investors and those saving for retirement**
 - Every enforcement matter, every examination, every public statement has some relation to this overarching focus
 - Advice provided to retail investors (seniors, teachers, military personnel)
 - High-risk products and retail-targeted investments
 - Mutual funds and ETFs
 - Municipal securities and other fixed income securities
- **Continuing Focus on Fees and Expenses**
 - Calculation of fees and expenses (house holding and other discounts)
 - Undisclosed (or inadequately disclosed) compensation arrangements

SEC Trends and Recent Developments

OCIE Priorities Include Focus on Reg BI Rule Set and Cybersecurity

- Regulation Best Interest (Reg BI) and Related Rules and Interpretations
 - Continues to be a focus pre-implementation
 - After compliance date – implementation of Reg BI policies and procedures on conflicts of interest, content and delivery of Form CRS
 - Investment adviser interpretation already integrated into IA/IC examination program
 - Strong indication OCIE will immediately examine for Reg BI implementation
- Cybersecurity and Data Privacy
 - Priority in every examination program
 - Third-party and vendor risk management, including cloud-based storage
 - Online access and mobile application access

SEC Trends and Recent Developments

OCIE Priorities Continue to Present Focus on Retail Investor Protection

- Investment Adviser Compliance Programs
 - Focus on advisers that are dual registrants or affiliated with broker-dealers, supervised persons who are registered representatives of unaffiliated brokers
 - Best execution, prohibited transactions, fiduciary advice, disclosure of conflicts
 - Due diligence on third-party asset managers
 - Adequacy of disclosures on new or emerging investment strategies, including sustainable and responsible investing (ESG)
- Anti-Money Laundering Programs
 - Focus on investment company and broker-dealer compliance with CIPs
 - SAR filing obligations

SEC Trends and Recent Developments

OCIE Priorities Include Fintech and Market Structure Matters

■ FinTech

- SEC registrants engaged in digital asset space – investment suitability, portfolio management and trading practices, safety of client funds and assets, pricing and valuation, effectiveness of compliance programs, supervision of outside business activities
- Electronic investment advice – registration eligibility, cybersecurity, marketing practices, adequacy of disclosures concerning fiduciary disclosure, effectiveness of compliance programs

■ Trading and Broker-Dealer Risk Management

- Odd lots (or fractional shares), which often require special treatment
- Algorithmic trading activities, including development, testing, implementation, maintenance, and modification of programs that support automated trading activities and access to code

SEC Trends and Recent Developments

SEC Proposed Advertising Rule Rewrite (Comments Due February 10)

- Proposed Amendments to Investment Adviser Advertising Rule
 - Principles-Based Approach
 - Eliminates specific prohibitions on testimonials and past specific recommendations
 - Addresses actual and hypothetical performance
 - Redefines Concept of an “advertisement” – includes communications directed to private fund investors
 - New Review and Approval Process – designated personnel, but not SEC or FINRA staff approval
 - Amendments to Form ADV and Books and Records Rule

SEC Trends and Recent Developments

SEC Also Proposed Solicitation Rule Modernization Amendments

- Proposed Amendments to Investment Adviser [Cash] Solicitation Rule
 - All Compensation – Proposed rule applies to both cash and non-cash
 - Private Fund Investors – Solicitation of fund investors would be subject to the rule
 - Solicitor Disclosures Expanded – Including discussion of conflicts of interest
 - Disqualifying Events Include Expanded List of Regulators in Addition to US Courts
 - Adviser Can Fulfill Solicitor Disclosure – Adviser may fulfill the solicitor disclosure requirement on behalf of the solicitor and provided the written agreement makes designation
 - Elimination of Duplicate Form ADV Part 2A Delivery Requirement

State-Level Standards of Care Rulemaking

Massachusetts Forged Ahead with State Fiduciary Rule in December 2019 While New Jersey Has April 2020 Regulatory Action Deadline

- Massachusetts Fiduciary Issued Pre-Proposal in July 2019, followed by Proposed Rule in December 2019
 - Both proposals build on existing state dishonest and unethical practices rules, with an emphasis on broker-dealer conduct, but with impact on IARs as well
 - Proposal includes ongoing fiduciary duty requirements, triggered by a variety of objective factors (contractual requirements) and subjective factors (reasonable client expectations)
- Hearing January 7, 2020 Included Coordinated Industry Opposition
 - Timing of adoption and extent of future revisions remains unclear currently
 - Rule could be adopted as early as February/March 2020 (though implementation/enforcement deadline would be later)
- New Jersey rulemaking similar but contains different triggers for application

SEC Reg BI & State Standards of Care

Examinations for Reg BI will Occur Amid Conflicting Policy Landscape

- SEC & FINRA Collaborating Closely To Roll Out Reg BI Exams
 - Implementation of exams modules and interpretation of Reg BI ongoing work for SEC and FINRA (including rule-writing & exams staff)
 - SEC Reg BI FAQs continue to be delayed; FINRA will follow SEC interpretations
- State Securities Regulators Plan to Complete Reg BI Branch Exams
 - NASAA has Reg BI Implementation Committee
 - Regulatory coordination with SEC chilled by AGs' Reg BI lawsuit
- State Fiduciary Proposals in Conflict with Reg BI
 - State proposals attempt to complement/improve Reg BI but raise conflict preemption
 - A state fiduciary rule (MA or NJ) near to adoption but will trigger litigation

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SEC Enforcement Trends and Developments

SEC Enforcement Trends and Developments

Aggressive Enforcement Tactics and Case Theories

- Retail Investors Focus: Potentially More Enforcement Cases Against Investment Advisers
- Length of Investigations Getting Longer / Benefit in Resolving Exam Deficiencies to Avoid Enforcement Referral
- A Pivot from Disclosure to Consumer Protection Enforcement Regime?
 - Conflicts of Interest
 - Hidden Fees and Costs
- Rulemaking by Enforcement
 - Expansive Secondary Liability Theory to Prohibit Longstanding Market Practices
 - Use of Sweeps and "Self-Reporting" Initiatives
 - Moving the target on "adequate" disclosure
- Additional Trends and Focus
 - Breach of Duty as an alternative to Fraud Theory?
 - Pricing and valuation of bonds and illiquid securities

SEC Enforcement Trends and Developments

Fiscal Year 2019 Represented the Best Year That the Enforcement Division Had Since 2016

Fiscal Year	Total Number of Enforcement Actions	Number of "Standalone" Actions	Total Penalties and Disgorgement Ordered
2015	807	508	\$4.19 billion
2016	868	548 (96 MCDC)	\$4.08 billion
2017	754	446	\$3.79 billion
2018	821	490	\$3.945 billion
2019	862	526 (95 SCSD)	\$4.349 billion

SEC Enforcement Trends and Developments

2019 Case Statistics by Categories: Decline in Cases Against Broker-Dealers

Type of Case	Number of Actions	Percentage of Total Actions	Number/Percentage in 2018
Investment Advisers/ Investment Companies	191	36	108 cases/22%
Securities Offering	108	21%	121 cases/25%
Issuer Reporting/Audit & Accounting	92	17%	79 cases/16%
Broker-Dealer	38	7%	63 cases/13%
Market Manipulation	30	6%	32 cases/7%
Insider Trading	30	6%	51 cases/10%
FCPA	18	3%	13 cases/3%
Public Finance Abuse	14	3%	15 cases/3%
SRO or Exchange	3	1%	1 case/0%
Miscellaneous	1	0%	3 cases/1%
Transfer Agent	1	0%	2 cases/0%
National Recognized Statistical Ratings Organization (NRSRO)	0	0%	2 cases/0%
TOTAL	526	100%	490 cases/100%

SEC Enforcement Trends and Developments

Decrease of Exam Referrals to Enforcement/Voluntary Return of Money to Investors as a Result of Deficiency Findings (\$70 Million in 2019)

Fiscal Year	Total Exams	Percentage Identifying a Deficiency	Percentage Resulting in "Significant Finding:	Percentage Resulting in Enforcement Referral
2014	1,878	76%	30%	12%
2015	1,992	77%	31%	11%
2016	2,427	72%	27%	9%
2017	2,873	72%	20%	7%
2018	3,175	69%	20%	6%
2019	3,089	not yet available	not yet available	not yet available

Case Study: Share Class Selection Disclosure Initiative

Example of Consumer Protection Pivot and Rulemaking by Enforcement

- 95 firms whose voluntary participation in the SCSDI to return a total of USD 135 million to investors
- Firms allegedly selected mutual fund share classes for client accounts that paid 12b-1 fees, when lower cost share classes of the same fund were available, and the firm failed to fully disclose the conflict of interest
- Once firms started to disclose, Enforcement moved the target and the issue became whether the disclosure was sufficient
- Many years of these very same mutual fund compensation practices had gone unnoticed in the OCIE exam process

Case Study: ADR (American Depository Receipts) Sweep

Example of Rulemaking by Enforcement and Aggressive Use of Secondary Liability Theory

- 11 separate cases (just in 2019) related to the “improper handling” of pre-released ADRs with total USD 295 million disgorgement and penalties.
- Depository banks and the intermediary brokers allegedly failed to abide by the terms of their pre-release agreements, with the result that these intermediary brokers were able to obtain pre-released ADRs in significant quantity, and furthered and permitted other alleged market abuses, like dividend arbitrage and short selling transactions
- The claims against the brokers who then borrowed shares from the intermediary brokers were that those firms' borrow transactions were improper because the SEC asserted that **they should have known** that the intermediaries with which they transacted were in violation of their pre-release agreements with the depository banks, and not in custody of the foreign shares.

Case Study: ADR (American Depository Receipts) Sweep

Example of Rulemaking by Enforcement and Aggressive Use of Secondary Liability Theory

- Dated conduct and transactions and Respondents were regularly examined throughout the period during which the conduct was alleged to have occurred, by the SEC, by FINRA, for the broker-dealers, and even by the banking regulators
- Yet conduct was never flagged as a securities law or any other violation. That is until the Enforcement Division concluded that dividend arbitrage transactions somehow rise to the level of “market abuse;” that the contracting parties’ failure to meet the terms of their pre-release agreements could rise to the level of a non-scienter based fraud
- SEC argues that **non-parties** to those pre-release transactions **should have known** about those third parties’ failures and “supervised” their personnel more closely to avoid borrowing such shares

Case Study: IA to Prudential Series Fund and Advanced Series Trust

Conflict of Interest and Hidden Costs: In the Matter of *AST Investment Services, Inc. and PGIM Investments LLC*, Sept. 16, 2019

- SEC charged two subsidiaries of Prudential Financial Inc. with failing to disclose conflicts of interest and making misleading disclosures to the boards for 94 funds they advised in connection with reorganization of funds to provide tax benefits to **Prudential**.
- Prudential Fund Advisers AST and PI allegedly cost the funds tens of millions of dollars in interest income when they temporarily recalled securities the funds had out on loan. AST and PI did not disclose, to the funds' boards of trustees or the beneficial owners of the funds' shares, the conflict of interest between Prudential and the funds in connection with the recalls.
- The funds' reorganization subjected them to less favorable tax treatment in certain foreign jurisdictions, but Prudential did not timely reimburse the funds for resulting losses despite AST and PI's assurances to the fund boards it would do so.

Case Study: Breach of Duty Action With No Fraud Charges

Focus on Pricing of Bonds and Breach of Fiduciary Duty

SEC v. Comer Capital Group, LLC and Brandon Comer (June 27, 2019)

- SEC civil action against MA and its Managing Director for “breaching their fiduciary duties” in violation of Section 15B(c)(1) of the Exchange Act in connection with negotiated offering by Harvey Public Library District
- Not Fraud Charges: Foreshadow of Enforcement Approach to Reg BI and IA Fiduciary Duty?
- Alleged Breach of Duty of Loyalty
 - MA, previously recommended by underwriter to issuer, asked underwriter to intercede with issuer to increase MA fees.
- Alleged Breach Duty of Care
 - MA allegedly failed to provide “contracted-for advice” regarding selection of underwriter. Underwriter was inexperienced and ultimately had difficulty finding investors.
 - MA failed to provide “contracted-for advice” regarding pricing of the bonds by failing to perform specific undertakings and steps detailed in MA agreement with Issuer.
- SEC also alleged that price of the bonds was “not fair and reasonable” to the Issuer



Questions

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