March 18, 2019

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ACA Insight

The weekly news source for investment management legal and compliance professionals

"Now we will see what happens with the advisers who elected not to participate in the Initiative."

Multiple Adviser Settlements Demonstrate Clout of SEC's Share Class Initiative

The SEC knocked it out of the park this month, demonstrating to naysayers that its Share Class Selection Disclosure Initiative has been effective in appealing to advisory firms. The agency on March 11 announced settlements with 79 different advisory firms that chose to self-report their violations. While these firms collectively agreed to pay more than $125 million in disgorgement and interest, they also escaped having to pay civil money penalties.

The Share Class Selection Disclosure Initiative, announced by the SEC in February

continued on page 2

SEC Alleges Adviser Ignored Compliance Responsibilities, Falsely Identified CCOs

Compliance and chief compliance officers are not just for show. Advisers that name CCOs but then fail to give them responsibility for administering their firm's written compliance policies and procedures may be called out by the agency for doing just that – as one advisory firm found out.

The SEC on March 7 charged New York City-based adviser **Ascension Asset Management** and its founder/owner **Grenville Gooder Jr.** with materially false identification of two CCOs, failure to adopt and implement written compliance policies and

continued on page 4

Custody Rule Reform: SEC Seeks Input on Non-DVP Practices, Digital Assets

The SEC staff, in what might be considered a prelude to reform of Advisers Act Rule 206(4)-2, the Custody Rule, on March 12 issued a public letter to the Investment Adviser Association seeking answers to questions involving a certain type of custodial practice, as well as questions related to custody of digital assets. Reform of the Rule is listed on the agency's long-term regulatory agenda, and the letter should be a welcome sign to those calling for the SEC to move forward.

The letter, "Engaging on Non-DVP Custodial Practices and Digital Assets," appears

continued on page 6

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Multiple Adviser Settlements

continued from page 1

2018 and the subject of much attention since, allowed advisers to avoid financial penalties if they voluntarily came forward and acknowledged that they enrolled clients in certain mutual fund share classes when less expensive share classes of the same investments were available. The additional expense was typically tied to the payment of 12b-1 fees, which, along with the fact that lower-cost shares were available, was not disclosed to investors. To take part in the Initiative, advisers had to self-report by June 12, 2018.

"We all knew these cases were coming, but no one knew how successful the SEC's efforts would be," said **Shartsis Friese** partner **Jahan Raissi**. "While not surprisingly large, the number of firms involved and the dollar amount of disgorgement is impressive and is certainly a success for the SEC. The results validate the Initiative as a smart approach by the SEC to address a widespread practice with its limited resources."

"Now we will see what happens with the advisers who elected not to participate in the Initiative," he said. "To show the industry the benefit of participating in such sweeps, we can expect to see the SEC insisting on more onerous settlement terms – requiring civil money penalties (which the advisers that participated in the initiative avoided) and possibly actions against individuals as well as the advisory firms."

"I'm sure the SEC views the Share Class Selection Disclosure Initiative as a huge success and we are likely to see more of these kinds of initiatives from the agency," said **Mayer Brown** partner **Matthew Rossi**. "These types of initiatives allow the agency to rapidly address what it perceives as an industrywide problem while expending a minimum of resources."

"I am pleased that so many investment advisers chose to participate in this initiative and, more importantly, that their clients will be reimbursed," said SEC Chairman **Jay Clayton**. "This initiative will have immediate and lasting benefits for Main Street investors, including through improved disclosure."

All of the settlements announced March 11 resulted from the Initiative, and all, according to the SEC, involved share classes tied to 12b-1 fees, which are typically used to pay for distribution. Those fees went to advisers that also acted as broker-dealers, as well as to broker-dealer affiliates, or to advisory firm personnel who are also registered representatives.

These payments "creat[ed] a conflict of interest with . . . clients, as the investment advisers stood to benefit from the clients' paying higher fees," the agency said in its announcement of the multiple settlements.

"The mutual fund share class issues are critical to the SEC since conflicts of interest – especially over fees – are central to the fiduciary duty that advisers owe their clients," Raissi said. "Moreover, mutual funds are an asset class widely held by retail investors and matters impacting retail investors have been a particular focus of the SEC under Chairman Clayton."

Rogers & Hardin partner **Stephen Councill**, noting that the cases all reflect situations where the RIAs or their reps received 12b-1 fees without proper disclosures, said that "it will be interesting to see how the SEC handles more complicated scenarios, such as failure to obtain the best share class, but without the conflict from 12b-1 fees."

The settlements

While there were 79 advisers that settled these allegations, there were only 77 settlements, as two of the settlements covered two advisers. As part of the settlements, the advisory firms agreed to be censured, and to disgorge the improperly disclosed fees and distribute them, along with prejudgment interest, to those clients that were affected. In addition, each adviser agreed to review and correct all relevant disclosure documents concerning mutual fund share class selection and 12b-1 fees, as well as to "evaluate whether existing clients should be moved to an available lower-cost share class and move clients, as necessary."

The advisory firms, as part of the settlements, were charged by the SEC with having violated Advisers Act Section 206(2) and, in the case of state-registered

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only advisers, Section 207 to address the following allegations:

- Failing to adequately disclose receipt of the 12b-1 fees, and
- Failing to adequately disclose additional compensation received for investing clients in a fund's 12b-1 fee paying share class when a lower-cost share class was available for the same fund.

"The federal securities laws impose a fiduciary duty on investment advisers, which means they must act in their clients' best interest," said agency Division of Enforcement Co-Director **Stephanie Avakian**. "An adviser's failure to disclose these types of financial conflicts of interest harms retail investors by unfairly exposing them to fees that chip away at the value of their investments."

Enforcement Division Co-Director **Steven Peikin** noted that the Initiative "leveraged the expertise of the agency in crafting an efficient approach to remedy a pervasive problem. "Most of the advisory clients harmed by the disclosure practices were retail investors, and in just a year's time, we made tremendous headway in putting money back into their hands while significantly improving the quality of firms' disclosures."

The SEC has been targeting mutual fund share class fees since at least 2013, resulting in a number of settlements, even before the Initiative was launched. The agency's Office of Compliance Inspections and Examinations (OCIE) in 2016 issued a risk alert on the subject (*ACA Insight*, 7/18/16). "FINRA has similarly addressed share class selection issues with brokers, imposing censures and fines on brokers that failed to provide adequate disclosures," the agency said.

When the SEC announced the Initiative, it was met with caution by some in the industry. Attorneys were not sure they would advise their clients to take advantage of it. Some noted that the self-reporting program should not be confused with amnesty, just a promise to ease up on fines. Furthermore, they warned, self-reporting could lead to further examinations, which in turn might lead to examiners finding other problems that might result in different enforcement actions. There was also a danger that voluntary disclosure might lead to clients leaving.

Whether some potential self-reporters took these concerns to heart and chose not to report is not yet known, but the fact that 79 advisers chose to settle, in addition to multiple settlements between individual advisory firms and the SEC since the Initiative was announced, indicates that some firms found the chance to avoid civil money penalties too good to pass up.

The settlements

While the individual settlements among the 79 advisory firms differ on certain details, such as the amount of assets that each firm manages, the general contours of each settlement are roughly the same. Following is an approximation of what most of them state.

"These proceedings arise out of breaches of fiduciary duty and inadequate disclosures by [respondent] in connection with mutual fund share class selection practices and the fees [respondent and/or its associated persons] received pursuant to Rule 12b-1 under the Investment Company Act of 1940. At times during [a certain period], respondent purchased, recommended, or held for advisory clients mutual fund share classes that charged 12b-1 fees instead of lower-cost share classes of the same funds for which the clients were eligible. Respondent and its associated persons received 12b-1 fees in connection with these investments. Respondent failed to disclose in their Form ADV or otherwise the conflicts of interest related to (a) its receipt of 12b-1 fees, and/or (b) its selection of mutual fund share classes that pay such fees. During the relevant period, respondent and its associated persons received 12b-1 fees for advising clients to invest in or hold such mutual fund share classes."

Also included in most, if not all, of the settlements was a "self-reporting" paragraph that stated, in part, "In determining to accept respondent's offer, the Commission considered that respondent self-reported its conduct to the Commission pursuant to the [Share Class Selection Disclosure] Initiative." Another paragraph later states that "respondent acknowledges that the Commission is not imposing a civil penalty based upon respondent's self-report in the [Share Class

Selection Disclosure] Initiative," along with a warning that the SEC will reopen the matter if it discovers that the respondent knowingly provided materially false or misleading information or materials to the agency.

SEC Alleges

continued from page 1

procedures, and failure to perform annual compliance reviews. Tied to these compliance process allegations were charges that the adviser violated the Custody Rule and the Books and Records Rule.

Ascension's Forms ADV contained "materially untrue statements that . . . demonstrate respondents' indifference to the regulatory requirements of an SEC-registered investment adviser," the agency said in its order instituting administrative proceedings. In particular, it said, in multiple Forms ADV filed with the Commission, Gooder and Ascension:

- Falsely stated that Ascension did not have custody of client assets,
- Repeatedly named an individual as the firm's CCO even though that person was never responsible for administering any written compliance policies and procedures, and
- On one occasion in 2011, identified a second individual as Ascension's CCO in its Form ADV, "unbeknownst to this individual."

The case now goes to an administrative hearing, unless a settlement is reached before then. Ascension was charged by the SEC with willfully violating Advisers Act Section 206(4) and its Rule 206(4)-7 for failing to adopt and implement written compliance policies and procedures, review them at least annually, and designate a CCO responsible for administering them.

The agency also charged the firm with willfully violating Section 206(4) and its Rule 206(4)-2, for failing to meet custody requirements; Section 204 and its Rule 204(2), for failing to make and keep proper books and records; and Section 207, for making untrue statements of material fact in any registration application or report filed with the Commission. Gooder was charged with causing Ascension's violations of Rule 206(4)-7, Rule 206(4)-2, and Rule 204-2, and with willfully violating Section 207. The attorney representing Ascension and Gooder, when reached, said that since the matter was currently in the SEC's administrative process, his only comment was that he and his clients were looking forward to their day before the administrative law judge, presenting their defenses.

"This action should be a wake-up call to advisory firms who deliberately make false material assertions on a Form ADV," said **Lewis Baach** partner **Jason Berland**. "This is particularly true when a firm blatantly fails to designate an appropriate individual to be responsible for administering compliance programs. "In a situation, such as the one here, where one of the chief compliance officer designees was allegedly unaware he was designated, civil money penalties should be a real concern."

Decade long

Nor was the situation for only a brief time, according to the SEC's order. The period when Ascension did not adopt or implement written compliance policies and procedures or conduct annual compliance reviews, both of which are required by Advisers Act Rule 206(4)-7, the Compliance Program Rule, lasted more than 10 years – "from in or about October 2004 until November 2015," according to the agency.

It was only after being notified of an SEC examination in 2015 that Ascension created its first written compliance policies and procedures, the agency said. The firm had never previously been examined by the SEC's Office of Compliance Inspections and Examinations.

As for the CCO designations, the SEC wrote that "from September 2005 until March 2016, Ascension and Gooder designated in Ascension's Forms ADV two individuals, Individual A and Individual B, who allegedly served as Ascension's CCO at different times. Neither of these individuals, nor anyone else, was ever responsible for administering polices and procedures adopted under Advisers Act Rule 206(4)-7 for Ascension."

What's more the agency said, "Individual B never agreed to serve as Ascension's CCO and was unaware that Ascension and Gooder had named him as the firm's

CCO until after he was contacted by the Enforcement Division in 2017."

The message from this case is that advisory firms ignore compliance requirements at their own peril. If nothing else, it makes clear that the SEC is watching and will take action when it finds problems like these. "Some cases have more nuance," said **Ropes & Gray** partner **Jeremiah Williams**. "This was a situation where the Rule was just ignored, the adviser had an opportunity to do something and allegedly just didn't do it."

Compliance background

The SEC, in its order, noted that Gooder, who in June 2004 founded Ascension, a firm with more than $152 million in assets under management, has worked in the securities industry for approximately 40 years, including with other SEC-registered advisers. As the sole owner and operator of Ascension, which provides asset allocation and portfolio management services to high net worth investors, trusts, foundations and a pension plan, he prepared, reviewed and signed its Forms ADV, the agency said.

What's more, according to the agency, was that since approximately September 2005, "Ascension was a continuous member of an industry organization that advocates for and provides compliance and educational resources to SEC-registered investment advisory firms."

Williams said he found the adviser's membership in this organization, identified in the order as "Industry Organization A," as "one of the most interesting parts of this case. It's like the SEC was making clear that Gooder knew the compliance requirements."

"Gooder testified that his sole means of staying informed of regulatory compliance issues was reviewing compliance bulletins published by Industry Organization A that Ascension received monthly," the SEC said. "Gooder had an opportunity to review information published in certain Industry Organization A monthly compliance bulletins concerning the requirements of the rules."

However, the agency also noted that Gooder "failed to take steps to educate himself about the rules." Specifically, it said, he did not:

- Attend training events on advisory compliance issues that were offered by Industry Organization A,
- Visit the SEC's web site to review guidance on investment adviser compliance issues,
- Contact Commission staff for guidance, or
- Take any other steps to educate himself on his firm's compliance requirements.

Custody Rule allegations

Ascension had custody of client assets from at least July 2005 to at least November 2015, according to the SEC's order. "Respondents not only made untrue statements about having custody in their Forms ADV, they also failed, from March 2010 to November 2015, to take any steps to comply with the Custody Rule itself," the agency said. "In short, respondents made no effort to satisfy multiple important aspects of their compliance obligations until the SEC's examination staff initiated an examination of Ascension in November 2015. Instead, respondents blatantly disregarded key statutes and rules that apply to SEC-registered advisers."

Rule 206(4)-2, the Custody Rule, requires advisers that maintain custody of client funds or securities to have surprise examinations of those funds or securities conducted by independent public accountants, or to have any private fund clients distribute audited financial statements to their investors, with the financial statements having first been audited by an independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board.

However, according to the SEC, from approximately March 2010 until November 2015, Ascension never did either of these tasks for a private fund it managed. Separately, from approximately July 2012 through at least December 2015, in regard to a $5.2 million trust for which Gooder was the sole trustee, the advisory firm did not engage an independent public accountant to conduct an annual surprise examination to verify the trust's assets, the agency alleged.

Books and records allegations

Rule 204-2, the Books and Records Rule, requires advisers to make and keep true, accurate and current certain books and records, including a journal showing the adviser's cash receipts and disbursements, and a general ledger showing the adviser's assets, liabilities, reserves, capital, income and expense accounts. Other records the Rule requires advisers to keep include the firm's compliance policies and procedures, and its annual review of those procedures.

From about June 2004 until at least November 2015, according to the administrative order, Ascension did not keep a true, accurate and current journal of its cash receipts and disbursements; a general ledger reflecting the firm's assets, liabilities, reserves, capital, income and expense accounts. From about October 2004 until at least November 2015, Ascension did not keep a proper copy of its written compliance policies and procedures, and from approximately March 2006 through at least November 2015, it did not keep true, accurate and current records documenting an annual compliance review, the agency said.

Custody Rule Reform

continued from page 1

on the SEC's web site. In it, the agency staff says that it "expects to utilize what it learns in any future recommendations to the Commission with respect to any regulatory action that may be necessary or appropriate."

"I see the request for input as progress, although as the letter notes, the industry – particularly the **Investment Adviser Association** – has been in active discussions with and provided extensive input to the staff on many of these issues for years," said **Sidley Austin** partner **Laurin Blumenthal Kleiman**. "I hope, as the letter suggests, that it signals an important step toward amending the Rule to address the full scope of the realities investment advisers and their clients face in the twenty-first century."

The term "non-DVP custodial practices" refers to adviser and custodial trading practices that are not processed on a "delivery versus payment" basis. Most custodial practices rely on delivery versus payment, such as a transaction involving the purchase of negotiable securities in exchange for a cash payment. In such transactions, delivery of the securities will occur once the payment occurs.

However, there are certain transactions that do not involve cash payments, such as those involving derivatives, and it is here where the SEC staff has concerns. Among these, according to its public letter, are "the risks of misappropriation inherent in non-DVP arrangements. Where trading or settlement does not occur through a delivery versus payment arrangement, there is a heightened risk that an investment adviser could misappropriate funds or securities in its client's custodial account."

"Advisers who seek to comply in the context of investments in, e.g., loans, swaps, real estate-related securities and now digital assets confront both technical and practical obstacles," said Kleiman. "These obstacles can be compounded by the challenges for clients who have engaged their own custodians on their own terms and do not wish to pay for additional compliance (in which they see no benefit), and custodians who are not willing or able to provide assistance to comply with the Rule. In addition, clients who intentionally limit their advisers to DVP trading do not acknowledge the need for, and do not want to pay for, the cost of custody rule compliance."

"We've been waiting for some clarity on this issue for some time, and it is helpful that the staff is open to conversation and input, as opposed to simply stating that non-DVP trading creates custody, which, from my perspective, would be an overly broad conclusion," said **Morgan Lewis** partner **Christine Lombardo**.

The SEC staff, in its letter, said that it "believes that questions surrounding non-DVP trading, as well as additional questions and issues the staff has identified regarding the Custody Rule over the past 15 years, should be considered by the Commission," adding that amendments to the Custody Rule are on the Commission's long-term unified agenda as part of this process.

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Digital concerns

As for digital assets, the staff is seeking to find out "whether and how characteristics particular to digital assets affect compliance with the Custody Rule. Among these characteristics, it said, are the:

- Use of digital ledger technology (DLT) to record ownership,
- Use of public and private cryptographic key pairings to transfer digital assets,
- "Immutability" of block chains,
- Inability to restore or recover digital assets once lost,
- Generally anonymous nature of DLT transactions, and
- Challenges posed to auditors in examining DLT and digital assets.

The staff, in its letter, noted that the market for digital assets "has grown rapidly and some advisers have sought to invest in digital assets on behalf of their clients." The staff, in light of these developments, has worked with the SEC's Strategic Hub for Innovation and Financial Technology to engage with advisers, broker-dealers, service providers, market observers, academics and others to "understand and discuss related compliance questions."

The letter contains two sets of questions for which it says it would appreciate input, one set relating to non-DVP trading, and the other to custody of digital assets.

Non-DVP questions

Following are some of the questions related to non-DVP practices:

- What types of instruments trade on a non-DVP basis? How do these instruments trade?
- Describe the risks of misappropriation or loss associated with various types of non-DVP trading. What controls do investment advisers have in place to address the risks of misappropriation related to such trading? What types of independent checks, other than a surprise examination, do investment advisers use currently to test these controls?
- What role do custodians play in the settlement process of non-DVP trading? What role do they play in mitigating risks of misappropriation or loss arising from such trading?
- For advisers who currently obtain surprise examina-

tions, what is the marginal cost of adding accounts that trade on a non-DVP basis to the list of client accounts provided to the accountant performing the surprise examination if a sample of client accounts?

Digital assets questions

Following are some of the questions related to custody of digital assets:

- What challenges do investment advisers face in complying with the Custody Rule with respect to digital assets? What conditions specific to the custody of digital assets should the staff evaluate when considering any amendments to the Custody Rule? For example, are there disclosures or records other than account statements that would similarly address the investor protection concerns underlying the Custody Rule's requirement to deliver account statements?
- To what extent are investment advisers construing digital assets as "funds," "securities" or neither, for purposes of the Custody Rule? What considerations are advisers applying to reach this conclusion?
- To what extent are investment advisers including digital assets in calculating regulatory assets under management for purposes of meeting the thresholds for registering with the Commission? What considerations are included with this analysis?
- To what extent do investment advisers use state-chartered trust companies or foreign financial institutions to custody digital assets? Have these investment advisers experienced similarities/differences in custodial practices of such trust companies as compared to those of banks/broker-dealers?

"Custodians are creating programs to address digital assets and related issues," said Lombardo, which she said raises some operational concerns because digital assets have unique characteristics.

She also noted that some of the SEC staff's questions here, such as whether advisers count digital assets toward their AUM totals, are unrelated to custody, but nonetheless demonstrate the staff being open to input from advisers and other affected parties.

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