October 2, 2017

ACA COMPLIANCE GROUP

ACA Insight

The weekly news source for investment management legal and compliance professionals

"On one hand, the SEC is telling registrants to be ready for cybersecurity, but on the other hand, the agency didn't even follow its own guidance."

After the Cyber Breach: SEC Faces Questions, Clayton Testifies, Effect on the CAT

The asset management industry, including the SEC, is weighing the impact of the cybersecurity breach that agency chair **Jay Clayton** recently disclosed to the public (*ACA Insight*, 9/25/17). In the wake of the disclosure, the SEC announced a new initiative, Clayton testified before a Senate committee, and industry leaders and observers speculated as what it all might mean for future regulation and oversight, including the launching of the agency's Comprehensive Audit Trail (CAT).

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SEC Work with DOL on Standards of Conduct Already Underway

SEC chairman **Jay Clayton's** testimony before a Senate committee was not limited to cybersecurity. He also used his September 26 testimony before the Senate Committee on Banking, Housing and Urban Affairs to address other topics, including developing standards of conduct for advisers and broker-dealers – and let Congress and the public know that collaboration with the Department of Labor on these standards has already begun.

"We are engaging expeditiously and constructively with our colleagues at the DOL to best serve the interests of investors," he testified, although he did not provide any

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12b-1 Fees: SEC Settles Share Class Charges with Two More Advisers

If you think the SEC only occasionally charges advisers for placing clients in expensive share classes when less expensive classes are available, recent events should change your mind. The agency reached settlements with two advisory firms involving share classes just last month, and those followed up on still other settlements and developments earlier this year and the year before.

Atlanta-based **SunTrust Investment Services**, a dually registered adviser and broker-dealer and a subsidiary of **SunTrust Banks**, on September 14 reached a settlement with the SEC that resulted in it paying more than $1.1 million. The settlement resolved

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After the Cyber Breach

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"I have the sense that the breach is something of an eye-opening experience for at least some SEC staffers. They got to see firsthand that what can happen in the private sector can also happen in the public sector," said **Willkie Farr** partner and former SEC Division of Investment Management director **Barry Barbash**. "It was likely a governmental wake-up call."

There is also the issue of the agency's credibility in regulating firms' cybersecurity compliance when it apparently, at least in this one instance, failed to do so itself. "You can go one step further and say that, on one hand, the SEC is telling registrants to be ready for cybersecurity, but on the other hand, the agency didn't even follow its own guidance," said **Ropes & Gray** counsel **David Tittsworth**.

Perhaps, suggested **Kirkland & Ellis** partner and former SEC Division of Investment Management director **Norm Champ**, "the agency should consider putting in place a moratorium on certain sensitive filings, such as Form PF or others outside of registration filings, until information security is straightened out."

Overall, "the industry is transfixed by this," said **Shearman Sterling** partner **Nathan Greene**. "Everyone is talking about it."

The SEC itself refused to comment on the matter beyond Clayton's statement, testimony and those press releases that have already been issued.

The breach

What happened, according to testimony Clayton provided September 26 before the U.S. Senate Banking, Housing and Urban Affairs Committee that built on information he provided in his initial February 20 statement, was that this past August, he was informed of a possible 2016 intrusion into the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. The SEC uses EDGAR to perform automated collection, validation, indexing, acceptance, and forwarding of submissions by investment advisers, broker-dealers, companies and others required by law to file forms with the agency.

"I was informed that the 2016 intrusion into the test filing component of our EDGAR system provided access to nonpublic EDGAR filing information and may have provided a basis for illicit gain through trading," Clayton told the committee. "We believe the 2016 intrusion involved the exploitation of a defect in custom software in the EDGAR system."

When the intrusion was first discovered, he said, the agency's Office of Information Technology "took steps to remediate the defect in custom software code" and reported the incident to the Department of Homeland Security's United States Computer Emergency Readiness Team. "Based on the investigation to date, [Office of Information Technology] staff believes that the prior remediation effort was successful. We also believe that the intrusion did not result in unauthorized access to personally identifiable information, jeopardize the operations of the Commission or result in systemic risk."

But Clayton also added this proviso: "Our review and investigation of these matters, however, as well as the extent and impact of the intrusion and related illicit activity, is ongoing and may take substantial time to complete."

He also said this: "There are limits on what I know and can discuss about the 2016 incident due to the status (ongoing and incomplete) and nature (enforcement) of these reviews and investigations."

"This was totally foreseeable," said Champ, who attributed much of the problem to the "outdated" nature of EDGAR. "It was state of the art in the 1980s, but not now. EDGAR would be out of date anywhere. It wouldn't be state of the art in North Korea. It's a shame our markets regulator does not have a better tool."

Barbash said that when he initially read about the breach, "I thought about the data registrants have to file with the SEC on Form ADV, Form PF, and soon with the CAT. I've had clients ask me in the past, in the context of those requirements, whether the SEC's data protection systems were sufficient to protect the information. Those clients are very concerned now."

"Adviser clients have asked me, in the wake of the breach, how they should go about their business, how they should handle confidential client information, why did some SEC commissioners not find out about this until August 2017, was the former SEC chair aware of this during her tenure, and more," he said.

Agency commissioner **Michael Piwowar**, in a separate statement issued September 20, said that he did not find out about the cybersecurity breach until recently.

Cybersecurity initiative

The new initiative, which the agency announced September 25, is the creation of a cyber unit "that will focus on targeting cyber-related misconduct," the SEC said. The agency at the same time announced the creation of a retail strategy task force, apparently not related to cybersecurity, "that will implement initiatives that directly affect retail investors."

Under the cyber initiative, the Division of Enforcement will focus its "substantial cyber-related expertise" on targeting cyber-related misconduct, the SEC said, including:

- Market manipulation schemes involving false information spread through electronic and social media,
- Hacking to obtain material nonpublic information,
- Violations involving distributed ledger technology and initial coin offerings,
- Misconduct perpetrated using the dark web,
- Intrusions into retail brokerage accounts, and
- Cyber-related threats to trading platforms and other critical market infrastructure.

The agency said that the unit has been in the planning stages "for months," but one may perhaps be excused for noting the timing of the announcement just three work days after Clayton revealed the EDGAR breach. The SEC said that the new initiative complements other Clayton initiatives to implement an internal cybersecurity risk profile and create a cybersecurity working group to coordinate information sharing, risk monitoring and incident response efforts throughout the agency.

"Sometimes the best defense is a good offense," said **Bell Nunnally** partner **Robert Long**. "With the SEC taking it on the chin over the past week due to its EDGAR system being breached by hackers, the agency's enforcement initiative is well-timed, particularly since it coincided with Clayton's Senate testimony the next day."

The CAT

Depending on one's point of view, disclosure of the breach came out at either a bad time or a good time in relation to the CAT, part of which is expected to be in operation in November (*ACA Insight* 7/24/17, 12/5/16). Once in place, the CAT would capture, in a single, consolidated data source, customer and order information for orders in national market system securities, across all markets, from the time of order inception through routing, cancellations, modification or execution.

Market exchanges will be required to report all of their transactions on CAT, with broker-dealers having to do so over the subsequent two years. Nor are investment advisers immune, as they will eventually be asked questions about trades involving best execution, trade timing, and choices made on behalf of some clients and not others.

But given the EDGAR breach, the question is raised of the security of information collected not only for the CAT, but on other forms recently required to be completed, such as more comprehensive information on Form ADV or private fund information on Form PF.

"It's possible the CAT will be delayed," said Tittsworth, adding that the key is whether those contributing information to it "can believe reasonable steps are being taken to secure the information."

Barbash suggested that what will most likely happen is that "the SEC will conduct an internal evaluation to assure itself that the CAT is safe," and will move forward with it on schedule. In doing that, he said, "it will be doubling down on its ability to protect against a breach."

Clayton, in his testimony, said that he "expect[s] that the roll out of the various components of CAT data reporting, the first phase of which is scheduled to take effect on November 15, 2017 . . . , will reflect an ongoing assessment of the sensitivity of the data reported and related security concerns and protections."

Protection of sensitive CAT data, he said, "is of paramount importance to the Commission. . . . I appreciate that security issues are particularly acute with respect to a data repository that contains comprehensive information on trading activity in the securities markets, especially in light of recent events. I am therefore focused on issues of data security with respect to CAT."

SEC Work with DOL

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details into what has been involved so far in the collaboration between the agency and the Department.

"While the SEC and the DOL have different statutory mandates, rulemaking processes and jurisdictions, actions taken by one regarding standards of conduct are going to have a significant effect on the other's regulated entities and the marketplace," he said. "In other words, effects of the DOL Rule extend well beyond the DOL's jurisdiction, and vice versa."

"It is important that we understand these effects and work closely and constructively with DOL to implement appropriate standards of conduct for financial professionals who provide advice to retail investors," Clayton said.

"I am encouraged by Clayton's assurance that the SEC is engaging expeditiously and constructively with the DOL," said **Mayer Brown** partner **Lennine Occhino**. "I also find his testimony on standards of conduct very encouraging. Specifically, I like the fact that the SEC is seeking to develop standards for financial professionals that are consistent across retirement and non-retirement assets and coordinated with other regulatory entities. This will certainly help to reduce confusion and risk for all parties resulting from managing conflicting standards of conduct, even for dealings with the same customer."

"I think we can say safely that Clayton's testimony shows an interest and willingness to work with other agencies in devising more uniform standards of conduct, which may well affect the fate of the DOL fiduciary rule," said **Skadden Arps** ERISA counsel **Jeffrey Lieberman**. "However, it is still far too early to have a real sense of what the effect might be."

Clayton, in his testimony, also addressed a plethora of other topics, including the agency's regulatory agenda, disclosure effectiveness, enforcement and examinations. While he revealed little that was new – he has, after all, been on the job only since May – he made clear that he is on top of these areas and plans to move the agency forward in addressing them.

The DOL Rule and the SEC

The DOL earlier this year adopted a final Fiduciary Rule for broker-dealers and other financial entities that make retirement investment recommendations. While the Rule formally went into effect June 1, much of it and its related exemptions were postponed until January 1, 2018 – and recently the DOL proposed delaying key exemptions further, until July 1, 2019. As for the parts of the Rule that did take effect June 1, the DOL has said they will not be enforced until January 1.

Most of these postponements took place after President Donald Trump issued a presidential memorandum that, among other things, called for further study on the Rule and its effect on investors.

A DOL Fiduciary Rule has long been a controversial topic within the asset management community, as investment advisers – who would be covered under the DOL Rule if they make retirement investment recommendations – are already covered by a fiduciary obligation under the Advisers Act.

Both Labor Secretary **Alexander Acosta** and Clayton have recently begun making noises about coordinating their efforts. The SEC in June issued a call for comments on just what the agency should do in terms of developing a standard of conduct for advisers and broker-dealers, and has received more than 150 comment letters to date, Clayton said in his testimony.

Whatever standards the Commission may develop "should be clear and comprehensible to the average investor, consistent across retirement and non-retirement assets, and coordinated with other regulatory entities, including the DOL and state insurance regulators," he said.

Industry changes already underway

Clayton also shared with the committee his awareness of industry changes since the DOL Fiduciary Rule took effect in June.

"Staff conversations with investors and firms, prior to the DOL's proposed extension, as well as various press reports, indicate that broker-dealers are considering, and some have started taking, a variety of actions to comply with the DOL Rule." These, he said, include:

- Increasing compliance resources and efforts, such as for disclosure, documentation and training in regard to costs and rollover recommendations;
- Increasing the use of robo-advice; and
- Reevaluating and changing the types of products and accounts, as well as related fees, offered to retirement investors, "focusing particularly on products or accounts that would address the compliance requirements driven by the best interest contract exemption," such as shifting some or all of their retirement accounts to level-fee advisory accounts.

He also shared agency staff knowledge that mutual fund complexes are considering different approaches to accommodate what broker-dealers are doing to level compensation across similar types of products in response to the DOL Rule. These approaches, he said, include:

- Issuing what are known as "clean shares" that do not have sales loads, charges or other asset-based fees for sales or distribution, which would have the effect of allowing brokers to set their own commissions that could be paid directly by investors; and
- Issuing "T-shares," also known as "transaction shares," that have uniform sales charges across all fund categories.

The Commission and the agency staff, Clayton said, "have extensive experience regulating broker-dealers and investment advisers, and we are reviewing the information interested parties have submitted." He added that he is looking forward to continuing his work with commissioners and the staff "as we evaluate our next steps on this important topic."

12b-1 Fees

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charges that, between December 2011 and June 2015, SunTrust recommended to clients that they purchase Class A mutual fund shares when less expensive Class I shares were available. The practice was originally found during an examination of the firm, the agency said. More than 4,500 clients in more than 40 states were affected.

On September 8, Colorado-based **Envoy Advisory**, a firm with approximately 1,800 advisory clients and approximately $225 million in assets under management, settled charges with the agency that, from January 2013 through March 2017, it recommended to clients that they purchase more expensive share classes when less expensive ones were available. The firm paid more than $51,000 to settle the case.

Both settlements faulted the advisers over disclosures to clients, as well as for having what the SEC said were inadequate written compliance policies and procedures. Both settlements also credited the firms with taking remedial actions.

"The SEC is drilling down on conflicts of interests these days," said **Bell Nunnally** partner **Robert Long**. "Firms with affiliate relationships should pay particular attention to their ADV disclosures."

"Mutual fund share selection practices and related disclosure and procedures continue to be a focus of SEC adviser examinations," said **Pepper Hamilton** partner **John Falco**. "Advisers should make sure they have procedures in place to ensure that clients are placed in the lowest-cost share class that meets their needs in which they are eligible and disclose conflicts and payments by third parties in connection with their fund recommendations."

The settlements also tie into the July 2016 risk alert issued by the agency's Office of Compliance Inspections and Examinations. That alert, "OCIE's 2016 Share Class Initiative," let advisers know that examiners would focus on "conflicted investment recommendations" made to clients, including potential conflicts of interest tied to advisers' compensation or financial incentives regarding share classes that may contain distribution fees.

The SEC has not been shy in following up on this risk alert. In May, the agency settled similar cases with two advisory firms, Chicago-based **William Blair & Company**, and Maryland-based **Calvert Investment Management**. The Calvert settlement cost that firm more than $22 million in disgorgement and penalties. The month before those two settlements, the SEC reached a settlement with well-known financial adviser **Credit Suisse**, and the month before that, with advisory firm, **Alison**.

The SunTrust settlement

SunTrust offered products to clients in its capacities as an adviser and as a broker-dealer, the agency said in its order instituting the settlement. From at least 2011, it offered its advisory clients the option of investing through various wrap-fee programs, known as its Asset Management Consulting (AMC) programs, under which both advisory, brokerage and custody services were covered. In all of these AMC programs, clients were eligible to invest in mutual funds that offered Class A shares, as well as the less expensive Class I shares.

As explained in the SEC's order, while Class I shares were originally intended for institutional investors, "many mutual funds, over time, began making Class I shares available to non-institutional investors, including retail investors purchasing shares through wrap fee investment programs." These Class I shares have no upfront or deferred sales charges, and rarely have 12b-1 fees, which are used to pay for distribution services.

"As a result," the agency said, "an individual who invests in Class I shares of a mutual fund will pay lower fees over time – and keep more of his or her investment returns – than an individual who holds Class A shares of the same fund. Therefore, if an investor meets a mutual fund's criteria for purchasing Class I shares, it is almost always in the investor's best interest to select that share class over the same fund's more expensive Class A shares."

Further, the SEC noted, Class A shares have increasingly become convertible to Class I shares, often on a tax-free basis and without any charge or fee to either the client or the adviser. What this meant in terms of the SunTrust case, is that during the period in question, SunTrust clients holding existing, or "legacy" Class A shares in certain mutual funds could have converted those shares to Class I shares at the request of SunTrust to the mutual fund and the carrying broker, the agency said.

SunTrust share class selection

SunTrust had an investment policy committee that was charged with proposing and adopting policies and procedures to ensure that the advisory firm's products and services met all applicable regulatory requirements. The chief compliance officer was among those who sat on the IPC.

As early as 2011, according to the SEC, members of the IPC were aware that:

- Class I shares were gradually becoming more available for SunTrust clients to invest in;
- Some of SunTrust's investment advisory representatives "were nonetheless continuing to purchase for, or recommend to, their advisory clients certain Class A shares even though those clients were eligible to invest in the less expensive Class I shares of the same funds;" and
- Many SunTrust advisory clients continued to hold in their advisory accounts Class A shares carrying 12b-1 fees that were eligible for conversion to Class I shares on a tax-free basis and without charge.

What it all came down to

Here's what the SEC charged: "Despite knowing that [SunTrust] advisory clients with non-qualified accounts were continuing to incur 12b-1 fees that could be avoided, the IPC did not at that point adopt policies and procedures that prohibited [SunTrust investment advisory representatives] from recommending Class A shares to, or purchasing Class A shares for, advisory clients with non-qualified accounts, or investing or holding such clients in Class A shares, when less expensive Class I shares of the same mutual funds were available." Nor, the agency said, did the IPC adopt policies and procedures to convert the legacy Class A shares already held by advisory clients with non-qualified accounts to less expensive Class I shares.

"In fact, it was not until early June 2012 that the IPC adopted policies and procedures to halt the recommending or purchasing of Class A shares for advisory clients with newly opened non-qualified accounts when less expensive Class I shares were available," the agency said. It was not until a year after that that the IPC adopted policies and procedures to begin the conversion of Class A shares to Class I shares.

"From December 27, 2011 through June 30, 2015, [SunTrust] and its investment advisory representatives received at least $1,148,072 in avoidable 12b-1 fees that would not have been collected had [SunTrust] placed its advisory clients with non-qualified accounts in lower-cost share classes, or converted legacy clients . . . Class I shares," the SEC said.

"SunTrust made self-serving investment recommendations to the detriment of everyday investors who rely on mutual funds to secure their financial futures," said SEC Atlanta Office associate regional director **Aaron Lipson**. "The story has a happy ending for customers with the extra fees back in their accounts, and an obvious lesson for investment advisory representatives that you must always recommend the best deal for your clients, not yourselves."

"The firm addressed the matter on a prospective basis with remedial actions starting in the summer of 2015," said the attorney representing SunTrust. "Although the firm believes that its disclosures were in accordance with industry standards, the firm cooperated fully with the SEC and it is pleased to have settled this matter."

SunTrust was charged with willfully violating Section 206(2) and (4) of the Advisers Act, both of which prohibit fraud, as well as Section 207, which prohibits making untrue statements of material fact. The SEC credited the firm with taking a number of remedial steps, including, as of July 1, 2015, crediting any newly incurred 12b-1 fees back to clients, and the firm working to convert existing investments in Class A shares to Class I shares.

The Envoy settlement

While there are similarities between the SunTrust case and the Envoy case, there are also differences, among them no mention in the Envoy settlement of wrap-fee programs or of converting Class A shares to Class I shares.

"Envoy's disclosures did not adequately inform its advisory clients of the conflict of interest presented by its recommendations to purchase Class A mutual fund shares," the agency said, particularly that "Envoy's affiliated broker-dealer, Envoy Securities, received approximately $24,893 in 12b-1 fees that it would not have collected had plan participants and IRA holders been invested in lower-cost shares for which they were eligible."

"Envoy's Form ADV disclosures to plan sponsors during the relevant period disclosed that certain mutual funds 'may' pay a 'dealer' 12b-1 fees, but failed to disclose that the 'dealer' receiving the 12b-1 fees was Envoy's affiliate," the SEC said. Envoy's disclosures to IRA holders during the same period made no mention of 12b-1 fees at all, nor of the conflict of interest, it said, while the firm's investor handbook, provided to IRA holders during the relevant period, said that Envoy or the account custodian "may" receive 12b-1 fees.

"Envoy's general disclosures regarding the potential receipt of 12b-1 fees were inadequate to put advisory clients on notice that its affiliated broker-dealer, Envoy Securities, would, and did receive additional compensation by Envoy recommending investments in more expensive share classes of a mutual fund," the agency said.

As part of the settlement, Envoy was charged with having willfully violated Advisers Act Sections 206(2), which prohibits fraud; Section 206(4) and its Rule 206(4)-7, the Compliance Program Rule. The agency credited Envoy with taking certain remedial acts, among them stopping recommendations, as of October 2016, of investments in share classes that pay 12b-1 fees; and engaging a compliance consultant. An attorney representing Envoy did not respond to an email or voice mail seeking comment.

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The weekly news source for investment management legal and compliance professionals

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