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ACA Insight

The weekly news source for investment management legal and compliance professionals

"Predictions about potential future registrant behavior. These are precisely the types of algorithms that staff in DERA are currently developing."

Inside Insights

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Machine Learning and Artificial Intelligence Increasingly Part of SEC Oversight

Artificial intelligence may or may not be here yet, depending on one's definition of AI. There is little doubt, however, that machine learning – the analysis of data by machines without direct human direction – has already found a home at the SEC and is growing.

"The success of today's new technology depends on the machine readability of decision-relevant information," said agency Division of Economic and Risk Analysis (DERA) deputy chief economist and deputy director **Scott Bauguess**, who gave the

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DOL Won't Enforce Prohibited Transactions Claims in Light of Court Action

The last rites for the Department of Labor's Fiduciary Rule are turning out to be an extended affair.

First there were the delays initiated in 2017 as to when the Rule or its related exemptions would take effect (*ACA Insight*, 12/4/17). Then there was the SEC's April proposal of its own Best Interest Rule and related proposals (*ACA Insight*, 4/23/18), followed by the May 2 ruling of a federal appellate court vacating the entire DOL Rule and the exemptions. The latest is a May 7 bulletin from the DOL informing invest-

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SEC Keeps Gatekeepers in Its Sights with New Accounting Firm Settlement

The SEC made it known back when **Mary Jo White** was the agency chair that it would go after what it terms "gatekeepers" – attorneys, accountants, consultants and others – if it believes they took part in fraud. With its May 4 settlement with an accounting firm and two of the firm's partners, chairman **Jay Clayton** signaled that his SEC will do the same.

In its settlement with Wisconsin-based accounting firm **Winter, Kloman, Moter & Repp**, along with two of its partners, **Curtis Disrud** and **Paul Sehmer**, the agency

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Machine Learning

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keynote speech May 3 at the **Financial Information Management Association** conference in Boston. He also used his address to dispel what he described as five myths about machine-readable reporting standards.

Machine readability today is not just for numerical data, "but for all types of information," he said. "This includes narrative disclosures and analyses found in the written word. It also includes contextual information about the information, or data *about* the data [emphasis Bauguess], often referred to as 'metadata.' Today's advanced machine learning methods are able to draw incredibly valuable insights from these types of information, but only when it is made available in formats that allow for large-scale ingestion in a timely and efficient manner."

The upshot of all this, from a machine learning perspective, is that data, when standardized, "can be combined with other relevant financial information and market participant actions to establish patterns that may warrant further inquiry," Bauguess said. "And that can ultimately lead to predictions about potential future registrant behavior. These are precisely the types of algorithms that staff in DERA are currently developing."

Sounds a bit ominous, but does this constitute artificial intelligence? The answer to that depends on a person's perspective, said **Shearman & Sterling** partner **Nathan Greene**. It may not be at a point yet where a computer program reasons, argues and sounds like a human being, but programs looking for data patterns and making judgments on those patterns are more than mere number crunching.

Large financial firms, such as **BlackRock**, are already making forays into developing their own forms of inhouse artificial intelligence. Chief compliance officers at firms that make similar artificial intelligence inroads need to ask themselves a number of questions, Greene said. "These might include, 'Will this make a CCO's job easier or harder?' and 'Will the program draw on inhouse or other data that it shouldn't?'"

Bauguess "has been a thoughtful advocate and contributor to innovation at the SEC and we would all do well to pay heed to his most recent speech," said **Willkie Farr** partner and former SEC deputy chief of staff **John Burns**. "Remains to be seen, of course, but I would mark his words as foreshadowing where the agency will be making investments down the road."

Bauguess' speech follows up on another speech he made last year, in which he discussed the SEC's use of data analytics and the increasing role that both machine learning and artificial intelligence were playing (*ACA Insight*, 7/24/17).

Standardized data

In recent years, "RegTech" and "SupTech," short for, respectively, "Regulatory Technology" and Supervisory Technology," have emerged, Bauguess said. "Each uses machine learning methods to lessen the burden of either complying with or supervising a wide range of regulatory requirements in financial markets. And while neither has reached maturity, both offer significant promise by way of improved market functioning and increased operational efficiencies."

The SEC has been moving toward the use of standardized data when it requires information from registrants. Standardized data allows machines to read the data. "The first rule mandating a machine-readable disclosure dates back to 2003," he said, "and more than a dozen other rules requiring structured disclosure have been proposed or adopted since then."

"The key innovation of our developing disclosure technology is making machine accessibility invisible to the rendering of a document for human readability," Bauguess said. He said this was the case with a recently proposed rule that would require SEC reporting companies to file their periodic reports in an Inline eXtensible Business Reporting Language (XBRL) format. "Currently, filers separately report a human-readable html version of a periodic report and a machine-readable version in an [XBRL] format," he said. "The proposed rule, if adopted, would combine the two requirements and create a single document designed to be read equally well by humans and machines."

"From a machine learning perspective, the financial

statement data, footnotes and other key information contained in an Inline-XBRL filing can be easily and automatically extracted, processed and combined with similar data from other 10-K filings," he said.

"Sophisticated algorithms depend on this data being of high quality and being machine readable," Bauguess said. "When applied to the emerging fields of SupTech and RegTech, there is tremendous potential for enhanced regulatory compliance."

Burns noted that "the SEC has found ways to extend structured data requirements to managers (through the XML format mandated for Form N-MFP and Form 13F filings, for example) or offer the option to submit certain filings in XBRL format (such as risk/return summary information). It will be interesting to see to what extent other current or future data submissions are set in these formats."

Five myths

Bauguess, in his speech, said that he has found that there are "common perceptions about data and information access that are misguided, or even wrong." He named five, which were:

1. **Electronic access is equivalent to machine readability.** "It is often assumed that if a document is electronically accessible, then it must also be machine readable," Bauguess said. "This is not true." The problem, he suggested, is because many take the term "electronic access" to mean that something is "digitally" accessible. "But just because a document can be downloaded over the internet does not mean that it can be ingested by a computer algorithm," he said. "A document stored in an electronic format, and available for download over the internet, can be impenetrable to machine processing." This is true particularly if the document is scanned, stored in a proprietary format, or is guarded by security settings. "For advanced machine learning algorithms to generate unique insights, there must be structure to the information being read."
2. **The Commission alone develops the reporting standards incorporated in its rules.** The National Technology Transfer and Advancement Act, Bauguess said, requires federal agencies to use technical standards developed by voluntary consensus standards bodies. "We borrow from standards developed and/or endorsed by external groups, whenever possible." That's what the SEC did when it adopted XBRL for financial statement reporting in 2009, "which is an open standard format that is widely available to the public royalty-free at no cost," he said. "The standard originated from an [**American Institute of Certified Public Accountants**] initiative and was ultimately given its own organizational standing – XBRL International – that now has more than 600 members. And XBRL is now in use in more than 60 countries."
3. **Retail investors don't need machine-readable data.** "It is an unfortunate but common refrain among some market observers that the average retail investor does not benefit from structured data disclosures, such as those made using XBRL," Bauguess said. This belief misses the point that structured disclosures enable third-party vendors to make the information available to retail investors at low or even no cost. "Machine-readable disclosures fuel many online financial tools popular with investors," he said. "So while it may be trued that many investors do not directly use structured data, the fact is that they do consume the data downstream. Such access would be impossible without structured data. This is particularly true for smaller SEC reporting companies."
4. **Requiring machine-readable reporting standards ensures high-quality data.** This also is not true, Bauguess said. "Despite claims to the contrary, computer algorithms can't fix poorly reported data; they can only maximize its usefulness. Unless reporting entities comply with both the letter and the spirit of promulgated reporting requirements, a well-designed standard may still be insufficient for today's advanced analytics to generate unique insights about market behaviors."
5. **We don't need the public's views any more.** This tends to come from those who know data the best, he said. They "often just assume that we know their views and will do the 'right' thing when it comes to

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implementing new reporting requirements." The fact, however, is that it is "vital" for the SEC to hear "from consumers of data, from the experts who know best how the data can be used. Because while we have considerable inhouse expertise, there is no substitute for hearing directly from the public."

DOL Won't Enforce

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ment adviser fiduciaries that the Department will not enforce prohibited transactions claims against them until further regulations, exemptions or guidance are issued.

"The Department will not pursue prohibited transactions claims against investment advice fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards for transactions that would have been exempted in the Best Interest Contract Exemption and Principal Transactions Exemption, or treat such fiduciaries as violating the applicable prohibited transaction rules," the DOL said in Field Assistance Bulletin No. 2018-02.

In taking this step, the Department noted that the U.S. Court of Appeals for the Fifth Circuit had issued an opinion "vacating the entire Fiduciary Rule, the BIC Exemption, the Principal Transactions Exemption, and related amendments. . . . The Department understands that financial institutions, advisers and retirement investors may have questions regarding the investment advice fiduciary definition and related exemptive relief following the court's order." The DOL added that it "plans to provide appropriate guidance in the future."

Non-enforcement for vacated standards

There may appear to be a potential problem in the DOL's statement that it will not take enforcement action against financial advisers that violate the impartial conduct standards. Those standards were created as part of the BIC Exemption – which was vacated by the appellate court. So if the Exemption and its impartial conduct standards no longer exist, why is a non-enforcement policy needed?

"Some financial firms may have restructured their relationships and contracts to rely on the Best Interest Contract Exemption," said **Mayer Brown** partner **Lennine Occhino**. "But now that the exemption has been retroactively vacated, they may feel at risk of liability for conflicting conduct that could have been fiduciary in nature even under the fiduciary definition that preceded the DOL Fiduciary Rule. So the DOL's non-enforcement position appears to be intended to address that potential gap. The DOL is giving such firms the benefit of the BIC Exemption based on their good faith compliance with the standard, even though the exemption has been vacated."

The field assistance bulletin "is designed to allay concerns and confusion over just what needs to be done to avoid a prohibited transaction based on non-discretionary advice," said **Stradley Ronon** partner **George Michael Gerstein**. "Since last year, many firms have been fashioning their own ways to adhere to the impartial conduct standards for this very reason. FAB 2018-02 allows firms to continue relying upon such a compliance approach until the DOL decides to issue more formal guidance."

"While the impartial conduct standards were an essential part of the Best Interest Contract Exemption, they have been effectively decoupled from that exemption because of the Fifth Circuit decision," he said. "One can now consider the impartial conduct standards as a standalone compliance strategy for certain prohibited transactions."

The DOL said that it is "aware that some financial institutions may be uncertain as to the breadth of the prohibited transaction exemptions that remain available for investment advice fiduciaries following the court's order. The uncertainty about fiduciary obligations and the scope of exemptive relief could disrupt existing investment advice arrangements to the detriment of retirement plans, retirement investors, and financial institutions."

"Further," the Department continued, "some financial institutions have devoted significant resources to comply . . . and may prefer to continue to rely upon the new compliance structures."

The future

In terms of future regulation, exemption or guidance, the DOL said that it "is evaluating the need for other temporary or permanent prohibited transaction relief for investment advice fiduciaries, including possible prospective and retroactive prohibitive transaction relief."

That said, it should be noted that Labor secretary **Alexander Acosta**, not long after taking office, expressed a willingness to work with the SEC on developing best interest standards for broker-dealers. He and SEC chairman **Jay Clayton** reportedly conferred at least once, and both government entities, according to Clayton's testimony before Congress in September 2017, were working together over the steps to take (*ACA Insight*, 10/2/17).

After some months, the SEC proposed its own Best Interest Rule for broker-dealers, an interpretation of the existing fiduciary duty that advisers have been working under, and more. The proposals apply to all asset managers that are fiduciaries, not just those handling retirement accounts, as the DOL's Rule did. Whatever the DOL proposes in the future, it is expected to fit into whatever final rules the SEC comes up with.

The current situation, with the DOL Rule vacated and the SEC proposals a long way from being adopted, is that the definition of what constitutes a fiduciary, at least for ERISA purposes, will return to the 1975 ERISA five-part definition, said **Skadden Arps** ERISA counsel **Jeffrey Lieberman**. Under that definition an adviser was considered a fiduciary if it:

1. provides advice as to the value of securities or other property,
2. on a regular basis,
3. pursuant to a mutual agreement or understanding with the plan or plan fiduciary
4. that the advice will serve as a primary basis for investment decisions, and
5. the advice is individualized to the particular needs of the plan or IRA.

One possibility of what the DOL might attempt in the future is to "refine its thinking of elements of the five-part test," Lieberman said. "One of the DOL's concerns that led to the now-vacated Fiduciary Rule was that some advisers and brokers tried to position themselves so they would not be defined as fiduciaries. Changes to the test might allow more people to be classified as fiduciaries."

These efforts might occur even if an SEC Best Interest Rule for broker-dealers is adopted because Commission rules apply only to advisers and broker-dealers, and only to securities, he said. "Changes to interpretation of elements of the five-part test might encompass a wider group of service providers."

SEC Keeps Gatekeepers

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laid down a clear marker that if accountants retained to help advisers comply with Rule 206(4)-2, the Custody Rule, themselves violate the Rule, they can expect to be charged and, if found guilty, face financial and other penalties.

WKMR and its two partners, among other charges, allegedly failed to meet Custody Rule requirements that they be independent of the advisory firm, **Voit & Company**, also based in Wisconsin. Voit itself was not a party to this settlement.

Specifically, according to the administrative order instituting the settlement, the accounting firm was not independent when it was engaged to perform annual audits of Voit's funds for 2014 and 2015 because it had already prepared financial statements for the funds for those years, and because Voit already had a direct business relationship with the accounting firm. Under that relationship, a WKMR advisory firm affiliate, received a fee when it referred advisory clients to Voit.

The SEC leveled other charges against the accounting firm and its partners as well, including that it was not subject to regular inspection by the Public Company Accounting Oversight Board, something required by the Custody Rule of accounting firms that are retained to perform independent audits. Other charges listed

in the settlement were that the respondents failed to engage in proper professional conduct as spelled out in Section 4C of the Exchange Act and Rule 102(e)(1)(ii) of the SEC's Rules of practice, among them that WKMR and Disrud failed to design and implement an appropriate response to the risk of material misstatement and failed to obtain sufficient appropriate audit evidence.

Custody and gatekeepers

Voit owner and portfolio manager **Todd Voit** said that his firm's "legal counsel indicated that we did not have custody, and WKMR relied on that information. Once it was determined that we did in fact have custody, the accounting firm took steps to mitigate the damage by becoming PCAOB certified and redoing the audit."

"The Custody Rule is serious business both for investment advisers and for the service providers upon which they rely," said **Pasquarello Fink** partner **William Haddad**. "Here, the investment adviser was not charged, apparently because it did not appreciate the conflicts and issues associated with having respondents prepare and audit the funds, and serve as a referral source. Investment advisers with custody should not, however, rely on ignorance of such issues. While it is certainly tempting to 'one-stop shop' an accounting firm as an auditor and referral source, advisers should be careful that they don't trip over the Custody Rule and other issues by doing so."

"The takeaway for private fund managers is the importance of performing due diligence on your vendors," said **Morgan Lewis** consultant attorney **Steven Hansen**. "Even when the advisory firm involved is not charged, this type of proceeding is not a positive event for it in many ways, including the possibility of adverse publicity, the possible expense of redoing an audit, and more."

The agency's focus on gatekeepers goes back to at least October 2013, when White, in a speech before the Securities Enforcement Forum, made clear that firms that work with investment advisers cannot escape enforcement actions by stating that they are not the adviser. "We are . . . pursuing those who should be serving as the neighborhood watch, but who fail to do their jobs," she said. "Cases against delinquent gatekeepers remind them, and the industry, of the important responsibilities that gatekeepers share with us to protect investors."

Custody requirements and independence

Voit had custody of fund-invested client assets from at least December 2013 to December 2015 and therefore was required to comply with the Custody Rule.

Among other things, the Custody Rule requires that advisers maintain client assets with a qualified custodian, "who must provide account statements to investors at least quarterly, and requires client assets to be verified through an annual surprise examination by an independent public accountant," the SEC said. The adviser, however, in what is known as the "audit exception," does not have to comply with certain requirements if it provides limited partners with annual audited financial statements prepared in accordance with GAAP within 120 days of the end of the partnership's fiscal year.

"The financial statements must also be audited in accordance with generally accepted auditing standards," the agency said. The financial statements are required to be audited by an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, by the PCAOB (emphasis SEC) .

And therein lies the rub. "WKMR was not independent because it both prepared and audited the funds' 2014 and 2015 financial statements and notes to the financial statements, which it then audited," the agency said in the settlement order.

Under Rule 2-01(c)(4)(i) of Regulation S-X, which governs the specific form and content of financial reports, the SEC said, "an accountant is not independent if he provides certain bookkeeping or other services, related to the accounting records of financial statements unless it is reasonable to conclude that the results of those services will not be subject to audit procedures during an audit of the audit client's financial statements."

"The financial statements and accompanying notes that WKMR prepared were subject to the audit procedures

that WKMR performed during its audit of the funds," the agency said. It noted that the WKMR engagement team, after analyzing whether WKMR's preparation of the financial statements and notes impaired the accounting firm's independence, "erroneously concluded that independence was not impaired." Nor, the SEC said, did WKMR provide any analysis to support this conclusion.

Referrals count

The second reason the settlement provided as to why WKMR could not be considered independent was that the accounting firm "had a direct business relationship with Voit."

It turns out that a WKMR investment adviser affiliate, WKMR Financial, "had a referral fee arrangement," the agency said. The main advisory service provided by WKMR Financial included recommending other investment management firms, including Voit, to its clients. WKMR, in exchange for these recommendations, "received a percentage of the annual fee that the investment adviser receive[s] from those referred clients," the SEC said. "WKMR Financial did not receive any referral fees from Voit if the client did not become an investment management client, nor did it receive any referral fees for referring clients who invested in the Voit funds."

Disrud and Sehmer, since they were WKMR partners, were also indirect owners of WKMR Financial – which meant that they would receive a portion of the income that the affiliate generated.

"Under Rule 2-01(c)(3) of Regulation S-X, accountant is not independent if it has a direct business relationship with an audit client," the agency said. "WKMR had a direct business relationship with Voit because WKMR Financial . . . provided advisory services and recommended Voit to its clients and, in exchange, received a fee from Voit." That fee amounted to most of the affiliate's revenue, according to the settlement order. "For 2014 and 2015, all of WKMR Financial's income came from Voit, and WKMR's net income for 2014 and 2015 was approximately $217,000 and $233,000, respectively." The SEC also alleged that the WKMR engagement team did not analyze whether the accounting firm was considered to have a direct business relationship with its audit client.

As mentioned above, financial statements, are required, among other things, to be subject to regular inspection the PCAOB. According to the SEC, this was not the case with WKMR, which, as of the beginning of the 2014 and 2015 funds' engagement periods, "was not subject to regular PCAOB inspection."

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Charges and punishment

As part of the settlement, WKMR and Disrud were found to have caused, and willfully aided and abetted, Voit's 2014 and 2015 violations of Section 206(4) of the Advisers Act and its Rule 206(4)-2, the Custody Rule. Sehmer was found to have caused Voit's 2015 violations of Section 206(4) and the Custody Rule.

WKMR was banned from working before the Commission as an accountant for one year, ordered to pay disgorgement and prejudgment interest of more than $18,800, and a civil money penalty of $15,000. Disrud was banned from working before the Commission for two years and ordered to pay disgorgement and prejudgment interest of more than $10,000 and a civil money penalty of $10,000, and Sehmer was banned from working before the Commission for one year.

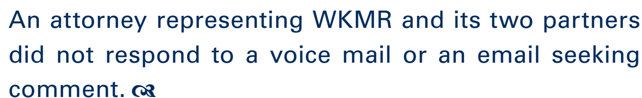
An attorney representing WKMR and its two partners did not respond to a voice mail or an email seeking comment.

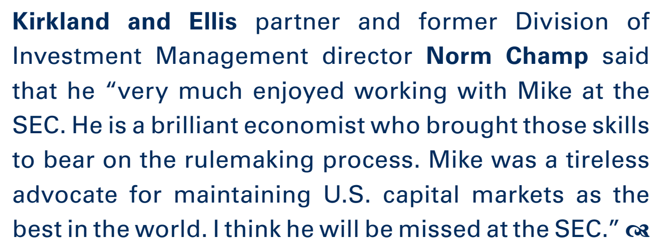
Piwowar Plans July Departure

Michael Piwowar will be leaving his role as an SEC commissioner on July 7 or the swearing in of his successor, whichever comes first. He sent a letter to President **Donald Trump** on May 7 announcing his resignation.

Unlike most commissioners, Piwowar, a commissioner since August 2013, served as acting chairman of the SEC for several months after former chair **Mary Jo White** left before President Trump took office. SEC chairman **Jay Clayton** praised Piwowar's leadership, "including during his tenure as chairman, during which he advanced a number of important initiatives in times that saw significant developments in our markets.

Kirkland and Ellis partner and former Division of Investment Management director **Norm Champ** said that he "very much enjoyed working with Mike at the SEC. He is a brilliant economist who brought those skills to bear on the rulemaking process. Mike was a tireless advocate for maintaining U.S. capital markets as the best in the world. I think he will be missed at the SEC."





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