Regulatory Compliance Watch

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Five-year battle with SEC ends with $92m penalty

An adviser that vowed to take on the **SEC**'s enforcement action asserting it should have disclosed revenue sharing has seen the case end after many years with a huge penalty, and the judge's admonition that the firm shouldn't have kept its CCO in the dark.

A final decision came down March 29 from Boston-based federal Judge **Indira Talwani** against **Commonwealth Equity Services** ($177B in AUM) in Waltham, Mass. The Commission had sued Commonwealth in 2019, claiming the firm placed clients in more expensive mutual fund share classes when cheaper alternatives were available, failed to disclose conflicts arising from a revenue sharing venture and lacked related compliance P&Ps (*RCW*, Aug. 1, 2019).

Five years ago, Commonwealth hit back hard, questioning whether the agency even had the legal authority to bring its case, contending there weren't any formal rules against the behavior (*RCW*, Oct. 3, 2019).

Rule violations

Talwani sided with the Commission, citing Commonwealth violations of Advisers Act *section 206(2)* (prohibited transactions: engaging in "a fraud or deceit"), *section 206(4)* (engaging in a practice that is "fraudulent, deceptive, or manipulative"), and the compliance rule, *rule 206(4)-7* (for lack of P&Ps).

These findings were echoed in a summary judgment Talwani issued last year (*RCW*, April 13, 2023). In her new, 29-page *final ruling*, the judge also rejected late Commonwealth filings and set the penalty: $65m in disgorgement, $21m in interest and $6.5 million in fines.

"Commonwealth's failures to disclose were egregious," wrote Talwani March 29th. "The court determined that Commonwealth was aware that lower-cost share classes of funds in which its clients were invested were available, knew that it was generating revenue from keeping its clients in the higher cost share classes, and failed to disclose any of this to its clients. This is a fundamental

SEC examiners to eye T+1 readiness, page 2.

Content

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violation of an investment advisers' fiduciary duty to act in the best interest of its clients."

Talwani also addressed the CCO issue: "The egregiousness of Commonwealth's actions is compounded by its failure to keep its Chief Compliance Officer … adequately apprised of any conflicts of interest regarding Commonwealth's revenue-sharing agreements with NFS" (***RCW***, April 13, 2023).

Commonwealth's long-time CCO **Paul Tolley** didn't return ***RCW*** inquiries. But a statement from Commonwealth CEO **Wayne Bloom** noted the firm "is very disappointed in the ruling, and we are exploring all options to continue to defend our position in the legal system." The SEC declined to comment.

Turning aside adviser arguments

Talwani rejected Commonwealth's assertion that the SEC provided no proof that clients would have sought the lower-charging funds if they knew they were available. "The court squarely rejected this argument, finding it defied both 'common sense' and basic economics," she wrote. There "is reason to believe that at least some of those clients would have elected to move their money to the lower-cost funds."

Clients "were deprived of relevant information and therefore of their ability to give informed consent to the conflicts," the judge continued. She similarly rebuffed Commonwealth's analogy with **The Robare Group**'s case (***RCW***, May 13, 2021). The judge wrote that that disclosure case didn't involve placing clients in higher share classes when lower costing ones were available.

The judge defended her "substantial penalty" because of "the egregiousness of Commonwealth's conduct, the four-year duration of Commonwealth's violations, Commonwealth's failure to accept responsibility, and Commonwealth's finances."

The ending of the case, which arose during the Commission's share class initiative (***RCW***, May 24, 2018), flags the need for advisers to accept their responsibility to disclose conflicts, especially around revenue sharing. ■

SEC RISK ALERT

Examiners to eye T+1 transition readiness

Memorial Day weekend is typically looked forward to with a great deal of anticipation, but this year the feeling for the financial services industry may be trepidation as firms prepare for the May 28 transition to T+1. The **SEC**'s Division of Examinations released a ***risk alert*** March 27 revealing that the Commission will "continue to conduct examinations and engage in outreach" with firms to review and assess their T+1 preparedness and changes that have

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been made in response to the new rules.

May 28 is a big day for the industry. In addition to the move to T+1, it is the compliance date for new rules tied to the processing of institutional trades by broker-dealers and certain clearing agencies (***RCW***, Feb. 16, 2023). The final settlement rules also come with recordkeeping requirements that apply to SEC-registered investment advisers (see related story, this page).

"I encourage all market participants to ensure that they are ready for the upcoming transition," said SEC Chairman **Gary Gensler** in a ***speech*** April 2 before the annual *SEC Speaks* conference.

Compliance impact

The Commission acknowledges that the shortening of the settlement cycle will require broker-dealers, clearing agencies and IAs to change their "business practices, computer systems, and technology solutions." The new rules also could have an impact on how firms comply with other currently existing regulatory obligations (e.g., reducing the number of days that broker-dealers will have to obtain possession of customer securities before being required to close out a customer transaction).

SEC examiners will be looking to determine changes made to a firm's allocations, confirmations and affirmations process. The addressing of the requirements for straight-through process will be a further focus point. The alert reported that custodians and investment managers that manually affirm their transactions are providing affirmations "at a significantly lower rate on trade date than prime brokers or investment managers that use central matching tools."

Examiners' lines of inquiry

In the new risk alert, the Division of Examinations signaled that examiners may review whether and how firms have evaluated the potential impact of the final rules on their:

1 Business activities.

2 Operations and risk assessments.

3 Services.

4 Customers, clients, and/or other relevant parties.

Examiners further will be asking about firms' preparations relating to clearing services provided to institutional clients, retail customers, or other broker-dealers; custodial or prime brokerage services; trade allocation and fail management processes; and custodian communication.

Operational readiness and any information pertaining to testing events with the **DTCC** will be a further interest. Details on disclosures, representations, and/or communications to customers, clients, and/or vendors regarding changes that will occur additionally will be queried.

A helpful appendix

Compliance will be happy to learn that an appendix to the risk alert provides a baker's dozen list of information and documents that examiners may seek to review. One such request includes information regarding changes to a firm's P&Ps to comply with the shortening of the settlement cycle and the related new regulatory requirements. ■

Timely FAQs ahead of T+1 compliance deadline

The **SEC**'s divisions of Investment Management and Trading and Markets have issued FAQs concerning the fast-approaching May 28 transition to a T+1 standard settlement cycle (see related story, page 2). One of the seven FAQs addresses IA recordkeeping requirements and advises that IAs must make and keep records of each confirmation they receive and of any allocation and each confirmation they send or receive for any transaction subject to Exchange Act rule 15c6-2. That rule holds regardless of the source or the form of the allocation, confirmation or affirmation, the divisions note.

Date/time stamp requirement

The divisions added that "the recordkeeping requirements apply without regard to when each confirmation is received or when any allocation and each affirmation is sent or received." As with each affirmation and any allocation sent or received, the affirmation must include a date and time stamp that indicates when it was sent or received.

The Commission said the amendments to Advisers Act rule 204-2 are intended to reduce risk following the transition to T+1 by improving affirmation rates.

The Investment Management division has anticipated that the industry may have additional questions about investment adviser recordkeeping requirements. Questions can be directed to the IM Chief Counsel's office at (202) 551-6825 or ***IMOC@sec.gov***.

More on the new internet advisers' rule

If your firm provides investment advisory services over the web only, do note that next March you'll have a new Form ADV section to complete: Schedule D, Section 2.A(11) internet adviser.

This notice comes thanks to the **SEC**'s new ***final rule*** affecting internet advisers (***RCW***, March 27, 2024). It's the latest new rule approved recently by the Commission that targets advisers. The Commission states there are fewer than 300 internet advisers, but they appear to be growing.

The changes to Schedule D would give you the option of checking two boxes, one indicating if you will "provide investment advice on an ongoing basis to more than one client exclusively through an operational interactive website" and a second that you have "provided and will continue to provide investment advice on an ongoing basis to more than one client exclusively through an operational interactive website."

These attestations would be necessary to claim the registration exemption provided by Advisers Act ***rule 203A-2*** (exemptions from prohibition on Commission registration), which the new final rule amends. The answers also may help direct the SEC to which firms they may wish to examine.

Compliance Toolbox

Find tools-you-will-use at ***www.regcompliancewatch.com***. Visit our ***Compliance Toolbox***. Five examples of what you'll find in our toolbox are below. Or visit our website and find the tools you need.

- ***Client Release Form***
- ***Soft Dollars P&Ps***
- ***Robo Advisor Exam Letter***
- ***Holdings Report Form***
- ***Small Firm Cybersecurity Checklist***

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Aligning rules to current practices

Modernizing the two-decades old rule "will better align current practices in the investment adviser industry with this narrow exemption and will adapt the rule to the broader evolution in technology and the marketplace that has occurred since the rule was adopted," reads the rule's preamble.

Other changes will drop the old phrase "interactive website" for "operational interactive website." This also would cover apps and any "similar digital platform," perhaps positioning the rule for future technological advancements.

Similarly, the rule includes a definition of "digital investment advisory service," meaning "investment advice to clients that is generated by the operational interactive website's software-based models, algorithms, or applications based on personal information each client supplies through the operational interactive website."

Gone also is the *de minimis* exception for providing advice to fewer than 15 non-internet clients during the prior 12 months. In essence, internet advisers would have to be just that—supplying services over the internet. Although the rule will not prohibit non-internet contact by advisory personnel, it will limit it.

As with the current rule, "personnel generally can continue to assist clients with technical issues or collect feedback in connection with the use of the website (e.g., accessing the website), including by assisting clients with explanations of how the algorithm generating the investment advice was developed or operates. Advisory personnel generally should be able to perform those services telephonically, through email, live electronic chats, and similar forms of electronic communication," the preamble continues.

Drawing lines around human interaction

However, human-directed "client-specific investment advice, even if delivered through electronic means, would not be eligible activity under the Internet Adviser Exemption."

While internet advisers make up a small portion of the 15,531 SEC RIAs, the Commission recognizes that "the growth of services available on digital platforms, such as those offered by online brokerage firms and robo-advisers, has multiplied the opportunities for investors to invest in and trade securities," a trend demonstrated by the broad impact of the **GameStop** debacle (***RCW***, Sept. 27, 2021).

While the new rule will become effective later this year, its compliance date coincides with next year's Form ADV update deadline for most advisers: March 31, 2025.

Internet advisers also should be aware of the three-year-old SEC ***exam risk alert*** sharing exam findings involving

The top 10 RCW stories for March

Here are our most popular stories of the month that can be found on *RCW*:

1 *Gensler hears earful on new rules*

2 *Here's timely Form ADV update advice*

3 *The case that got away from the SEC*

4 *SEC releases 38 Form ADV FAQs*

5 *A couple of approaches to the use of AI*

6 *What the war on ESG means to you*

7 *More insights into the impact of AI*

8 *SEC watches ESG disclosures*

9 *The top 10 RCW stories for February*

10 *How new SEC ESG rules hit private funds*

"Electronic Investment Advice."

What do you think about this story? Please, ***share your thoughts*** *with Publisher* **Carl Ayers**. ■

E-comm charges stem from mass marketing

Mass marketing e-mails sent to large distribution lists were the primary culprit leading to charges against an Atlanta-based broker-dealer for failing to preserve and review over 1.25 million business-related electronic communications on four platforms. **H2C Securities**—the latest in a long line of firms to be hit with e-comm-related regulatory enforcement actions—agreed in a **FINRA** ***settlement*** to pay a $250,000 fine for its violations.

FINRA noted that the enforcement action originated from the SRO's review of a rule 4530 disclosure filed by H2C Securities in April 2021. In addition to the mass marketing materials, FINRA reported that the communications included internal and external e-mails, instant messages, and documents requiring customers' electronic signatures. The communications, spanning from at least January 2013 to June 2021, were sent or received by "associated persons" of H2C Securities using four platforms that the firm made available to them.

WSPs lacking

FINRA determined that the firm's supervisory system, including WSPs, was not "reasonably designed" to achieve compliance with the firm's obligation to capture, retain, and review communications sent or received using the e-communications platforms. Specifically, the SRO said the WSPs failed to identify: 1) that associated persons had access to these platforms; 2) the circumstances under which associated persons could use these platforms for e-communications; or 3) how the firm would preserve and review communications through the platforms.

Compliance review discovery

Compliance eventually caught the e-comm shortcomings. In March 2021, H2C Securities discovered, during a compliance review, that it had not established data feeds from the four platforms to the system that the firm used to store and maintain e-communications. The firm discontinued the use of three of the communication platforms a month after the finding and, in July 2021, H2C Securities established a data feed from the remaining platform to the firm's system for storing and maintaining e- communications.

H2C Securities has since retrieved "some communications" sent or received using the four platforms but the firm has "been unable to recover most of the communications." ■

ESG gets its day(s) in court

The theater of battle in America's ESG war is moving quickly into the country's courts.

The **Fifth U.S. Circuit Court of Appeals** has already stayed the **SEC**'s public company reporting ***rules***, adopted March 6. There are challenges to those rules from either side of the ESG question in at least six other federal courts.

In California, the **U.S. Chamber of Commerce** and other groups are suing to block the Golden State's ***new*** carbon disclosure laws. In New York, workers backed by right-wing groups have filed suit ***accusing*** New York City's pension plans of breaching their fiduciary duty for divesting from fossil fuel companies.

"The central question is, 'Are you breaching your fiduciary by focusing on these 'political' questions or are you actually upholding your fiduciary by upholding value for your investors?'" says **Giovanna Ferrari**, a partner at, and co-founder of, **Seyfarth Shaw**'s impact and ESG group.

Earlier this year, Ferrari and her colleagues released Seyfarth's annual analysis of corporate America's litigation risks. ESG was one of the top threats.

"As companies increasingly disclose their ESG efforts in public filings, they risk allegations that the achievements or metrics that they present constitute material misstatements or omissions in violation of securities laws," Ferrari and her colleagues ***wrote***, adding that it's not just federal regulators but plaintiff's lawyers who are looking for opportunities to sue.

The *Wong* case

Ferrari is one who ***thinks*** the crusade against "woke" investing is "window-dressing" (***RCW***, May 19, 2023).

"If your company is losing money because it's inefficient in the way it uses energy, that hits the bottom line," she says. "That's a pure profit question."

The New York City pension case is one to watch, Ferrari says. **Wayne Wong** and other city employees claim that the city's pension managers breached their fiduciary duty by divesting from fossil fuels, hurting workers' retirement funds. The pension funds have ***asked*** New York's Supreme Court to dismiss the claims. Among other things, the city is claiming they've made more money for pensioners by avoiding fossil fuels. That's a traditional defense in a breach-of-duty claim, Ferrari says.

"If that case is dismissed, it's not going to stop conservative political activists and lawyers that are bringing these cases," she says. "They're going to keep trying. We actually have the Fifth Circuit ***taking up*** the **NASDAQ** board diversity rules. That said, I think we can start to predict the arguments that private plaintiffs are going to claim. We'll likely get some rulings that will help the defense bar."

If they're allowed to stand, the new SEC public company rules—and the reams of data it's likely to generate—may also give private fund managers some clarity, and even a defense against plaintiffs' suits from either side of the aisle, Ferrari says.

"The more conservative Republicans will tell you that you're only investing for political reasons. And private investment advisers are going to say, 'No, we actually spent some time looking at the portfolio,'" Ferrari says.

'Don't call it ESG'

Among the problems anti-ESG activists face is that even if they win in court, the regulatory pressures to come up with meaningful and enforceable ESG metrics won't go away, because they're driven by investor demand, Ferrari and ***others*** say (***RCW***, March 29, 2024).

"I do think we have a younger generation of workers and consumers who feel very, very strongly about the way companies behave. It's not going away," she says. "We're not going to stop worrying about human rights violations in the supply chain. And it's not about climate change or human rights in the abstract. It's about how it affects our people, our products, our planet, our performance and our profit. Don't call it 'ESG.' Each of those things are traditional matters that you'd be concerned about in traditional investing. It's not new."

In an age of social media, a company's reputation and brand's value is a lot more brittle. "What's different today is that there are more stakeholders making more claims on companies, and they can move the needle because the barriers to entry are lower," she says.

'The trend is very clear'

Whatever American courts decide, the UK and EU have committed to robust ESG disclosure standards, says **Jagmeet Lamba**, founder and CEO of **Certa**, a compliance-and-procurement software platform with backing from several private funds, including **Steve Cohen**'s **Point 72 Ventures** and **Fin Capital**.

"The SFDR rules in the UK are driving a lot of business," Lamba says. "Anyone who is not already working on getting their company ready for climate-related disclosures is behind."

For Lamba, the "first thing" private fund CFOs ought to worry about is whether their firm or its portfolio companies are making ESG-related marketing claims that they can't substantiate. It may be time to decide whether your firm can or will make any ESG claims for itself.

"You can just say, 'We don't care, we're not doing anything with ESG.' That's fine," Lamba says. But "you could get a competitive advantage by being proactive on ESG reporting. Any funds have to do this to stay competitive. Otherwise, the scope of where they can raise money will reduce and keep reducing. The trend is very clear."

Start now

The SEC's embattled public company rules don't require Scope 3 disclosures—that is, the carbon emissions from along a company's supply chain. But California's and Europe's and the UK's rules do, and "it's painful," Lamba says.

"The biggest pain is basically gathering data from hundreds of portfolio companies," he says. Firms that are already disclosing Scope 3 emissions "are very worried about accuracy of the data—data validation, standard deviation, et cetera," Lamba adds.

While American courts wrestle with the legal implications of ESG rules, it might be a good time for fund managers to build up their reporting infrastructure, Lamba says. "They should act now," he says. ESG metrics still "is a nascent industry. In about five to 10 years, the fund administrators will be able to do this, but for now fund managers will need to do it themselves."

Lamba says there are two things firms can do to get started. "An effective organizational strategy I've observed is appointing a dedicated ESG champion. This person should be deeply passionate about sustainability and possess the ability to drive impactful change within the company," Lamba adds. "Number two, make sure the software you're using is flexible enough to adapt and grow with your firm." ■

Non-traditional ETPs yield recurring suitability issue

A fundamental compliance maxim holds that it's smart to promptly and properly address issues cited in a prior regulatory enforcement action. Not fully tackling the underlying problems identified in the previous violative conduct invites being charged again.

The St. Louis-based **Stifel, Nicholaus & Co.** and **Stifel Independent Advisors**, whose compliance policies and supervisory procedures are created and implemented by their public holding company **Stifel Financial Corp.**, are learning this lesson the hard way—and paying the price.

Charges ten years apart

Back in 2014, the firms settled **FINRA** charges that they failed to establish and maintain supervisory systems "reasonably designed" to achieve compliance with their suitability obligations in connection with transactions involving non-traditional exchange-traded funds. On March 25, the SRO again charged the firms for deficiencies tied to transactions involving non-traditional ETFs and other non-traditional exchange-traded products.

In settlements after the first go round, the Stifel firms agreed to a $550,000 penalty and restitution of $474,613 to affected customers. This time, those ***settlement*** figures have escalated to $1 million in aggregate fines and $1.29 million in customer restitution.

Regulator interest

FINRA examiners have been eyeing complex products. The **SEC** also signaled in its 2024 examination priorities that Commission examiners would focus, among other things, on "those recommended products that are complex, such as derivatives and leveraged ETFs."

In the new cases, FINRA determined that the Stifel firms failed to take reasonable steps to detect and address hundreds of potentially unsuitable recommendations that customers buy and hold NT-ETPs for longer periods of time than they were designed to be held. The SRO noted that the complex NT-ETPs are designed to be held for only short periods of time—typically a single day or a single month. Customers ultimately realized losses, said FINRA.

Revisions made

After the 2014 settlement, the Stifel firms did take certain steps to address their supervision of NT-ETPs. Those steps included revising their WSPs and implementing a new automated alert to monitor NT-ETP holding periods. The problem: after the changes were implemented, the firms' supervisory system "was still not reasonably designed to achieve compliance with their suitability obligations in connection with recommendations of NT-ETPs."

FINRA noted that the revised WSPs did not require supervisors to take any action to assess whether NT-ETP recommendations, including recommended exit or hold strategies, were consistent with the intended holding periods identified in the products' prospectuses. The WSPs further did not provide any guidance to supervisors regarding how to conduct reviews or how to evaluate the appropriateness of any intended exit strategy, said FINRA.

Compliance steps in

The firms' compliance department did step up, but its efforts sometimes fell on deaf ears. Compliance determined that reps were "routinely" recommending long-term holding periods for NT-ETPs, a practice compliance referred to as "product misuse," FINRA reported. A "clean-up" effort involving tracking NT-ETP positions held for more than 30 days and encouraging supervisors to speak with reps and customers about selling aged positions was initiated by compliance. Some reps didn't listen, however, until solicited sales of NT-ETPs were prohibited. ■

Treasury markets post-trade transparency enhanced

For the first time, the public will be privy to the dissemination of **U.S. Treasury** transactions on a trade-by-trade basis after the **SEC**'s Division of Trading and Markets approved a **FINRA** proposal. The latest action is part of a now eight-year long series of initiatives in coordination with the Department of the Treasury to increase transaction reporting and transparency in the Treasuries market.

Last February, FINRA stepped up the timing of the aggregated volume data it publishes for Treasury securities to daily and the content of the data was enhanced. The detail reported to TRACE concerning individual transactions in Treasury securities is currently used for regulatory purposes but is not disseminated publicly. Under the approved change, FINRA will begin disseminating individual transaction information for on-the-run nominal coupon U.S. Treasury securities on an end-of-day basis.

Protecting confidentiality

The transaction information will include the market participant identifier or other information that could be used to identify parties to the trade, the approval order notes. The information would, however, include counterparty type, a flag to indicate whether the trade was executed on an ATS, and other trade modifiers and indicators.

Transaction size caps above which the exact size of the transaction would not be disseminated were proposed. The provision was aimed at concerns about information leakage for large trades. It is believed that the rules adoption is "reasonably designed to preserve the confidentiality of individual market participants and transactions."

Expanding the scope?

Some commenters on the then-proposed rule suggested that FINRA expand the scope of the Treasury securities subject to reporting and recommended the shortening of reporting timeframes. FINRA stated any future changes along these lines would be based on careful analysis.

SEC Chairman **Gary Gensler** hailed the rule approval for bringing "greater post-trade transparency to those shopping for or selling Treasury securities…. This is an important step towards bringing the Treasury market's post-trade transparency closer to that which has benefitted investors in the corporate, municipal, and mortgage bond markets," he added. ■