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May 31, 2018

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Industry Update

SEC Launches Investor Protection Search Tool

On May 2, 2018, the SEC announced the launch of a new online search tool, designed to aid investors in researching whether a person trying to sell them investments has a judgment or order entered against them in an enforcement action. According to the press release announcing the launch (the "**Release**"), the SEC Action Lookup for Individuals ("**SALI**") was designed to aid retail investors in avoiding financial fraud.

According to the release, SEC Chairman Jay Clayton hopes that SALI will not only aid investors in avoiding potentially fraudulent transactions, but also hopes that "Main Street Investors" will be able to act as an additional line of defense in detecting and preventing fraud. The Release notes that the search results offered by the tool not only include investment professionals, but also include individuals who have settled, defaulted on or contested enforcement actions brought by the SEC, provided that a final judgment or order was entered against them in a federal court or in an administrative proceeding. These results include individuals from SEC actions filed between October 1, 2014 and March 31, 2018, and will be updated periodically to include newly filed actions as well as earlier data.

The Release states that the SEC hopes that SALI will function as a supplement to existing investor education resources available on **http://www.investor.gov/**, which include a free investment professional search tool, alerts and bulletins, planning tools and frequently asked questions, prepared and provided by the Office of Investor Education and Advocacy.

- **Access the SEC Action Lookup for Individuals**

Dalia Blass Remarks at the 2018 PLI Investment Management Institute

On April 30, 2018, Dalia Blass, the Director of the Division of Investment Management of the SEC (the "**Division**"), addressed the 2018 PLI Investment Management Institute. Blass discussed the recently proposed standards of conduct for investment professionals and the previously proposed liquidity risk management rule.

Blass began by discussing the standards of conduct for investment professionals. She noted that the SEC recently proposed for public comment an updated set of standards relating to the standards of conduct for investment professionals. Blass discussed providing clarity to retail customers about investment professionals, including the requirement that firms take measures such as communicating to clients what kind of firm they are (i.e., a registered investment adviser, a registered broker-dealer, or both). According to Blass, the proposed changes would also restrict stand-alone broker-dealers and their financial professionals from holding themselves out as "advisers" or "advisors," given that potential investors may confuse these terms with "investment advisers." Additionally, firms would now be required to provide investors with a short-form summary disclosure to educate potential investors on the type of firm they are engaging with, the services offered, legal standards of conduct applicable to that entity and the potential conflicts of interests that may exist. Blass indicated that discussion surrounding the proposal has already begun, and she invited the public, including retail investors themselves, to provide its thoughts on the proposed rules.

Another aspect of the proposed regulation is called Regulation Best Interests ("**Reg BI**"). According to Blass, this regulation would create a duty under the Securities Exchange Act of 1934 (the "**Exchange Act**") for broker-dealers to act in the best interests of their retail customers. Blass discussed the reason for not defining "best interest" in the proposal, noting that despite this, the "contours of the obligation" have been defined, and include a broker-dealer not putting its interests ahead of the retail customer's, as well as requiring the broker-dealer to comply with disclosure, care and conflict of interest obligations. In discussing how this approach differs from the suitability standards for broker-dealers in FINRA rules, Blass states that this approach "goes beyond suitability," with respect to the aforementioned disclosure, care and conflict obligations. Additionally, in discussing the difference between the requirement for both broker-dealers and investment advisers to act in the best interest of a retail customer, Blass notes that the broker-dealer's obligation is tied to the recommendation given, while the investment adviser's obligation applies to the ongoing relationship with the client.

Additionally, Blass discussed another aspect of the proposed regulation, whereby the SEC would reaffirm and, in some cases, clarify the SEC's views on the investment adviser fiduciary duty standards. Blass notes that this proposal is intended to reaffirm that investment advisers must act in the best interests of their clients and that they owe a duty of care and a duty of loyalty to their clients. According to Blass, this means that an investment adviser may not favor its own interests over those of a client, and it cannot unfairly favor one client over another. The proposal also goes on to require investment advisers to avoid conflicts of interest with their clients, or at a minimum, require disclosure of such conflicts. Blass notes that the intent of this particular proposal was to "draw together a range of sources and provide advisers with a reference point for understanding their obligations to clients."

Blass added that the SEC is seeking investor feedback on all of the above proposals.

Next, Blass discussed liquidity risk management and the steps the SEC has taken to facilitate managing liquidity of fund portfolios. In 2016, the SEC adopted a rule that (i) required funds to adopt liquidity risk management programs, (ii) updated and enhanced existing guidance regarding the 15% limitation on illiquid investments for mutual funds, and (iii) introduced a new requirement for each fund to classify the liquidity of each investment into different "buckets." Blass noted that the rule also strengthened liquidity risk reporting to the SEC. Since adopting the rule, the SEC has solicited feedback from funds and investors regarding the proposed implementation and certain unintended consequences related to the rule's adoption. In response to this feedback, the SEC has released frequently asked questions, extended the compliance date for certain elements of the rule by six months and modified certain of the classification and reporting requirements.

Overall, Blass continued to solicit feedback from both investors and firms, and highlighted the SEC's work to help improve clarity and efficiency in a market that heavily involves retail investors. She noted that she is also working on a variety of other proposals including, for example, in the exchange-traded fund space, as well as in the design, delivery and content of disclosures to fund shareholders.

- **See a transcript of the speech**

Jay Clayton: The Evolving Market for Retail Investment Services and Forward-Looking Regulation – Adding Clarity and Investor Protection While Ensuring Access and Choice

On May 2, 2018, SEC Chairman Jay Clayton provided remarks to Temple University, outlining the importance of the relationship between investment professionals and their retail customers and clients.

Clayton began by emphasizing the importance of facilitating long-term, broad retail participation in capital markets through effective and pragmatic regulation. He discussed the importance of preserving and protecting our capital markets, as well as noting that individuals are largely responsible for funding their own higher education and retirements. Clayton noted that although it is more important than ever for people to save for their futures – given prolonged life expectancy and increased health care and living costs – over half of Americans do not have retirement account savings. Clayton then began to underscore the critical importance of access to personal investment advice. He next noted that this access can help less experienced and informed investors, by bridging the "knowledge, information, and comfort gap" that exists today.

In describing how he frames the SEC's job in regulating the capital markets for the benefit of retail investors, Clayton outlined three objectives:

- ensure investors can get clear, plain-language answers from investment advisers and broker dealers;
- require that investment professionals follow standards of conduct that embody key fiduciary principals tailored to the client relationship; and
- have effective enforcement tools if investment professionals do not follow the standards of conduct or provide false or misleading information.

Clayton further indicated that these goals should be accomplished while also aligning investor expectations with legal standards and ensuring a variety of investment advice services at reasonable cost to "Main Street" investors. He further stated that he had tasked the SEC staff to review the status of the market for retail investors with this framework in mind.

Next, Clayton discussed three key issues with respect to the provision of investment advice to retail investors:

- *Confusion and Lack of Clarity*. Clayton acknowledged that there are a number of different titles that firms use to advertise their advisory services, including "financial advisor," "financial consultant" and "wealth manager." However, Clayton stressed that from the SEC's perspective, the federal securities laws recognize and the SEC regulates two different legal entities: investment advisers and brokers-dealers. He discussed key differences between the two, including, for example, that investment advisers typically charge an ongoing management fee (usually a percentage of the assets that are being managed), while broker-dealers generally charge a commission that is associated with each transaction. Clayton noted that this legal distinction has real-world consequences for retail investors in terms of both fees paid to the investment professional and services received. Clayton underscored that many investors are not aware of whether they are dealing with an investment adviser or a broker-dealer, especially in situations where a firm is dually licensed. Thus, Clayton stated that investors may end up signing up for a relationship or account type that does not match their expectations and can be more costly.
- *Professional Obligations, Conflict Disclosures and Mitigation, and Other Investor Protection Requirements*. Clayton highlighted the need to clarify and bring the legal obligations owed by investment professionals in line with what a reasonable investor would expect. Clayton discussed the different legal standards that are applicable to investment advisers and broker-dealers and how those standards diverge from what retail customers would reasonably expect. He noted that generally, investment advisers owe a duty of care and a duty of loyalty,

which includes a duty to fully and fairly disclose material conflicts of interest and obtain retail customers' informed consent. He added that broker-dealers are generally required to make recommendations that are "suitable" for their customers, which requires the broker-dealer to understand the product, determine that the product is suitable for the client and not excessively trade in the client's account. Clayton noted that under this requirement, a broker-dealer can recommend a security to a client that may be "suitable," but that makes the broker-dealer more money, as compared to a different security that may be a better fit for an investor's investment needs. He also stated that it is important to note that neither investment advisers nor broker-dealers are required to give "conflict-free advice." He suggested amending current regulations to require both investment advisers and broker-dealers to disclose conflicts of interest in plain language and in reasonable detail so that a retail client can understand the financial incentives of his or her investment professional.

- *Multiple Regulators, Lack of Regulatory Consistency and Coordination*. Clayton next listed examples of numerous regulatory bodies that may regulate a retail investor's relationship with his or her investment professional, including the SEC, FINRA, the Department of Labor, state insurance regulators, state securities regulators, state attorneys general and federal and/or state banking regulators. Clayton emphasized that inconsistent and uncoordinated regulation imposes compliance costs on investment professionals, which are then passed on to the consumer. Clayton stated that "it is incumbent on . . . regulators to work together to ensure a seamless relationship from the perspective of the customer."

Clayton then identified a two-pronged solution to the aforementioned issues: eliminate the gaps between investor expectations and understandings on the one hand, and the market and legal realities on the other hand. He noted the balance that must be struck between correcting the issues without adversely affecting the market or eliminating access to a "broad range of high quality, low cost investment advice." Clayton proposed to address these objectives through a variety of regulatory tools:

- *Disclosure Mandate*. Clayton discussed a proposed disclosure mandate that would require investment advisers and broker-dealers to disclose the key aspects of their relationship to the client in a form that is "clear, short, and complete." This mandate would require investment professionals to be transparent about a number of data points, including the type of professional that they are, the services provided, fees charged and conflicts of interest they may have. Clayton also discussed steps that investors can take to protect themselves, including by checking to confirm if an investment professional is registered, and whether they have any disciplinary history.
- *Conduct Mandate*. Clayton discussed a proposed rule to heighten the broker-dealer standards of conduct by requiring that broker-dealers act in a retail investor's best interest. Under this proposed rule, Clayton stated that a broker-dealer must (1) disclose material facts about the relationship, including conflicts of interests, types of services provided, and fees charged; (2) exercise "reasonable diligence, care, skill, and prudence to make recommendations that are in the best interests of the retail customer"; and (3) eliminate, or disclose and mitigate, "conflict of interests related to financial incentives." Clayton further noted that the obligations of investment advisers have also been addressed by proposing an interpretation to "address in one release and reaffirm and, in some cases, clarify" certain specific aspects of the fiduciary duty owed to a client by their financial adviser.

Clayton noted that the SEC is looking to "harmonize" the conduct standard applicable to broker-dealers by applying "consistent, fiduciary principles across the spectrum of investment advice." He added that, while investment advisers are already required to act in the investor's best interest, broker-dealers will now be as well. He noted that certain underlying obligations may differ, as the relationships with these professionals differ. Finally, he added that he believes the approach taken by the SEC "puts us in a good position to work with our fellow … regulators to seek consistency and cohesion across the entire spectrum of investment professionals and products…" Clayton concluded his speech by underscoring the importance of input from the public.

- **See a transcript of the speech**

Litigation

SEC Charges Investment Adviser for Failing to Disclose Revenue-Sharing Arrangement with Service Provider to Portfolio Companies

On April 24, 2018, the SEC issued an order (the "**WCAS Order**") instituting and settling administrative and cease-and-desist proceedings against WCAS Management Corporation ("**WCAS**"), a New York-based investment adviser, for failing to disclose to its private equity clients conflicts of interest surrounding its receipt of a percentage of the revenues from certain services provided to portfolio companies of its managed funds.

According to the WCAS Order, WCAS entered into an agreement with a group purchasing organization (the "**GPO**"), which is a company that aggregates companies' spending to obtain volume discounts from participating vendors. The SEC alleged that, under this agreement, the GPO paid WCAS compensation based on a share of the fees that the GPO received from vendors as a result of the WCAS portfolio companies' purchases through the GPO. Further, the SEC alleged that, while negotiating this agreement, the GPO suggested it would enter into the agreement if one of WCAS's portfolio companies signed a separate agreement to purchase services from the GPO's affiliate. According to the WCAS Order, from September 2012 through December 2016, WCAS received $623,035 pursuant to its agreement with the GPO. The SEC alleged that WCAS failed to disclose its receipt of fees from the GPO in fund organizational documents and failed to disclose to fund investors that it had an incentive to recommend the GPO's services to portfolio companies and to encourage a portfolio company to enter into an agreement with the GPO's affiliate, because WCAS stood to receive a share of revenue generated for the GPO.

As a result of the conduct described above, the SEC alleged that WCAS willfully violated Section 206(2) of the Advisers Act, which prohibits investment advisers from directly or indirectly engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The SEC further alleged that WCAS willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which make it unlawful for any investment adviser to a pooled investment vehicle to "[m]ake any untrue statement of material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle" or "engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

Without admitting or denying the findings, WCAS consented to entry of the cease-and-desist order and a censure, and agreed to pay disgorgement of $623,035, prejudgment interest of $65,784, and a civil monetary penalty of $90,000.

The WCAS Order is only the latest in a number of enforcement settlements arising out of actual or potential conflicts of interest created when an investment adviser receives a financial incentive (including a discount on services to the adviser) from a service provider to its advised funds' portfolio companies.

- **See a copy of the WCAS Order**

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