How an Investment Adviser Can Take Steps to Avoid a Costly SEC Enforcement Action

What to do if you discover a potential violation of the federal securities laws

No investment adviser can get it 100% right all the time. New information becomes available, a firm changes its products and services or enters into new business relationships, and sometimes (though rare) there are rogue employees who circumvent or act counter to policies. As a result, investment advisers are regularly faced with what to do when they have information indicating a possible violation of the federal securities laws. Most issues can be fully addressed immediately with little cost or time. Sometimes, however, a deeper review may be warranted to determine whether the issue has broader application and, if so, what to do about it.

There can be consequences for an investment adviser for not fully tackling an issue. Incomplete remedial measures, especially where clients or investors suffered financial harm, are likely to result in more serious consequences with the SEC if and when the agency discovers the conduct. The SEC's recent case against Betterment, highlights the consequences of partial remedial measures. There, the SEC found that there were multiple instances where upon learning of an issue, the firm reimbursed only a subset of the harmed clients a total of $37,600, when thousands suffered harm of approximately $4 million. The SEC not only made various findings of the incomplete remedial efforts, it also imposed a $9 million civil penalty.

The odds of the SEC discovering possible misconduct are increasing. With astronomical whistleblower awards, including a $279 million award the agency recently issued, employees, clients, and investors have significant incentives to report any possible violation to the SEC. These odds are even higher for investment advisers who are subject to examination and, with the May 2023 amendments to Form PF, compelled to self-report certain events to the SEC.

If an investment adviser quickly and candidly addresses errors and affirmatively remediates them without SEC intervention, that could mean avoiding a civil penalty, an enforcement action, or even a lengthy investigation altogether if the SEC later becomes aware of the issue. Further, proactive remedial efforts will also likely improve the SEC staff's view of a firm's compliance culture so that if there are future issues, the firm already have a favorable reputation with the SEC staff. Moreover, such proactive remedial efforts allow the firm to control any messaging and can support a relationship of trust with its clients and investors.

Key Remedial Measures To Consider

Based on experience, there are a handful of key remedial efforts an investment adviser can consider when it identifies an issue. Even if a firm concludes that a particular measure was unnecessary, it is important that the firm be prepared to explain why to the SEC staff why that is the case.

Did the firm conduct a thorough review? Firms should put careful consideration into the scope of their review. The SEC staff will want to know that the firm examined how the violation occurred, and identified all impacted clients or investors. This is not to suggest an expansive investigation is necessary in every instance in which a firm finds an issue. Rather, a careful consideration of how to conduct the internal investigation to be able to give the SEC reasonable assurances the issue has been fully captured will be based on the particular facts and circumstances.

Did the firm act promptly to stop the conduct? The firm will want to make sure that the conduct at issue has stopped. Depending on the nature of the violation, this may including changing an internal practice, updating the firm's disclosures, or both. With respect to updating a firm's disclosure, it is important that the firm's revised disclosures are complete, as incomplete revisions that leave the disclosure deficient will not get credit from the SEC and may instead be used as evidence a firm was aware of the need to make the disclosure but only made incremental changes. This includes (1) examining <u>all</u> the firm's disclosures to make necessary corrections (e.g., website, advertising, Form ADV Brochure, etc.), (2) making sure that the revised disclosure fully and fairly addresses the issues, and (3) identifying the updates to its Form ADV disclosures in the material changes section.

Did the firm fully reimburse clients and investors that were financially harmed by the conduct? Often most critical to an SEC's evaluation of a firm's remedial measures is whether the firm took steps to remediate any client or investor harm. This is expected even when the firm does not actually receive a quantifiable financial benefit from the violation. There are several important considerations for the staff in assessing the reimbursement: (1) does it cover all harmed clients and investors, (2) does it go back an appropriate period of time, and (3) was interest paid.

Did the firm act to make sure the conduct Is unlikely to occur again?

In settlements, the SEC frequently orders other additional measures in order to ensure compliance with the federal securities laws. Thus, to the extent a firm proactively takes these steps it provides for a stronger argument that no enforcement action is warranted. These include the following.

> **Address Any Personnel Issues.** In many instances, a firm's violation is not attributable to any one person. Where it is, however, a firm should address any particular personnel who engaged in the conduct. If the firm's policies have provisions for disciplinary conduct for the conduct at issue, the firm should impose those sanctions. Even absent a specific policy, certain conduct is so serious the SEC will expect certain actions, such as transferring or terminating an employee. Alternatively, the firm may want to consider whether the conduct was the result of having insufficient personnel or personnel without the required skillset and act accordingly to address that deficiency.
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> **Conduct Training.** To the extent the issues involve more than a handful of people at the investment adviser, providing additional training can be an effective remedial measure. This additional training is often a minimal expense that can pay significant dividends both for future firm compliance and showing the SEC the firm has taken the issue seriously to fix the problem going forward.
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> **Update the Firm's Policies and Procedures.** In most cases the SEC brings against investment advisers, the SEC charges the adviser with violating Rule 206(4)-7 under the Advisers Act for deficient or failing to implement policies and procedures. Thus, where a firm identifies a violation it should at least review its policies and procedures and how they are implemented and make improvements.
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> **Compliance Consultant.** The SEC often orders investment advisers to retain an independent compliance consultant (ICC) to review the firm's policies and procedures. This can be a time-intensive and expensive task, with the SEC frequently ordering an ICC do an initial review and then at least one review a year later. An ICC order also results in certain disqualifications, thus presenting operational issues for some investment advisers who rely on particular registration exemptions. As a result, it may be prudent under the circumstances to consult with a compliance consultant to discuss the issue and determine what other improvements the firm could make to its compliance program. In general, even if a firm does not retain a compliance consultant that meets the SEC's definition of "independent", the SEC will frequently give the firm credit for the review and not require the firm retain an ICC.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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