Quelle Surprise! Enforcement Cases Reflect SEC's Priorities

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It is not one bit surprising when enforcement cases show up on the SEC's website soon after the Commission publishes its yearly examination priorities. On March 30, 2022, the SEC's Division of Examinations ("Division") announced its priorities for fiscal year 2022. In plain English, the Division warned Registered Investment Advisors ("RIAs") and other registrants about potential compliance risks that examiners will focus on during the year.

In two recent enforcement cases, the SEC reinforced that it does more than give lip service to the Division's priorities. Although it is quite likely that the SEC was already investigating these RIAs before the Division announced its annual priorities, it should come as no surprise when examinations focus on similar issues.

Environmental, Social, and Governance ("ESG") claims will be scrutinized

Among the priorities announced, examiners will remain focused on ESG-related advisory services and investment products. Examiners will analyze whether RIAs and registered funds are accurately disclosing their ESG investment approaches. The publication observed that there is a risk that firms will overstate or misrepresent the ESG factors considered or incorporated into their portfolio selection. The Division's publication is available at https://www.sec.gov/files/2022-exam-priorities.pdf.

On May 23, 2022, the SEC charged an RIA with making misstatements and omissions about ESG considerations utilized by the firm in making investment decisions for certain mutual funds that it managed. The RIA allegedly misled investors regarding its investment selection process for certain funds it advised.

The SEC concluded that the RIA represented or implied in various statements that all investments in the funds were subject to an ESG quality review, which was not always the case. The SEC determined that numerous investments held by certain funds did not have an ESG quality review score at the time of investment.

According to the Commission's press release that quoted Adam S. Aderton, Co-Chief of the SEC Enforcement Division's Asset Management Unit, "Investors are increasingly focused on ESG considerations when making investment decisions." The SEC will hold investment advisors accountable when they do not accurately describe how ESG factors impact their investment selection process.

In this case, the RIA was held accountable. The RIA consented to the SEC's order finding that the firm violated Sections 206(2) and 206(4) of the Investment Advisers Act of 1940, as well as Rules 206(4)-7 and 206(4)-8 thereunder. The RIA also allegedly violated Section 34(b) of the Investment Company Act.

Without admitting or denying the SEC's findings, the RIA agreed to pay a $1.5 million penalty to settle the charges against it. In addition, the RIA agreed to a cease-and-desist order and censure. Because the RIA promptly undertook remedial acts and cooperated with the investigation, the firm likely avoided more serious penalties.

The enforcement action can be found at https://www.sec.gov/litigation/admin/2022/ia-6032.pdf.

Protecting retail investors is always a priority

In the same yearly priorities release, the Division indicated that the SEC will focus on advisors who recommend wrap fee accounts without evaluating whether they are in the best interests of clients. Less than a month later, on April 27, 2022, the SEC announced that it settled charges against an RIA in Downers Grove, Illinois. According to the SEC, the RIA invested certain wrap program clients in higher-cost mutual fund share classes, despite the availability of less expensive alternatives, Furthermore, the RIA did not disclose the conflicts of interest related to those investment recommendations.

Like many wrap programs, the RIA was obligated to pay all of its clients' trading costs, including fees for buying and selling mutual funds. The SEC determined that the RIA and its Investment Advisor Representatives avoided transaction fees by recommending mutual fund share classes from a no-transaction fee ("NTF") program offered by their clearing firm. Those NTF shares usually had a higher expense ratio, and wrap fee clients paid more than they should have. The RIA failed to fulfill its duty of care obligations when it advised certain wrap clients to invest in NTF shares without conducting any evaluation to determine whether they were in their best interest

Without admitting or denying the findings, the RIA consented to a cease-and-desist order and to be censured. The firm also agreed to pay disgorgement of $508,995, prejudgment interest of $130,742, and a civil money penalty of $125,000.

The action is available at https://www.sec.gov/litigation/admin/2022/ia-6003.pdf

Conclusion

Whereas protecting retail investors is a perennial examination priority, examiners are now keeping a close watch on firms' claims regarding how ESG impacts their investment strategies. On May 25, 2022, the SEC proposed amendments to rules and reporting forms to promote consistent, comparable, and reliable information for investors pertaining to funds' and advisors' utilization of ESG factors. The proposal, if adopted, would establish disclosure requirements for funds and advisors that market themselves as having an ESG focus.

As part of its proposal, the SEC is proposing amendments to Form ADV Part 2A to include information about RIAs' practices related to ESG. These proposed requirements will provide clients and prospects with useful and comparable information to help them to better evaluate the ESG-related services offered by a growing number of advisors. These requirements will also help clients to understand the ESG investing approach, if any, used by the RIA.

The SEC's proposal can be reviewed at https://www.sec.gov/rules/proposed/2022/ia-6034.pdf.

Aside from this relatively new focus on ESG in recent years, examinations will always scrutinize whether advisors adhere to their fiduciary duty and act in the client's best interests. As the French would say, "Plus ça change, plus c'est la même chose." When it comes to examinations, some things remain the same. Quelle surprise!