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Strengthened SEC Enforcement Activity is a Reminder that Investment Advisers Must Ensure their Practices and Procedures are Current and Compliant

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As evidenced by an influx of recent activity over the past month, it's becoming more and more apparent that the U.S. Securities and Exchange Commission (SEC) is strengthening its regulatory framework and pushing forward with an acute focus on enforcement actions and activity. In the past month alone, the SEC has successfully brought enforcement actions spanning a varied set of rule violations–including violations of the SEC's Custody Rule, the SEC's Pay-to-Play Rule, and the SEC's Proxy Voting Rule. These enforcement actions coincide with a recent Risk Alert circulated by the SEC that highlights the upcoming November 4, 2022 deadline for investment advisers to comply with the SEC's new marketing rule, which the SEC has indicated will similarly be regulated by enforcement.

Given the SEC's ramped-up efforts to strengthen compliance across the industry, investment advisers should pay close attention to the SEC's recent enforcement activities, especially in light of the new marketing rule compliance deadline. The following alert discusses these recent enforcement efforts in greater detail, both to help prepare investment advisers for the increased regulatory activity expected to continue by the SEC and to remind investment advisers to pay particularly close attention to their current policies and procedures in light of this increased focus on enforcement.

SEC Custody Rule and Form ADV Violations

On September 9, 2022, the SEC announced charges against multiple investment advisers for violations of the SEC Custody Rule along with ancillary violations related to Form ADV reporting and amending obligations. Specifically, these advisers failed to have audits performed or to deliver audited financial statements to investors in a timely manner, in violation of Rule 206(4)-2 of the Investment Advisers Act–more commonly known as the Custody Rule. Additionally, certain advisers also failed to file amended Form ADVs to reflect they had received audited financial statements after having initially reported that they had not yet received the audit reports. Moreover, on September 19, 2022, the SEC charged yet another investment adviser for violations of the Custody Rule, finding the investment adviser failed to obtain surprise examinations for client assets over which it had custody from at least 2013 through 2019, as well as failing to implement written policies and procedures reasonably designed to prevent such violations. Of note, none of the aforementioned enforcement actions brought under the Custody Rule alleged or involved the misappropriation of client assets.

The Custody Rule requires advisers to not only maintain client funds with a "qualified custodian," but to further obtain either (i) a surprise examination of custodied assets annually from an independent public accountant or (ii) an annual audit of pooled investment vehicle clients' financial statements, prepared in accordance with GAAP standards, by an independent public accounting firm that is registered with and regulated by the PCAOB–and distribute those financial statements to each investor within 120 days of the fund's fiscal year-end or 180 days for fund-of-funds.

The investment advisers sanctioned either did not have these audits performed properly or failed to timely deliver audited financial statements to investors in certain private funds. Private fund investment advisers registered with the SEC must also include on their Form ADV information regarding the status of their financial statement audits as well as annual updates to same–and if such statements are not available at the time of the Form ADV update, an amendment must be made

when the financial statements are in fact received (see instructions to Form ADV, Part 1A, Schedule D, Section 7.B.23(h)). Historically, enforcement actions enforcing the latter are rare, but given the SEC's increased focus on enforcement, it's clear that certain violations can open the door for enforcement of other, more technical violations, as seen here. Investment advisers should ensure their current procedures comply with the SEC's Custody Rule, and similarly should ensure a proper cadence and practice is in place to appropriately report and update the status of their required audited financial statements on Form ADV.

SEC Pay-to-Play Rule Violations

Also in September, the SEC announced enforcement actions for violations of the SEC's "Pay-to-Play Rule" against four investment advisory firms whose personnel made prohibited contributions of $1,000 or less, including a contribution of just $400. The fines, however, resulted in larger five-figure penalties in each instance–ranging from $45,000 to $95,000–and further solidified the strict liability nature of the SEC's prohibitions against pay-to-play conduct.

Rule 206(4)-5 under the Investment Advisers Act, which is commonly known as the Pay-to-Play Rule, prohibits investment advisers from providing investment advisory services "for compensation" to a state or local government entity if the investment adviser, or a covered associate of the adviser, has made a political contribution to certain state or local government officials in the prior two years. The rule governs contributions to any local- or state-level candidate or elected official whose office has the authority to directly or indirectly influence the hiring of an investment adviser or to appoint a person with such authority.

Aside from the monetary penalties issued by the SEC for relatively minor infractions, the SEC's enforcement actions show that actual corruption or improper influence is not required for a violation of the Pay-to-Play Rule–as each case had significant mitigating factors. Indeed, each of the four investment advisers sanctioned had a long-standing, existing advisory relationship with the government client or entity when the improper contributions were made, and the political candidates who received the contributions had little or minimal influence over the government entities' adviser selection. These recent actions further demonstrate the increased focus on enforcement from the SEC, and firms should be aware that even the most minor of infractions can lead to significant monetary penalties and corresponding reputational risk.

SEC Proxy Voting Rule Violations

Maintaining this trend, the SEC continued to highlight its enforcement priorities, having recently consented to a six-figure settlement with a registered investment adviser for violating the SEC's Proxy Voting Rule. On September 20, 2022, the SEC brought an action under Sections 206(2) and 206(4) of the Investment Advisers Act and Rule 206(4)-6 thereunder, alleging the investment adviser failed to act in its clients' best interest when voting proxies on behalf of registered investment company (RIC) clients and failed to develop and implement policies and procedures reasonably designed to ensure proxies were voted in the best interests of its clients.

Over the course of three years, the investment adviser engaged a third-party service provider to cast proxy votes on behalf of RICs managed by the adviser. It was discovered that the adviser provided standing instructions to the service provider to always and consistently vote in favor of proposals put forth by the issuers' management and vote against any and all shareholder proposals. The SEC found the adviser failed to take any steps to determine if such proposals were in the RIC's best interest or if the proxies were in fact being voted in its clients' best interest, as required by the Advisers Act. Here again we see the SEC taking a hardline approach to misconduct, further evidencing its desire to pursue enforcement actions to ensure proper compliance.

The Upcoming SEC Marketing Rule Compliance Deadline

In the context of a staunch uptick in enforcement activity, the SEC found it important to remind investment advisers of their expected compliance with the SEC's new marketing rule, which requires full compliance by November 4, 2022. Noncompliance or violations of the marketing rule will likely result in increased and severe penalties if the SEC's recent trend continues, so it remains important for advisers to take heed of the impending deadline and ensure their practices, policies, and procedures are updated accordingly.

When the new rule was initially announced, the SEC allowed investment advisers the option to comply with the prior marketing and cash solicitation rules up until November 4, at which time the SEC advised that advisers would no longer be able to make such a choice–and would need to fully comply with the new marketing rule. With the deadline quickly approaching, investment advisers should decide whether updates or revisions to their written policies and procedures are necessary, and that such procedures are reasonably designed to prevent violations by the investment advisers of the marketing rule, as required by Advisers Act Rule 206(4)-7. Advisers should also take note of Advisers Act Rule 204-2 (the Books and Records Rule), which, as amended, "will require investment advisers to make and keep certain records, such as records of all advertisements they disseminate, including certain internal working papers, performance related information, and documentation for oral advertisements, testimonials, and endorsements."

Given the breadth of the new marketing rule, it is expected that SEC examiners will make compliance

a primary focus area for 2023. Between this and the SEC's increased enforcement focus, investment advisers should ensure they are fully compliant with such rules in advance of the November 4 deadline.

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As evidenced by the abundance of recent enforcement activity, it's clear that the SEC is prepared to move strongly and expediently to abate violations of its many rules and regulations. We've not only seen an increase in enforcement actions, but witnessed seemingly innocuous and attenuated technical violations tacked on to other more substantive violations as well as significant increases in monetary penalties for infractions despite mitigating factors and minor monetary thresholds. Investment advisers should pay careful attention to these trends and should take every effort now to review and revise their policies and procedures to ensure full compliance with the current SEC regulatory framework, especially with the new marketing rule implementation date on the horizon. The SEC has cemented its strict regulatory stance, and advisers would do well to take the right steps now to avoid facing an enforcement action later.

For more information and further clarity on how investment advisers can protect themselves and prepare for the SEC's continued focus on enforcement, please reach out to the authors, Scott Moss, partner in Lowenstein Sandler's Investment Management Group and Chair of the firm's Fund Regulatory & Compliance Group and Michael Gordon, counsel in the firm's Investment Management, Broker-Dealer, FinTech, and Crypto Groups, or directly to your regular Lowenstein Sandler contact.

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