Regulatory Compliance Watch

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SEC guidance warns IAs against robo-votes

Republican **SEC** Commissioners have approved new rules that define proxy advisors as "solicitors" and voted to issue new guidance warning investment advisers to be careful casting clients' proxy votes until they've heard targeted companies' responses to proxy advisors.

The new rules and the supplementary guidance are a step back from the more rigid rules proposed last fall. They would have required a seven-day review period in which targeted companies got a look at proxy advisors' findings before they were released to shareholders (*RCW*, November 7, 2020). But they are still likely to be dead letters to proxy advisors and IAs.

The supplementary guidance shifts those once-proposed review burdens from proxy advisors onto IAs. It does so through a series of "safe harbor" provisions that define IAs' fiduciary duty to include careful review of proxy advice. For instance, if a targeted company notifies a proxy advisor that it's considering a rebuttal, "then [the] proxy advice business should consider whether, for purposes of complying with this safe harbor requirement, it needs to send two separate notices to the business' clients: (1) one notice regarding the registrant's intent to file and (2) another notice regarding the registrant's actual filing."

Robo-voting

It's a direct blow to IAs who automate their clients' proxy votes based on proxy advisors' reports.

The new guidance underlines "the principle that asset managers may not rely on this advice wholesale in so-called robo-voting," Commissioner **Elad Roisman** said in his remarks. Roisman championed the new reforms.

"I have said before that I am skeptical of how heavy reliance on such mechanistic features, in many instances, can be consistent with the duties investment advisers undertake as fiduciaries to their clients," he said.

Survey: COVID-19-related BCP now hottest compliance topic, page 2.

Content

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'Bad policy'

IAs and their advocates condemned the new rules and guidance. The **Investment Adviser Association** called the rules and guidance "bad policy."

"They represent a major step backwards for corporate governance and will make it more difficult for investment advisers to use the services of proxy advisory firms to fulfill their proxy voting responsibilities on behalf of their clients," the association said.

Some advocates are worried that the new guidance will subject IAs to rulemaking-by-enforcement, where they learn what the guidance means only by deficiencies or even enforcement actions.

"The SEC has not established a compelling case to tighten regulation of proxy advisory firms, and we are concerned that it has adopted untested and unvetted requirements that could have adverse effects on investors' ability to get the timely and unbiased proxy advice they need to act as stewards of the companies they own," **Council of Institutional Investors** Executive Director **Amy Borrus** said in a statement.

'Harder and more costly'

Commissioner **Allison Herren Lee** voted against the package and was forceful in her criticism. As many critics have done, she suggested that the new rules were the SEC's aid and comfort to the C-suite in its ongoing war with shareholders.

"The bottom line is this: even if certain defects in the proposal have been mitigated, the final rules will still make it harder and more costly for shareholders to cast their votes, and to do so in reliance on independent advice," Herren Lee said.

If IAs aren't thrilled with the new rules and guidance, proxy advisors will be livid. The new rules codify last August's guidance that defines proxy advice as "solicitation" under Exchange Act rule 14a-1(l). Proxy advisors see this as an existential challenge. They say it opens them up to endless lawsuits from disgruntled investors or even publicly held companies (*RCW*, July 20, 2020).

Last year, **ISS**, one of the two largest proxy advice businesses, sued to block the Commission's guidance. ISS agreed to pause the litigation last fall when the SEC issued its rulemaking notice. You can expect that pause to lift in the days ahead. ■

COVID-19 knocks cybersecurity from its perch

For six years, cybersecurity rested atop the list of advisers' concerns. It would take a pandemic to replace it.

On the positive side, even those advisers whose BCPs lacked plans to counter a pandemic have performed very well when their employees were forced to work from

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home, according to the **Investment Adviser Association**'s 2020 compliance testing survey. Just over 80% of respondents answered that they had all of their employees work from home after the coronavirus began to rage.

The vast majority of the 384 firms that replied to the survey, which was done in concert with **ACA** and **Brightsphere Investment Group**, reported no material impacts from working from home. Managing HR in the absence of office workers proved to be the biggest challenge, according to the results.

Good news

Not one respondent reported that the COVID-19 crisis spawned a privacy breach, a delay in Form ADV reporting or a cybersecurity event. Of the minority that did report the virus impacted them, many indicated they had to enhance their BCP, ran into some internal operational issues or lost a key person due to health or caregiving reasons.

Nearly 80% of respondents reported they need not make any material enhancements to their BCPs, while 13% indicated they would modernize their plans. Almost 70% of advisers whose plans hadn't mentioned a pandemic intend to add the topic to their BCPs. The survey found that only 37% of advisers mentioned contagious diseases in their BCPs in 2017. This year, that percentage rose to 53%.

When it comes to testing, only 52% of firms stated that they do a complete annual test of their BCP. Some answered that they've never done a full BCP test (16%). Before the pandemic, 11% of firms failed to test or review their critical vendors' BCPs. Those that did usually sent a due diligence questionnaire.

Fewer than one-third of respondents reported that they questioned their significant vendors about the execution of their own BCPs after COVID-19 was in full swing.

Three IA testing topics that debuted in the new annual survey were conflicts of interest, ESG/sustainability and liquidity management. Respondents showed heightened interest in testing around privacy but their interest waned for testing best ex.

Cybersecurity concerns

The virus hasn't shaken cybersecurity far from advisers' concerns. Every one of the respondents (100%) reported that their firms engage in regular software patches compared with 80% that routinely took this protective step just one year ago. The percentage of advisers stating they now deploy tabletop incident response exercises jumped from 35% to 61% in the last year, according to the survey.

The top two data privacy steps reported by firms—each scoring 18%—were using a checklist to terminate computer access of departing employees and destroying hard drives and memory drives of obsolete machines.

Form CRS

The survey found the person most likely to be involved in drafting the new Form CRS was the CCO (88%), far ahead of "management" (48%).

A benchmark for your compliance budget also could be seen in the survey. Nearly half (46%) answered that their budget is under 5% of the firm's revenues.

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IIG co-founder charged with 'string of frauds'

Mounting pressure from bad bets on trade finance loans in emerging market economies had the CEO of a private fund adviser fearing for the life of the firm he co-founded. Faced with "tens of millions of dollars in losses," the CEO of **International Investment Group David Hu** engaged in a "string of frauds," the **SEC** alleges in a ***complaint*** filed July 17 in federal district court in New York.

Hu stands charged with fraud for his role in what the Commission characterizes as a $60 million "Ponzi-like scheme."

The SEC had previously charged IIG with fraud in November 2019 and revoked the firm's registration as an investment adviser that same month (***RCW***, Dec. 5, 2019). This past March, the Commission obtained a final judgement that requires IIG to pay more than $35 million in disgorgement and prejudgment interest (***RCW***, April 20, 2020). At the time, the SEC stated that its investigation was "ongoing."

'Risky investments'

IIG specialized in trade finance lending and focused on advising clients with respect to investments in emerging market economies. The loans are "typically risky investments," the SEC notes.

The New York-based IIG served as investment adviser to several private investment funds—the Trade Opportunities Fund, the Global Trade Finance Fund, and the Structured Trade Finance Fund. Beginning in 2007, the SEC alleges that Hu and others at IIG hid losses in the TOF portfolio by overvaluing troubled loans and replacing defaulted loans with fake "performing" loan assets.

Fake loans sold

When it was necessary to create liquidity, including to meet redemption requests, the Commission alleges Hu would

cause IIG to sell the overvalued and/or fictitious loans to new investors, including to GTFF and STFF. Hu allegedly sold at least $60 million in fake trade finance loans to other investors. The proceeds were then used to generate the necessary liquidity to pay off earlier investors, according to the SEC's complaint.

The complaint alleges that Hu deceived IIG clients into purchasing these loans by directing others at IIG to create and provide to the clients fake loan documentation to substantiate the non-existent loans, including fake promissory notes and a forged credit agreement.

IIG also advised an open-end mutual fund marketed to retail investors and selected trade finance loans for the retail fund's portfolio. The firm touted its risk control strategies, including portfolio concentration limits at the borrower, country, and commodity level. It further called out its robust credit review process for borrowers.

Valuation suspect

The SEC states that Hu prepared valuations of the private funds on a regular basis. Hu virtually always valued every trade finance loan in the private fund portfolios at par plus accrued interest throughout the entire life of the funds, the Commission adds.

Hu's practices artificially inflated TOF's net asset value and resulted in IIG receiving management and performance fees to which it was not entitled, the SEC claims. For his part, Hu received distributions of a portion of these excess fees, the Commission adds.

Hu owed a fiduciary duty to the private funds and the retail fund, the SEC maintains. The Commission's complaint seeks permanent injunctive relief, disgorgement, and civil penalties.

"The SEC remains committed to holding accountable individual wrongdoers who seek to take advantage of investors for personal gain, including when they employ elaborate means to cover up their fraud," said **Sanjay Wadhwa**, senior associate director of the SEC's New York Regional Office.

Parallel criminal charges

The **U.S. Attorney's Office for the Southern District of New York** announced parallel criminal charges against Hu. The SDNY charged Hu with investment adviser fraud, securities fraud, and wire fraud offenses.

"Putting profit ahead of his fiduciary duties, Hu allegedly mismarked millions of dollars of loans to cover up millions in losses," said U.S. Attorney **Audrey Strauss**. "Hu also created fake entities and loans, and falsified paperwork to deceive auditors and avoid detection," she added. Any sentencing of Hu will be determined by a judge. ■

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SEC alum pans valuation proposal

A plan to change the way mutual funds engage in valuation attracted only 14 comment letters but two came from someone the staff at the **SEC**'s Division of Investment Management knows very well: former IM Chief Counsel **Doug Scheidt**.

Scheidt, who was deeply involved with valuation issues for 20 years before retiring from the SEC in 2018, submitted two separate comments about the ***valuation proposal*** (***RCW***, May 1, 2020). He used phrases such as "fundamentally flawed" and "not legally viable" in urging commissioners not to finalize the proposal.

IAs as the fox

The proposal runs "contrary to public policy because it would inappropriately put the fox (the investment adviser) completely in charge of the henhouse (valuation) while simultaneously disempowering fund directors," ***wrote*** Scheidt.

The plan also "contains no conditions reasonably designed to protect against investment advisers' conflicts of interest when fair valuing fund portfolio securities. As a result, the rule

is extremely likely to lead to more valuation-related fraud and substantial monetary harm to fund investors," he continued.

The **Investment Company Institute** ***took*** a more charitable view of the proposal, applauding IM for producing it and praising the proposal for permitting sub-advisers to assume fair value responsibilities and leaving "the type and frequency of fair value methodology testing to the fund's discretion."

But the ICI did recommend changes, including permitting "a fund board to assign fair value responsibilities to entities other than investment advisers, such as fund administrators" and giving the industry an 18-month compliance period.

A request for more time

The ICI also expressed concerns about the proposal's three-day window for a fund's investment adviser to report valuation issues to the board. That's not enough time to investigate matters, the ICI stated.

Like the ICI, **Deloitte & Touche** ***encouraged*** the SEC to expand "valuation functions" beyond investment advisers to others, such as fund officers.

Investment adviser **J.P. Morgan Asset Management** ***found*** the proposal thoughtful in addressing "the fair valuation process and the roles of the board and fund investment advisers." It also recommended changes, including shifting the reporting of a fund's valuation program from a quarterly to an annual responsibility.

The adviser also described its approach to valuation, noting it begins with "a primary pricing service" but that it could depart from this structure due to things like "recent adverse market conditions caused by COVID-19."

"Although our methodology provides for instances in which internal fair value should be considered, it would not be possible to enumerate all such circumstances in advance and the corresponding methodologies that should be applied. The rationale for deviating from the hierarchy and alternate methodology used is documented and presented to the board on a quarterly basis," J.P. Morgan continued (***RCW***, June 18, 2020).

The adviser also urged the Commission to modify its three-day reporting window, giving IAs more time to produce a written report—although the initial notice could be done orally or in writing.

Professors **Will Gornall** and **Ilya Strebulaev** ***lectured*** the Commission to require "increased disclosure on valuation methods." Venture "capital funds and mutual funds holding private companies often provide little more than legal boilerplate about their valuation techniques and assumptions. This makes it difficult for investors to grasp the underlying reality of these companies and compare funds to each other. The current proposal pushes toward these goals, but it may not go far enough in protecting the interests of investors and fund managers in the venture capital space," they wrote.

The pair also recalled the COVID-19 crisis in urging that funds account for market turmoil. "If the broad stock market falls 10%, funds should mark down their investments by 10% unless there is a compelling reason not to," the professors held.

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Private funds betting on Democrats in 2020

Employees for private fund advisers are betting on the Democrats this year but private funds' political action committees are still hedging, an analysis of campaign finance records shows.

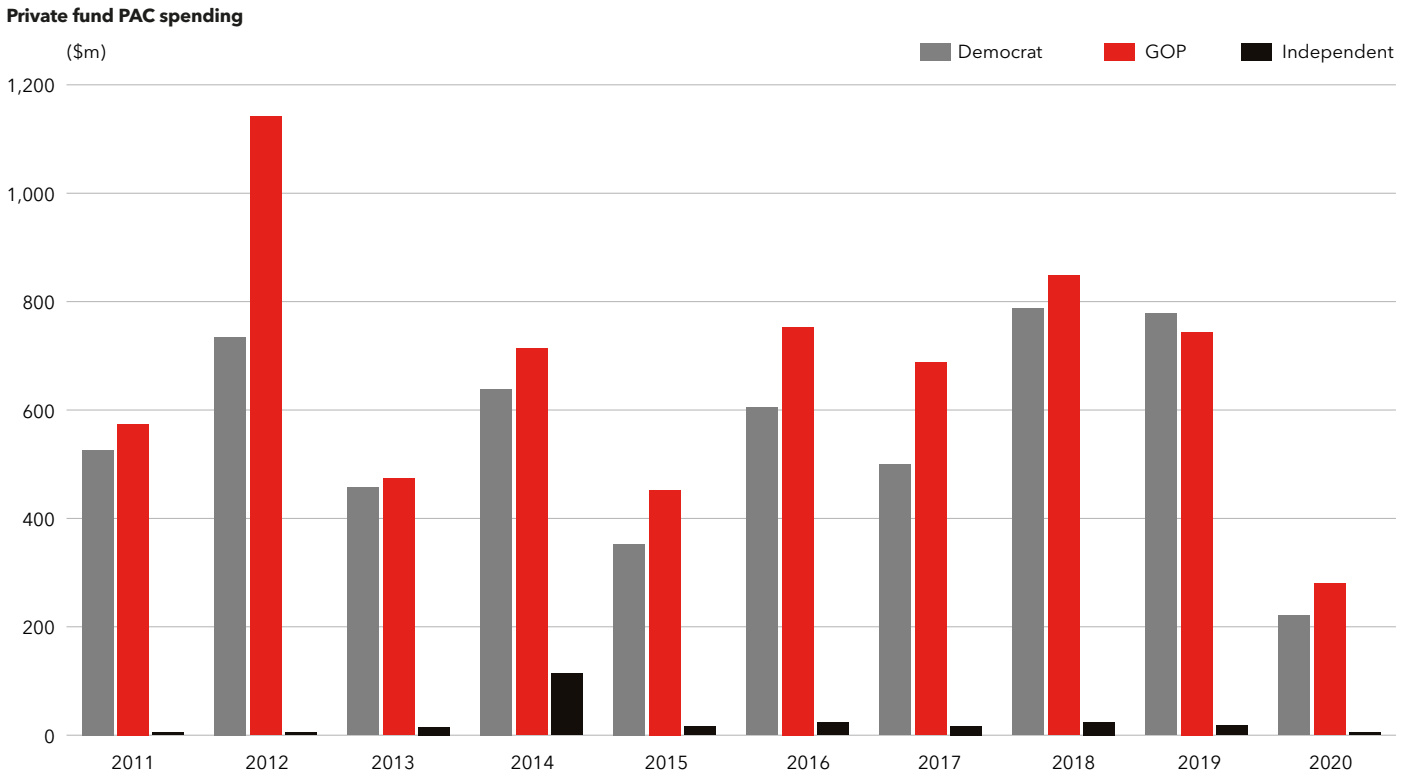
Staff of the 40 most politically active private funds have given a combined $38.2 million in direct donations to candidates this year, according to data tracked by the **Center for Responsive Politics,** a Washington, D.C. nonprofit group that advocates for campaign finance reform. Of that, nearly 53% of private equity adviser donations have gone to Democratic candidates this year, and more than 72% of direct donations from hedge fund staff have gone to the Democrats.

It's still early in the election cycle, and the direct donations are but a small segment of private funds' political largesse—the 40 most active private equity and hedge fund companies have combined to spend nearly $136 million on PACs and other "soft" spending, CRP records show—but it's still a remarkable turnaround. In 2012, private funds' largest PACs gave more than 57% of their donations to Republicans. This year, Republicans account for barely half of private fund PAC spending, according to records kept by the **Federal Election Commission** (see chart on page 6).

Top 10 shakeup

Candidate by candidate, it's also a turnaround from the last election. In 2016, **Hillary Clinton** was the top candidate for both private equity and hedge fund advisers, but seven of the top 10 private equity recipients, and six of the top 10 hedge fund recipients, were Republicans, CRP data show. This year, **Joe Biden** tops both lists, but only three of the top 10 private equity recipients and only one of the top 10 hedge fund recipients was a Republican.

Even that was a hedge: **Susan Collins**, R-Maine, was eighth on the list of hedge fund donations, with nearly



$158,000. She follows Democrat **Sara Gideon**, a statehouse delegate running for Collins' seat, CRP's data show.

The biggest private equity spenders so far have been the **Blackstone Group** ($21.1 million, most of it to GOP candidates or conservative groups), **Bain Capital** ($6.5 million, almost all of it to Democrats or liberal causes), **Schooner Capital** ($2.4 million, most of it to Democrats or liberal causes), **Tao Capital Partners** ($2.2 million, most to Democrats or liberal causes) and **JW Childs Associates** (nearly $2 million, most of it to GOP or conservative causes), CRP data show.

The most generous hedge funds have been **Paloma Partners** (nearly $22 million, all of it to Democrats or liberal causes), **Renaissance Technologies** (most of it to Democrats or liberal causes), **Euclidean Capital** (nearly $9.6 million, most of it to Dems or liberal causes), **Soros Fund Management** (more than $8.7 million, most to Dems or liberal causes) and **Citadel LLC** (more than $7 million, almost all to Republicans or conservative causes), CRP data show. ■

Three-fifths of private fund CCOs wearing multiple hats

More than three-fifths of private fund CCOs are wearing multiple hats on the job, an analysis of **SEC** data reveal.

There were 4,561 private fund advisers registered with the Commission in the first quarter of this year, Form ADV data show. Of those, at least 2,819 CCOs had more than one job at their firm, the data reveal.

The actual number of multi-hatted CCOs might even be higher than that–hundreds of private fund registrants didn't indicate a title for their designated compliance person. At least seven, in fact, put "Mr." in the spot marked for title. One labeled their CCO "Ms." Of those firms that did offer a title for their compliance officer, only 622 (17% of the discernible cases) were solely compliance officers.

Article of faith

It has become an article of faith in the industry that the bigger a firm gets, the more important it is to have an independent CCO. The SEC has even examined firms to determine how multi-role compliance officers prioritize their jobs (***RCW***, July 21, 2014).

The data from the first quarter of this year suggests that this gospel has been slow to spread among private fund advisers.

"In a perfect world, you would have a dedicated CCO," says **Kurt Wolfe**, a lawyer with **Troutman, Pepper**. "But there is a range of possibilities for building an acceptable compliance function that might include a CCO that wears multiple hats, or a compliance team that reports to a dual-hatted CCO, or even outsourcing aspects of the compliance function to a third party. The key is to make sure your compliance function grows with the firm."

Breakthrough year

This has been something of a breakthrough year for private funds in the U.S. The **Trump Administration** has opened up pensions to private offerings (***RCW***, June 11, 2020) and reformed the Volcker Rule so that banks can back private equity and venture capital (***RCW***, July 2, 2020). At the same time, regulators have made clear that private funds have a lot of compliance work in front of them—especially on conflicts, fees and insider trading risks—and some reform advocates have even argued that there are structural problems in the way private funds do business (***RCW***, July 2, 2020).

"Building a solid compliance component requires devoting adequate resources—whether that's funding for software solutions, retaining third party consultants or hiring compliance resources in-house," Wolfe says. "And it is imperative to periodically reassess your compliance resource allocation. Growth can be a good thing, but with it comes additional compliance burdens."

We don't lack for horror stories about what can happen when a fund's compliance and business lines get crossed but the Commission's data suggest they might be just that—stories. Of the firms who registered with the SEC, only 277 said they had any kind of regulatory violation in their pasts. Of those, 118 had multi-hatted compliance officers, and 74 of them sole practitioners.

Of the CCOs with multiple titles, CFO or other top financial designation was the most common, with 808 CCO/CFOs. General counsel was the next most common, with 521 compliance officers sporting that title, followed by 470 chief operating officers or top operations executives. At least 90 firm CEOs, founders or top executives were also their firms' compliance officers, the data show. ■

Eight years later, advisor's case remains frozen

For years, **Beck Asset Management** ($26M in AUM) in Zurich has made an unusual disclosure in its Form ADV out "of an abundance of caution."

The firm's latest Form ADV reveals that "Josef Beck works as Investment Advisor for Beck Verwaltungen AG ("BVAG"), an entity that is under common control with Beck AM only because it shares a single board member with BVAG." It goes on to state that the U.S. indicted Beck in 2012 on criminal charges related to helping wealthy Americans avoid taxes.

The case hasn't progressed beyond the indictment. Although the U.S. and Switzerland have an extradition treaty, it's unclear if the U.S. **Department of Justice** ever sought to extradite Beck. The DOJ didn't return ***RCW*** inquiries.

"I'm not a fugitive. That's all I can tell you," Beck told ***RCW*** when reached by phone at his Zurich office. He works in the same building as Beck Asset Management but for another company. His two sons registered their advisory firm one month after their father was indicted and the elder Beck ended his previous RIA at the same address.

No connection whatsoever

Josef Beck is "not connected with my firm," says Beck Asset Management's CEO/CCO **Jizchak Arjeh Mosbacher**. It's a third-generation firm and Beck's sons were simply "following in the steps of the grandfather," adds Mosbacher.

"All clients are obviously tax compliant," Mosbacher continues. "All clients pay their taxes." The adviser's Form ADV states it has 16 clients. Mosbacher says some of Josef Beck's former clients stayed on with the new advisory firm.

Josef "Beck is not providing investment advisory services to the clients of Beck AM. Mr. Beck will not be employed with Beck AM, nor will he have any management, director or ownership function," reads the adviser's Form ADV. Mosbacher says disclosure related to Josef Beck began in 2012 when the new advisory firm was formed.

A decade ago the U.S. government sued **UBS**, Beck and dozens of others related to claims of helping thousands of citizens evade their taxes. UBS settled the case in 2009, paying more than $700 million.

"A lot of those cases with foreign professionals have not come to fruition," says **Mark Matthews**, a Washington, D.C.-based attorney with **Caplin & Drysdale**. The defendants avoid the U.S. or countries that would extradite them, he adds.

A surprising acquittal

Then again, there is the case against **Raoul Weil**, a former UBS bank executive in Switzerland. Six years after being charged related to tax fraud, Weil made the mistake of taking his family on a vacation to Italy. The U.S. extradited him and he stood trial in 2014—and he won.

That "very notorious acquittal" hasn't dampened the government's appetite to pursue alleged international tax cheats, says **Steven Toscher**, an attorney who defends alleged tax evaders from his firm ***Hochman Salkin Toscher*** in Beverly Hills, Calif. It's well known Switzerland doesn't like to extradite its citizens and the U.S. seldom pursues criminal charges in absentia, he adds.

Toscher suspects the DOJ has for years been negotiating possible settlements with those like Beck who were charged with tax fraud. He's also ***written recently*** about a new enforcement office created at the **IRS** to target tax cheats.

A hotter spotlight

"I think we're going to see heightened scrutiny, increased IRS enforcement," Toscher adds. Record budget deficits soaring thanks to trillions in government aid due to COVID-19 will only fuel the fire. "They have to collect the money somewhere," he says.

Those who help tax cheats—Matthews calls them "facilitators" and Toscher, "enablers"—face increased risk of enforcement, too. These can be lawyers, bankers, investment advisers and others, he notes. ■

Another flipping case prompts $10M fine

The writing was clearly on the wall. It was only a matter of time before **UBS Financial Services** was going to be charged with municipal bond offering flipping and retail order period abuses.

First, two of the "flippers" were the subject of enforcement actions in August 2018. Next, a former executive director settled ***charges*** of submitting retail orders to the underwriting syndicate from certain UBS customers who were flippers.

And now the **SEC** announced July 20 that UBS will pay more than $10 million to ***settle*** charges that it circumvented the priority given to retail investors in certain municipal bond offerings. The Commission found that over a four-year period, UBS improperly allocated bonds intended for retail customers to flippers who then immediately resold the bonds to other B-Ds at a profit.

Circumventing priority

In the SEC's view, UBS' registered reps knew or should have known that the flippers were not eligible for retail priority. The Commission's order details that UBS reps facilitated over 2,000 trades with flippers. The moves resulted in UBS obtaining bonds for its own inventory, thereby circumventing the priority of orders set by the issuers and improperly obtaining a higher priority in the bond allocation process.

The conduct that is the subject of the SEC enforcement action against UBS occurred between 2012 and 2016. The dual registrant headquartered in Weehawken, N.J., utilized both **Core Performance Management** and **RMR Asset Management** as flippers, the SEC claimed.

It noted that UBS reps often represented that the orders were bona fide retail orders, and either concealed or did not disclose the fact that their customers were flippers.

A red flag: zip codes provided were not associated with the UBS customers' account and submitted with the customers' retail order to the underwriting syndicate.

Millions in profits

UBS ultimately made a profit of $1.54 million from allocations of new issue bonds to CPM and RMR. The firm further made a $5.2 million profit from reselling bonds that it had obtained through CPM and RMR.

UBS's written supervisory procedures did not address retail order period restrictions to comply with federal securities laws and applicable **MSRB** rules, the SEC found. The firm further lacked P&Ps to verify the retail eligibility of customer orders or the accuracy of zip codes. UBS's WSPs did not address evasion of issuers' priority rules in new issue bond offerings and when UBS bought new issue bonds for its inventory, the SEC noted.

Corrective steps taken

UBS has taken a number of remedial steps, including reviewing and improving its retail order period P&Ps, introducing retail order period training for reps and others whose work relates to municipal bond trading, enhancing monitors and controls for the retail order period, and revising its account opening and client verification procedures.

UBS also took steps to restrict delivery-versus-payment accounts, which were typically used by the flippers, from receiving negotiated new issue municipal bond allocations.

Enforcement trend

The SEC has been active in pursuing flipping cases over the last couple of years and will be discussing municipal advisors in an outreach event next month. The Commission brought prior actions in August 2018, in December 2018, and in September 2019. This past April a settlement was also reached with **Boenning & Scattergood** (***RCW***, April 23, 2020).

Like the Boenning & Scattergood enforcement action, two UBS reps were also charged. The SEC settled proceedings against reps **William Costas** and **John Marvin**. They were found to have negligently submitted retail orders for municipal bonds on behalf of their flipper customers. Costas also helped UBS bond traders improperly obtain bonds for UBS's own inventory through his flipper customers, the SEC charged. Each will pay a $25,000 penalty.

Look for the enforcement activity to continue. "Retail order periods are intended to prioritize retail investors' access to municipal bonds and we will continue to pursue violations that undermine this priority," said **LeeAnn Gaunt**, chief of the SEC Division of Enforcement's Public Finance Abuse Unit. ■