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ACA Insight

The weekly news source for investment management legal and compliance professionals

"I think it will take up to a couple of months for the SEC to be up and running as normal."

SEC Deals with Backlog as It Resumes Full Operations

This past week marked the first full week that the SEC, as well as much of the rest of the federal government, resumed business since the shutdown began on December 22. It will likely be several weeks more, however, until the agency deals with the backlog of applications, requests, examination actions, enforcement matters and more, enabling it to move forward at its previous pace.

"Our approximately 4,500 employees are now returning to their posts in our Washington, DC home office and our 11 regional offices," wrote SEC Chairman **Jay Clayton** in a statement issued shortly after President **Donald Trump** and

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Determine Auditor's Custody Rule Savvy before Engagement

The Custody Rule can be a major headache for advisory firms and their legal counsel. It is complicated, open to interpretation, and the SEC is on the lookout for advisers – and accounting firms – that violate it. All the more reason, for both advisers and auditors to be knowledgeable and experienced about the Rule before taking steps that may violate its requirements.

The agency in January settled charges with an Indianapolis-based accounting firm, **Katz, Sapper & Miller** (KSM), and **Scott Price**, one of its partners, that they engaged

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Advertising: SEC's Pursuit of Back-Tested Performance Nets another Settlement

Any adviser considering the use of back-tested performance in its advertising would be wise to think twice. The SEC, which has made no secret in recent years of its concerns about this practice, may well look further into firms that employ it, as one advisory firm recently discovered.

Sterling Global Strategies, a Carlsbad, California-based adviser with approximately $223 million in assets under management, recently settled charges with the agency that from at least 2010 through 2018 it made material misstatements and omissions to clients and prospective clients in advertising the back-tested performance of one of the

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SEC Deals with Backlog

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Congressional leaders reached agreement on a deal to temporarily (for three weeks, until February 15) end the 35-day shutdown. "The leaders of our Divisions and Offices, in consultation with various members of our staff, are continuing to assess how to most effectively transition to normal operations."

"I think it will take up to a couple of months for the SEC to be up and running as normal," said **Proskauer** partner and former SEC Division of Investment Management Deputy Director **Robert Plaze**. "There is undoubtedly a backlog of work, and a long line of industry participants waiting for the staff to engage on a range of matters. OCIE and the Enforcement Division's numbers will be down this year by around one twelfth (given that the shutdown lasted just over a month). New agency initiatives will be postponed as existing ones are being completed. There is no silver lining in this shutdown for any of the market participants."

Then there is the effect that this period of catch up will have on the SEC's planned initiatives, whether the adoption of final standards of conduct, a proposed Advertising Rule update, or adoption of an ETF Rule.

"Devoting resources to backlog efforts may result in various announced pending SEC initiatives moving ahead more slowly than originally anticipated," said **Sidley Austin** senior counsel **Jonathan Miller**.

A related question to all these efforts is what happens if, at the end of the three-week period, a new government shutdown occurs? If the SEC has succeeded in eliminating its backlog by then, a new backlog would gradually begin to grow, depending on the length of any new shutdown. For those parts of the agency in which backlog from this past shutdown has not been eliminated, however, a new shutdown would compound the amount of work that SEC staff members have to do.

Ropes & Gray counsel **David Tittsworth**, who said that some of his clients have already been contacted by OCIE to resume examinations that were in progress before the shutdown, said that any additional shut down that occurs "would only exacerbate any delays."

The Division of Investment Management, the Office of Compliance Inspections and Examinations, the Division of Trading and Markets, and the Division of Corporation Finance each placed statements on their home pages. The Division of Enforcement and the Division of Economic and Risk Analysis did not, but the Enforcement Division began posting new administrative settlements and court actions shortly after the shutdown ended.

Division of Investment Management

The Division will, for the most part, deal with the backlog on a first come, first served basis. "We anticipate addressing filings, exemptive and guidance requests based on when an item was amended or initially filed. In other words, absent compelling circumstances, we expect to address matters in the order in which they were received," it stated on its home page.

While the Division staff is resuming responses to questions and guidance requests, including those involving adviser interpretive issues, Form PF, accounting matters and general interpretive concerns, "our response time for pending and new inquiries may be longer than ordinary," the Division statement said. If anyone sent a request that has become urgent, it said that those parties should "feel free to contact us again and include the reason why you believe expedited treatment is necessary."

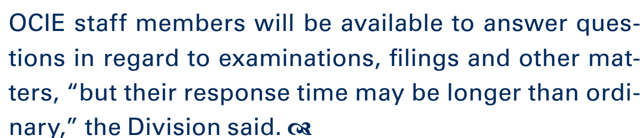
The Division said that, in regard to its review of filings by investment companies, including post-effective amendments, proxy statements and Form N-14 filings, the staff "may require more time in delivering comments to registrants" during the transition.

"Some registrants may have omitted or removed delaying amendments from their registration statements," the Division said. "We will consider requests to accelerate the effective date of those registration statements if they are amended to include a delaying amendment prior to the end of the 20-day period and acceleration is appropriate. In cases where we believe it would be appropriate for a registrant to amend to include a delaying statement, we will notify that registrant."

OCIE

The SEC's examination arm said that staff members "will be communicating with registrants about rescheduling postponed examinations, as well as completing in-progress examinations in the coming weeks."

"In general, OCIE anticipates resuming examinations, including those that were in progress prior to, as well as those that were postponed, during the lapse in appropriations," the Division said in its statement. In addition, it said that it anticipates "addressing filings, submissions and requests for staff action based on when an item was submitted, including initial registrations of an entity with the Commission." Like the Division of Investment Management, OCIE said that it expects to address matters, in particular new registrations, "in the order in which they were received."



OCIE staff members will be available to answer questions in regard to examinations, filings and other matters, "but their response time may be longer than ordinary," the Division said.

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in "improper professional conduct" in completing fund audits. One of those charges was that KSM violated the Custody Rule because, unbeknownst to its advisory firm client, the accounting firm was not independent in conducting those audits – because it had prepared year-end financial statements for those same funds.

The settlement noted that under Rule 2-01(c)(4)(i) of Regulation S-X, an accountant is not independent if it "provides certain bookkeeping or other services related to the accounting records or financial statements unless it is reasonable to conclude that the results of those services will not be subject to audit procedures during an audit of the audit client's financial statements."

The settlement is the latest example of the SEC going after what it calls "gatekeepers" – law firms, accountants, consultants and third-party administrators, among others that the agency believes brought violations to the door of the advisers, funds or broker-dealers that retained them. The SEC has been pursuing such cases since at least October 2013, when then SEC Chair **Mary Jo White** said that firms that work with advisers cannot evade enforcement actions. "We are . . . pursuing those who should be serving as the neighborhood watch, but who fail to do their jobs."

"While there were a number of issues underlying the decision, the SEC's heavy emphasis on the independence issue suggests that the SEC wants to send a message: CPA firms that undertake to audit or conduct surprise exams of registered investment advisers and their funds need to know the relevant rules and issues," said **Rogers & Hardin** partner **Stephen Councill**.

"While this case fits within the SEC's gatekeeper actions, it also likely was brought because the underlying accounting client, advisory firm **Mohlman Asset Management Fund**, previously settled SEC fraud charges (*ACA Insight*, 1/8/18)," said **Stark & Stark** attorney **Max Schatzow**. "Standing alone, the SEC might not have used its enforcement resources to bring this matter. However, in conjunction with the Mohlman case, the agency wanted to hold the accounting firm responsible for some of the investor harm."

"One of the lessons for the principals of an advisory firm is that when the registered investment adviser engages an audit firm, they should perform due diligence on the capabilities of that firm," said **Scarinci Hollenbeck** partner **Paul Lieberman**. "The RIA cannot satisfy the Custody Rule unless the fund audit is performed by an independent accounting firm that is registered with and subject to inspection by the PCAOB. The independence requirement is paramount."

"This is basic blocking and tackling, fundamental to the policies and procedures of an advisory firm," he said. "You need to know the Custody Rule, understand the Rule as it relates to auditor independence and quality control procedures for the accounting firm to be selected for this engagement – before you sign the engagement letter with the auditor. That's really the job of the advisory firm's management team, chief compliance officer and/or the law firm that works with the adviser. The auditing firm candidate should also demonstrate that it has the expertise to do the job. All of this should be suitably documented and put in the file."

The adviser and the auditor

Mohlman Asset Management Fund, also based in Indiana, was not charged in the KSM settlement. The adviser, which registered with the SEC in March 2010, withdrew its registration in September 2017. The adviser has the word "fund" in its name because it also operated as a pooled investment vehicle, the settlement order states. It managed other funds, as well.

From at least February 2010 through December 2015, the adviser had custody of client assets invested in its funds. Under the Custody Rule, advisers with custody of client assets are required, among other things, to maintain those funds and securities with a qualified custodian, who must provide account statements to investors at least quarterly. It also requires that client assets be verified through an annual surprise examination conducted by an independent public accountant.

However, an adviser may also satisfy the Custody Rule requirements if it completes and distributes an annual audited financial statement prepared in accordance with GAAP to each limited partner within 120 days of the end of each partnership's fiscal year. "The financial statements must be audited by an independent public accountant that is registered with, and subject to, regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the PCAOB."

Engaged but not independent

Mohlman Asset Management Fund engaged KSM to audit its funds' 2012 through 2015 financial statements. Price, the SEC said, was the KSM engagement partner on all of these projects "and thus was ultimately responsible for the funds' audit engagements and their performance, and for recommending that KSM issue its audit reports."

KSM, however, was not independent because it prepared the funds' 2012 and 2013 financial statements and notes to those statements, "which it then audited," the agency said, later noting in the settlement order that "KSM audited its own work."

"Auditor independence in the investment adviser space continues to trouble investment advisers and accounting firms," said Schatzow. "The Custody Rule requires that any accounting firm conducting an audit of a pooled investment vehicle managed by a registered investment adviser be independent, according to Regulation S-X. These rules prohibit the accountant performing the audit from maintaining or preparing the audit client's accounting records."

Questions of professional conduct

The SEC alleged that KSM and Price "engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's rules of practice by negligently engaging in highly unreasonable conduct that resulted in a violation of the applicable professional standards in circumstances for which heightened scrutiny is warranted, or by negligently engaging in repeated instances of unreasonable conduct." It listed the following specific instances of this, stating that the firm and its partner:

1. **Failed to comply with the SEC independence standards** for the audits of the funds' 2012 and 2013 financial statements, "for which heightened scrutiny was warranted. The KSM engagement team unreasonably concluded that AICPA independence standards applied, as opposed to SEC independence standards."
2. **Failed to have relevant knowledge, training and experience** prior to conducting the audits of those same financial statements, and failed to establish sufficient quality control standards to determine which independence conflicts had been appropriately reviewed and addressed.
3. **Failed to exercise due professional care** in relation to the funds' audits because they violated SEC independence standards for the audits of the funds' 2012 and 2013 year-end financial statements, and because they violated **American Institute of Certified Public Accountants** audit standards for the audits of one of the advisory firm's fund's 2013, 2014 and 2015 year-end financial statements.
4. **Issued an audit report containing an unmodified opinion regarding a fund's 2013 and 2014 year-end**

financial statements, "even though they should have been aware of a related party transaction that had not been properly disclosed."

5. **Issued an audit report containing another unmodified opinion regard the same fund's 2013 through 2014 year-end financial statements**, "even though they should have been aware that [the fund's] 2013 through 2015 year-end financial statements failed to properly disclose an unsecured loan to [an unnamed person and his wife]."

Remediation efforts

The SEC did note constructive efforts made by both KSM and Price, which it said it took into consideration in settling the case.

KSM, it said, "has already taken steps to improve its policies, procedures and training, including hiring an audit director to provide oversight and training for KSM's Custody Rule audits; revising its quality control policies and procedures – including client acceptance – and requiring SEC-specific training, twice yearly for all financial services group members."

As for Price, the agency noted that he played a "significant role" in the accounting firm's remediation efforts, including, but not limited to, "standardizing work papers and procedures for fund audits and engagements performed under the Custody Rule and drafting new policies and procedures." Price, the SEC said, was "the person who discovered the SEC independence standards applied to the funds' audits and caused the engagement team to apply those standards to the audits performed for the funds in 2015 and 2016."

"It's discouraging that the SEC calls out the audit partner's cooperation and involvement in identifying the issue, but then proceeded to charge and fine him," said Councill. "In my view, the SEC should save the enforcement actions and fines for the bad guys. This approach to regulation of the industry unfortunately deters people from coming forward voluntarily with problems."

Violations, sanctions and more

As part of the settlement, KSM and Price were found to have engaged in improper professional conduct under Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's rules of practice. They were also found to have caused Mohlman Asset Management Fund's 2012 and 2013 violations of Section 206(4) of the Advisers Act and its Rule 206(4)-2, the Custody Rule. An attorney representing KSM and Price did not respond to an email or voice mail seeking comment.

Price was censured and ordered to pay a civil money penalty of $15,000. KSM was ordered to pay disgorgement of $32,473, prejudgment interest of $6,257, and a civil money penalty of $63,104. It also agreed to retain an independent compliance consultant to, among other things, conduct a review of the advisory firm's policies, procedures, controls and training on auditor independence standards for Custody Rule audits and more, then make recommendations for changes in the firm's policies and practices. KSM also agreed to certify in writing its compliance with the consultant's recommendations.

Advertising

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indices used for investments. The advertisements from that period showed back-tested performance results "that significantly outperformed the S&P 500 index, including in the down market when [the index] avoided the significant downturn in the S&P 500 index," the SEC said.

The adviser, according to the settlement order, made a number of material errors in its back-tested performance calculations, the SEC said, and also deviated from the pricing methodology that it used during the live period that began in June 2010. The result of this, on a cumulative basis, was that the index's advertised performance was inflated by approximately 41.2 percent from 2000 to June 2010.

"Sterling also failed to disclose that the back-tested performance was based in part on investment in a commodity index that investors could not have actually invested in during most of the back-tested period," the agency said.

The SEC defines back-testing as involving "the retroac-

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tive application of an investment strategy or methodology to a historical set of data," it said in the settlement order. "Back-tested performance attempts to illustrate how a portfolio would have performed during a certain historical period if the performance had been in existence during that time."

"Once a strategy has been implemented for a reasonable period, a manager's continued use of back-tested performance carries certain risks," said **Alston & Bird** partner **Michael Saarinen**. "For example, the SEC may be more likely to scrutinize a manager that uses back-tested performance after a marketable track record has been established. In addition, the potential for unintended disparities between a manager's back-tested model strategy and its actual strategy tends to increase with time."

This settlement "is consistent with other cases the SEC has brought," said **Drinker Biddle** partner **James Lundy**. "This type of information is always subject to a high level of scrutiny by the Division of Enforcement staff."

Advisers considering the risky course of using back-tested performance in advertisements need to do so "with real expertise and controls in terms of how it is implemented and periodically monitored," he said. "The SEC might be willing to accept some small margin of error, but nothing like the 41.2 percent margin alleged here."

Sterling Capital was found by the SEC to have willfully violated Section 206(2) of the Advisers Act, which prohibits fraud; Section 206(4) and its Rule 206(4)-1(a)(5), for publishing, circulating or distributing an advertisement containing untrue statements of material fact, or which is otherwise false or misleading; and Rule 206(4)-7, the Compliance Program Rule, which requires advisers to adopt and implement reasonably designed written compliance policies and procedures.

Under the terms of the settlement, the advisory firm was censured and agreed to pay a civil money penalty of $175,000. It also agreed to prominently post a notice with a link to the settlement order on its website, retain a compliance consultant, and provide written certification to the SEC that it took each of these steps.

Sterling Capital, when contacted, did not respond with a comment.

"This matter was about modeled performance advertising, an area of recent SEC focus," Sterling said in a statement. "Before Sterling launched the index in question in 2010, it hired a reputable third-party index provider to calculate the hypothetical performance over the prior decade. Unfortunately, as discussed in the SEC order, certain back-tested calculations were erroneous. Much of the conduct at issue concerns Sterling's failure to oversee the third-party calculations, and to catch and correct mistakes that both over-and understated the advertised performance."

"The errors impacted the accuracy of Sterling's advertised back-tested performance, but did not impact the actual performance of the strategy once it was launched," Sterling said. "As soon as the SEC advised Sterling of the issue, the advertisements were taken down. As a result of all of this, Sterling has hired a new outside compliance firm to ensure the accuracy of its advertising. Sterling cooperated with the SEC staff and is grateful for the prompt resolution of the matter and that the agency staff agreed no charges were warranted against any individuals with the fund."

Strategy and index

Sterling, in 2010, began providing advisory services as an active manager, according to the settlement order. The accounts it managed were individual accounts, primarily for high net worth individuals, as well as institutional clients, for which it provided portfolio management and other services.

Among the strategies it used was one called the Sterling Tactical Rotation Strategy, referred to by the SEC as the "Sterling index," which the settlement order describes as "a rule-based momentum approach that rotated between six broad-based non-correlated global asset classes based on immediate trends." Those asset classes included domestic equities, domestic bonds, international equities, real estate, commodities and cash. Sterling would select, based on relative strength and momentum signals, two of the six asset classes each month, weighing each equally. The strategy also

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allowed for a 100 percent weighting to cash when the market declined.

"Sterling represented that the strategy was designed to outperform the domestic stock market while providing downside protection," the SEC said.

Enter the third party

The advisory firm began using the strategy to manage accounts in June 2010, a period described in the settlement order as the "live period" – but it also allegedly sought to provide hypothetical performance for the Sterling index prior to that period.

Sterling contracted with an unnamed third-party index provider to calculate the back-tested performance from 2000 to 2010, and used that back-tested past performance as the past performance of the Sterling index, according to the settlement order. The calculations showed that the back-tested performance exceeded the S&P 500 index, and also demonstrated downside protection. "Sterling used these calculations in many, but not all, advertisements to clients and prospective clients," the SEC said.

However, according to the settlement order, the advisory firm stopped using the back-tested performance calculations in 2018 – in response to concerns about the accuracy of their use in advertisements identified by agency Enforcement Division staff.

The problems

The SEC charged that Sterling's back-tested performance calculations "deviated from the actual strategy methodology in at least three material respects, and Sterling failed to disclose this fact in its advertisements," the agency said, adding that this resulted in inflated back-tested performance. The three deviations alleged in the settlement order were:

1. **Inconsistent with the approach used in the live period.** "For the back-tested period, Sterling calculated asset allocation signals based on the month-end closing price for the underlying asset class investments, the same date as the hypothetical investment," the SEC said. However, in contrast, during the live period, Sterling calculated asset allocation signals using the closing price that predated month end by two days, to allow time between the signal and the actual investment. "The failure to use a two-day lag that was essential to execute the actual strategy resulted in the back-tested performance being inflated by approximately 9.6 percent," the settle-

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ment order said. "This two-day lag imbedded in the live performance but not in the back-tested performance was never disclosed in Sterling's advertisements even though Sterling's advertisements blended the back-tested performance (not using a lag) with the strategy's performance (using a two-day lag).

2. **Third-party index provider inaccurately applied the model rules, selecting inaccurate portfolio holdings and returns in certain months.** The settlement order provides an example: According to the model, the index provider should have selected domestic bonds and domestic equities for December 2002. Instead, however, the index provider selected commodities and domestic equities. In addition, the SEC said, the inaccurate asset selection resulted in the advisory firm materially overstating the amount by which the index exceeded its benchmark. "In total, the months for which the Sterling index holdings did not follow the strategy's model resulted in the back-tested performance being inflated by approximately 31.6 percent," the SEC said.

3. **Based on a hypothetical investment.** "The back-tested performance from 2000 to 2010 of the Sterling index was also based in part on the Sterling index's hypothetical investment in a well-known commodity index," the agency said. "The commodity index Sterling's model used from 2000 to 2006 was not actually an investment investors could invest in." Nor, it said, was this disclosed to investors.

"The lesson here," said Lundy, is that "use of a proxy, in this case the third-party index provider, has to be monitored."

The SEC found that while the advertising section of Sterling's compliance manual addressed advertising actual performance results, and the means by which the advisory firm would verify the accuracy of those performance results, "it did not address specifically Sterling's use of back-tested performance results (e.g., noting the differences between live and back-tested performance calculations, disclosing any changes in investments used in the back test, or verifying whether the back-tested performance was calculated accurately)." ☙

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