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The SEC Speaks in 2022

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CORPORATE LAW AND PRACTICE
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Number B-2764

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Prepared for
THE SEC SPEAKS IN 2022
Washington, D.C., September 8–9, 2022

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Senior Program Attorney: Grace E. O'Hanlon

Program Schedule

The SEC Speaks in 2022
September 8–9, 2022
Washington, D.C.

AGENDA DAY ONE

Morning Session:

8:30
Opening Remarks
Gurbir S. Grewal, Director, Division of Enforcement
William A. Birdthistle, Director, Division of Investment Management

8:45
Chair's Remarks
Hon. Gary Gensler

9:05
Division of Investment Management
Senior staff will share insights on:
- Division Rulemakings and Guidance
- Disclosure Developments
- Analytics Developments
- Other Division Initiatives

Speakers: Division of Investment Management
William A. Birdthistle, Director
Timothy Husson, Associate Director, Analytics Office
Melissa Roverts Harke, Assistant Director, Investment Adviser Regulation Office
Michael Spratt, Assistant Director, Disclosure Review and Accounting Office
Thoreau Bartmann, Assistant Director, Chief Counsel's Office
Commentator: Hon. Paul S. Atkins

10:10 Networking Break

10:30

Division of Trading and Markets

Senior staff will share insights on:

- Proposed Commission Rules on Electronic Recordkeeping
- Custody of Digital Securities
- Paper-to-Electronic Filings
- Dealer Rulemaking
- Reg BI Updates; Staff Bulletins
- T+1 Proposal
- Clearing Agency Initiatives
- Security-based Swap Dealer Registration
- Rule 15c2-11
- Proposed Commission Rules
- Equity Market Structure
- Fixed Income Initiatives
- Security-Based Swaps Markets

Speakers: Division of Trading and Markets
Haoxiang Zhu, Director
Michael A. Macchiaroli, Associate Director
Thomas K. McGowan, Associate Director
Emily Russell, Chief Counsel
Jeffrey S. Mooney, Associate Director
Carol McGee, Associate Director
David S. Shillman, Associate Director
Eric Juzenas, Associate Director
Commentator: Hon. Roberta S. Karmel, Hon. Laura S. Unger

11:35

Remarks by Office of the Advocate for Small Business Capital Formation Deputy Director Sebastian Gomez Abero

11:50 Lunch

Afternoon Session:

1:15

Division of Corporation Finance

Senior staff will share insights on:

- Division Rulemakings and Guidance
- Disclosure Developments
- Other Division Initiatives

Speakers: Division of Corporation Finance
Renee Jones, Director
Erik Gerding, Deputy Director, Legal & Regulatory Policy
Cicely LaMothe, Acting Deputy Director, Disclosure Operations
Michael Seaman, Chief Counsel
Ted Yu, Chief of the Office of Mergers & Acquisitions
Commentator: Hon. Paul S. Atkins

2:20

Remarks by Office of Minority and Women Inclusion Chief Diversity Officer Pamela A. Gibbs

2:35 Networking Break

2:55

Accounting

Senior staff will share insights on:

- Current financial disclosure issues
- Accounting and auditing issues
- Emerging practice issues

Speakers:
Paul Munter, Acting Chief Accountant, Office of the Chief Accountant
Lindsay McCord, Chief Accountant, Division of Corporation Finance
Jenson Wayne, Chief Accountant, Division of Investment Management
Commentators: Hon. Cynthia Glassman

4:00 Networking Break

4:20
WORKSHOPS

Workshop A: Division of Investment Management
Discussions on:

- Enforcement initiatives
- Fund disclosure and processing developments
- Investment Company Rulemakings
- No-action letters and exemptive relief updates
- Data analytics developments

Speakers: Division of Investment Management
Robert Shapiro, Branch Chief, IM Liaison Office
Jay Williamson, Branch Chief, Disclosure Review and Accounting Office
Angela Mokodean, Branch Chief, Investment Company Regulation Office
Kaitlin Bottock, Branch Chief, Chief Counsel's Office
David Stevens, Assistant Director, Analytics Office

Workshop B: Division of Trading and Markets
Discussions on:

- Significant SRO Rules
- Treasury Clearing and Clearing Initiatives (Clearing agency rule filings and the CPMI-IOSCO Stablecoin Report)
- Security-based Swaps
- Updates from Trading Practices
- Infrastructure Implementation
- ATS Proposal

Speakers: Division of Trading and Markets
Raymond Lombardo, Assistant Director
Lourdes Gonzalez, Assistant Director
Elizabeth Fitzgerald, Assistant Director
Rajal Patel, Senior Special Counsel
Mick Riley, Branch Chief
Tyler Raimo, Assistant Director

Workshop C: Division of Corporation Finance

Discussions on:

- Disclosure and processing developments
- Accounting and financial reporting issues

Speakers: Division of Corporation Finance
Dan Morris, Special Counsel, Disclosure Review Program
Terence O'Brien, Accounting Branch Chief, Disclosure Review Program
Jennifer López Molina, Legal Branch Chief, Disclosure Review Program
Anne Parker, Office Chief, Disclosure Review Program
Tamara Brightwell, Program Director, Disclosure Review Program
Jessica Kane, Program Director, Disclosure Review Program

Workshop D: Accounting

Discussions on:

- Accounting and auditing issues
- Emerging practice issues

Speakers: Office of the Chief Accountant
Jonathan Duersch, Associate Chief Accountant
Anita Doutt, Senior Associate Chief Accountant
Jill Davis, Associate Chief Accountant

5:20 Adjourn

AGENDA DAY TWO

Morning Session:

8:30
Division of Enforcement
Senior staff will share insights on:
- Overview and Observations on current initiatives
- Legal and Policy Developments
- Litigation Developments

Speakers: Division of Enforcement
Gurbir S. Grewal, Director
Sanjay Wadhwa, Deputy Director
Samuel Waldon, Chief Counsel
Olivia Choe, Chief Litigation Counsel
David L. Hirsch, Chief, Crypto Assets and Cyber Unit
Osman Nawaz, Chief, Complex Financial Instruments Unit
N. Creola Kelly, Chief, Office of the Whistleblower
Daniel Gregus, Regional Director, Chicago Regional Office
Commentators: Hon. Daniel M. Gallagher, Hon. Harvey L. Pitt

9:35
Commissioner's Remarks
Hon. Mark T. Uyeda

9:55 Networking Break

10:15

Division of Economic and Risk Analysis

Senior staff will share insights on:

- Psychology and Finance
- Digital Identifiers and the use of Digital Identifiers
- DERA Economists as Testifiers
- Use of AI in Financial Regulation

Speakers: Division of Economic and Risk Analysis
Chyhe Becker, Deputy Director
Mike Willis, Associate Director
Eugene Canjels, Assistant Director
Marco Enriquez, Senior Applied Mathematician
Commentators: Hon. Daniel M. Gallagher, Hon. Cynthia Glassman

11:20

Division of Examinations

Senior staff will share insights on:

- National Examination Priorities

Speakers:
Richard R. Best, Director, Division of Examinations
Adam R. Wendell, Deputy Director, Office of Municipal Securities
Lori H. Price, Director, Office of Credit Ratings
Natasha Greiner, Co-National Associate Director, Investment Adviser/Investment Company Program, Division of Examinations
John Polise, National Associate Director, Broker-Dealer and Exchanges Program, Division of Examinations
Keith E. Cassidy, National Associate Director, Technology Controls Program, Division of Examinations
Allison Fakhoury, National Associate Director, Office of Clearance and Settlement, Division of Examinations
James T. Giles, Acting Chief Risk and Strategy Officer, Division of Examinations
Commentators: Hon. Paul S. Atkins, Hon. Daniel M. Gallagher, Hon. Harvey L. Pitt

12:25 Lunch

Afternoon Session:

1:30

Judicial and Legislative Developments

Senior staff will share insights on:

- Exclusive review scheme for challenges to administrative proceedings: SEC v. Cochran
- Challenges to SEC no admit/no deny policy: SEC v. Novinger
- Post-Liu developments
- Insider trading: SEC v. Clark
- Market manipulation SEC v. Lek
- Market Data Issues

Speakers: Office of the General Counsel
Dan M. Berkovitz, General Counsel
Michael A. Conley, Solicitor
Dominick V. Freda, Assistant General Counsel
Tracey A. Hardin, Assistant General Counsel
Jeffrey A. Berger, Senior Appellate Counsel
Kerry J. Dingle, Senior Appellate Counsel
David D. Lisitza, Senior Appellate Counsel
Daniel Staroselsky, Senior Appellate Counsel
Brooke Wagner, Appellate Counsel
Commentators: Hon. Roberta S. Karmel, Hon. Laura S. Unger

2:35

Ethical Issues for Securities Attorneys

Senior staff will share insights on:

- Overview of Commission's Rule 102(e) program for attorneys
- Recent case developments in discipline of attorneys appearing and practicing before the SEC
- Other ethical issues for practitioners before the Commission

Speakers: Office of the General Counsel
Tracey Sasser, Associate General Counsel
Thomas J. Karr, Assistant General Counsel
Philip Holmes, Special Trial Counsel
Karen Shimp, Special Trial Counsel
Commentators: Hon. Paul S. Atkins

3:35 Networking Break

3:55
WORKSHOPS

Workshop E: Division of Enforcement
Discussions on:
- Initiatives overview and observations
- Legal and Policy Developments
- Litigation Developments

Speakers: Division of Enforcement
Thomas P. Smith, Jr. Acting Regional Director, New York Regional Office
Jason J. Burt, Acting Regional Director, Denver Regional Office
Charles E. Cain, Chief, Foreign Corrupt Practices Unit
Rebecca Olsen, Deputy Chief, Public Finance Abuse Unit
Stacey Bogert, Associate Director
D. Mark Cave, Associate Director

Workshop F: Office of International Affairs
Discussions on:
- International Regulatory Policy
- Cross-Border Enforcement Cooperation
- Cross-Border Supervisory Cooperation

Speakers: Office of International Affairs
Michael Ferrario, Senior Special Counsel, Regulatory Policy and Supervisory Cooperation
Jeremiah Roberts, Branch Chief, Regulatory Policy and Supervisory Cooperation
Thomas Swiers, Branch Chief, Enforcement Cooperation and Policy and Technical Assistance

Workshop G: Division of Examinations
Discussions on:
- In depth review of examination priorities

Speakers: Division of Examinations
Grant Gartman, Assistant Director, FINRA and Securities Industry Oversight (FSIO) Program
Jennifer Duggins, Assistant Director, IA/IC Private Funds Unit
Alexis Hall, Senior Special Counsel, Technology Controls Program
Eric Celauro, Senior Special Counsel, Clearance and Settlement Program
Katherine Feld, Senior Special Counsel, Investment Companies
Akrivi Mazarakis, Assistant Director, Office of Security-Based Swaps
Katherine Monahan, Examination Manager, Broker-Dealer and Exchange Program
Stephanie Bennett, Examination Manager, Broker-Dealer and Exchange Program

Workshop H (Joint): Municipal Securities and Credit Ratings
Discussions on:
- Municipal Market Structure
- Municipal Securities Disclosure
- Municipal Market Participants
- NRSRO examinations and monitoring
- NRSRO legal and policy

Speakers:
Adam R. Wendell, Deputy Director, Office of Municipal Securities
Scott Davey, Assistant Director, **Office of Credit Ratings**
Patrick Boyle, Acting Assistant Director, **Office of Credit Ratings**

4:55 Adjourn

Faculty:

Co-Chairs:

William A. Birdthistle
Director, Division of Investment Management
U.S. Securities and Exchange Commission
Washington, D.C.

Gurbir S. Grewal
Director, Division of Enforcement
U.S. Securities and Exchange Commission
Washington, D.C.

Commentators:

Hon. Paul S. Atkins
Chief Executive Officer
Patomak Global Partners, LLC
Washington, D.C.

Hon. Daniel M. Gallagher
Chief Legal, Compliance and Corporate Affairs Officer
Robinhood
Washington, D.C.

Hon. Cynthia A. Glassman
Board Member, Discover Financial Services
Former Commissioner
Alexandria, VA

Hon. Roberta S. Karmel
Distinguished Research Professor of Law
Brooklyn Law School
Hastings on Hudson, NY

Hon. Harvey L. Pitt
Founder, CEO and Managing Director
Kalorama Partners, LLP
Kalorama Legal Services, PLLC
Washington, D.C.

Hon. Laura S. Unger
Independent Director and Private Consultant
Washington, D.C.

Program Attorney: Grace E. O'Hanlon

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Investment Management Compendium (September 1, 2022)

9.1.2022

Investment Management Compendium

Compendium of final rules, proposed rules, staff guidance, exemptive orders, significant enforcement actions, and other materials for the Division of Investment Management. The information below is a non-exhaustive list that focuses on the period October 1, 2021 through August 25, 2022.[1]

FINAL RULES

- Pay Versus Performance (Release No. 34-95607, Aug. 25, 2022), available at: https://www.sec.gov/rules/final/2022/34-95607.pdf.

- Proxy Voting Advice (Release No. 34-95266, July 13, 2022), available at: https://www.sec.gov/rules/final/2022/34-95266.pdf.

- Electronic Submission of Applications for Orders under the Advisers Act and the Investment Company Act, Confidential Treatment Requests for Filings on Form 13F, and Form ADV-NR; Amendments to Form 13F (Release No. 34-95148, June 23, 2022), available at: https://www.sec.gov/rules/final/2022/34-95148.pdf.

- Holding Foreign Companies Accountable Act Disclosure (Release No. 34-93701, Dec. 2, 2021), available at: https://www.sec.gov/rules/final/2021/34-93701.pdf.

- Universal Proxy (Release No. 34-93596, Nov. 17, 2021), available at: https://www.sec.gov/rules/final/2021/34-93596.pdf.

- Performance-Based Investment Advisory Fees (Release No. IA-5904, Nov. 4, 2021), available at: https://www.sec.gov/rules/final/2021/ia-5904.pdf.

- Filing Fee Disclosure and Payment Methods Modernization (Release No. 33-10997, Oct. 13, 2021), available at: https://www.sec.gov/rules/final/2021/33-10997.pdf.

PROPOSED RULES

- Amendments to Form PF to Amend Reporting Requirements for All Filers and Large Hedge Fund Advisers (Release No. IA-6083, Aug. 10, 2022), available at: https://www.sec.gov/rules/proposed/2022/ia-6083.pdf.

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[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission, the Commissioners, or other members of the staff.

- Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies (Release No. 33-11068, May 25, 2022), available at: https://www.sec.gov/rules/proposed/2022/33-11068.pdf.

- Investment Company Names (Release No. 33-11067, May 25, 2022), available at: https://www.sec.gov/rules/proposed/2022/33-11067.pdf.

- Special Purpose Acquisition Companies, Shell Companies, and Projections (Release No. 33-11048, June 13, 2022), available at: https://www.sec.gov/rules/proposed/2022/33-11048.pdf.

- Shortening the Securities Transaction Settlement Cycle (Release No. 34-94196, Feb. 9, 2022), available at: https://www.sec.gov/rules/proposed/2022/34-94196.pdf.

- Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies (Release No. 33-11028, Feb. 9, 2022), available at: https://www.sec.gov/rules/proposed/2022/33-11028.pdf.

- Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Release No. IA-5955, Feb. 9, 2022), available at: https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

- Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers (Release No. IA-5950, Jan. 26, 2022), available at: https://www.sec.gov/rules/proposed/2022/ia-5950.pdf.

- Share Repurchase Disclosure Modernization (Release No. IC-34440, Dec. 15, 2021), available at: https://www.sec.gov/rules/proposed/2021/34-93783.pdf.

- Money Market Fund Reforms (Release No. IC-34441, Dec. 15, 2021), available at: https://www.sec.gov/rules/proposed/2021/ic-34441.pdf.

- Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation (Release No. IC-34399, Oct. 14, 2021), available at: https://www.sec.gov/rules/proposed/2021/33-10998.pdf.

OTHER COMMISSION ACTIONS

- Request for Comment on Certain Information Providers Acting as Investment Advisers (Release No. IA–6050, June 15, 2022), available at: https://www.sec.gov/rules/other/2022/ia-6050.pdf.

STAFF STATEMENTS

- Accounting and Disclosure Information (ADI) (available at: https://www.sec.gov/investment/accounting-and-disclosure-information)
  - ADI 2022-12 – SEC Yield for Funds That Invest Significantly in TIPS (August 17, 2022).
- Filing Procedures (available at: https://www.sec.gov/investment/accounting-and-disclosure-information)
  - Derivatives Rule: Updated Reporting Forms Available for Fund Filers (February 16, 2022).
- Staff No-Action Letters (available at: https://www.sec.gov/divisions/investment/im-noaction.shtml)
  - Union Security Insurance Company (January 11, 2022).
- Staff Statements
  - Division of Investment Management: Modified or Withdrawn Staff Statements, available at: https://www.sec.gov/divisions/investment/im-modified-withdrawn-staff-statements.
  - Division of Investment Management Information Updates, available at: https://www.sec.gov/investment/im-information-updates.html.

EXEMPTIVE ORDERS

- The Commission has issued 77 exemptive orders under the Investment Company Act available at: https://www.sec.gov/rules/icreleases.shtml.
- The Commission has issued 0 exemptive orders under the Investment Advisers Act available at: https://www.sec.gov/rules/iareleases.shtml.

DATA

- Staff Analysis, available at: https://www.sec.gov/investment/im-staff-analysis.
  - Prime MMFs' Asset Composition and Asset Sales (June 23, 2022), available at: https://www.sec.gov/files/mmf-asset-sales-2023-jun-23.pdf.

- Business Development Company Report, available at: https://www.sec.gov/open/datasets-bdc.html.
- Closed-End Fund Information, available at: https://www.sec.gov/open/datasets-closed-end-investment_company.html.
- Investment Company Series and Class Information, available at: https://www.sec.gov/open/datasets-investment_company.html.
- Money Market Fund Information, available at: https://www.sec.gov/open/datasets-mmf.html.
- Money Market Fund Statistics, available at: https://www.sec.gov/divisions/investment/mmf-statistics.shtml.
- Mutual Fund Prospectus Risk/Return Summary Data Sets, available at: https://www.sec.gov/dera/data/mutual-fund-prospectus-risk-return-summary-data-sets.
- Private Funds Statistics, available at: https://www.sec.gov/divisions/investment/private-funds-statistics.shtml.
- Information About Registered Investment Advisers and Exempt Reporting Advisers, available at: https://www.sec.gov/help/foiadocsinvafoiahtm.html.
- Form ADV Data, available at: https://www.sec.gov/foia/docs/form-adv-archive-data.htm.

SIGNIFICANT ENFORCEMENT ACTIONS

- *In the Matter of MIO Partners, Inc.*, IA Rel. No. 5912 (Nov. 19, 2021) (settled) https://www.sec.gov/litigation/admin/2021/ia-5912.pdf
- *In the Matter of Upright Financial Corp. and David Yow Shang Chiueh*, IA Rel. No 5914 (Nov. 24, 2021) (settled) https://www.sec.gov/litigation/admin/2021/33-11010.pdf
- *In the Matter of Rita Mansour*, IA Rel. No. 5921 (Dec. 10, 2021) (settled) https://www.sec.gov/litigation/admin/2021/33-11012.pdf
- *In the Matter of J.P. Morgan Securities LLC*, 34 Act Rel. No. 93807 (Dec. 17, 2021) (settled) https://www.sec.gov/litigation/admin/2021/34-93807.pdf
- *In the Matter of Nicholas Abbate*, IA Rel. No. 5934 (Dec. 21, 2021) (settled) https://www.sec.gov/litigation/admin/2021/33-11019.pdf
- *In the Matter of Peachcap Tax & Advisory, LLC, and David H. Miller*, IA Rel. No. 5935 (Dec. 22, 2021) (settled) https://www.sec.gov/litigation/admin/2021/33-11020.pdf

- *In the Matter of Comprehensive Capital Management, Inc.*, IA Rel. No. 5943 (Jan. 11, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-5943.pdf
- *In the Matter of Wahed Invest LLC*, IA Rel. No. 5959 (Feb. 10, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-5959.pdf
- *In the Matter of BlockFi Lending LLC*, IC Rel. No. 34503 (Feb. 14, 2022) (settled) https://www.sec.gov/litigation/admin/2022/33-11029.pdf
- *SEC v. James Velissaris,* Lit. Rel. 25331 (Feb. 17, 2022) (litigated) https://www.sec.gov/litigation/litreleases/2022/lr25331.htm
- *SEC v. Cambridge Investment Research Advisors, Inc., et al.*, Lit. Rel. 25340 (March 2, 2022) (litigated) https://www.sec.gov/litigation/litreleases/2022/lr25340.htm
- *In the Matter of City Rochdale, LLC*, IA Rel. No. 5973 (March 3, 2022) (settled) https://www.sec.gov/litigation/admin/2022/34-94352.pdf
- *In the Matter of Alumni Ventures Group, LLC and Michael Collins*, IA Rel. No. 5975 (March 4, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-5975.pdf
- *In the Matter of Educators Financial Services, Inc.*, IA Rel. No. 5976 (March 4, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-5976.pdf
- *In the Matter of Medley Management Inc., et al.*, IA Rel. No. 6008 (April 28, 2022) (settled) https://www.sec.gov/litigation/admin/2022/33-11057.pdf
- *In the Matter of Maplelane Capital LLC*, IA Rel. No. 6011 (May 2, 2022) (settled) https://www.sec.gov/litigation/admin/2022/34-94830.pdf
- *SEC v. Synergy Settlement Services, Inc. et al.*, Lit. Rel. 25379 (May 2, 2022) (litigated) https://www.sec.gov/litigation/litreleases/2022/lr25379.htm and *In the Matter of True Link Financial Advisors, LLC and Kai H. Stinchcombe*, IA Rel. No. 6012 (May 2, 2022) (settled) https://www.sec.gov/litigation/admin/2022/33-11059.pdf
- *In the Matter of Allianz Global Investors U.S. LLC*, IA Rel. No. 6027 (May 17, 2022) (settled) https://www.sec.gov/litigation/admin/2022/34-94927.pdf
- *In the Matter of BNY Mellon Investment Adviser, Inc.*, IA Rel. No. 6032 (May 23, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-6032.pdf
- *In the Matter of RiverSource Distributors, Inc.*, IC Rel. No. 34592 (May 25, 2022) (settled) https://www.sec.gov/litigation/admin/2022/34-94978.pdf
- *In the Mater of Martin A. Sumichrast*, Lit. Rel. 25402 (May 31, 2022) (litigated) https://www.sec.gov/litigation/litreleases/2022/lr25402.htm
- *SEC v. Jennifer Campbell*, Lit. Rel. 25408 (June 2, 2022) (litigated) https://www.sec.gov/litigation/litreleases/2022/lr25408.htm

- *In the Matter of Alphacentric Advisors LLC*, IA Rel. No. 6040 (June 3, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-6040.pdf and *In the Matter of Garrison Point Capital, LLC*, IA Rel. No 6039 (June 3, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-6039.pdf
- *In the Matter of Charles Schwab & Co., Inc. et al.*, IA Rel. No. 6047 (June 13, 2022) (settled) https://www.sec.gov/litigation/admin/2022/34-95087.pdf
- *In the Matter of UBS Financial Services Inc.*, IA Release No. 6060 (June 29, 2022) (settled) https://www.sec.gov/litigation/admin/2022/34-95168.pdf
- *In the Matter of Hamilton Investment Counsel, LLC and Jeffrey Kirkpatrick*, IA Rel. No. 6061 (June 30, 2022) (settled) https://www.sec.gov/litigation/admin/2022/34-95189.pdf
- *In the Matter of Equitable Financial Life Insurance Company*, 33 Rel. No. 11083 (July 18, 2022) (settled) https://www.sec.gov/litigation/admin/2022/33-11083.pdf
- *SEC Charges JPMorgan, UBS, and TradeStation for Deficiencies Relating to the Prevention of Customer Identity Theft*, Press Release 2022-131 (July 27, 2022) https://www.sec.gov/news/press-release/2022-131
- *In the Matter of Deccan Value Investors LP and Vinit Bodas*, IA Rel. No. 6079 (Aug. 3, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-6079.pdf
- *In the Matter of IFP Advisors, LLC*, IA Rel. No. 6086 (Aug. 10, 2022) (settled) https://www.sec.gov/litigation/admin/2022/ia-6086.pdf
- *SEC v. Robert Brian Watson and WDC Holdings LLC d/b/a Northstar Commercial Partners*, Lit. Rel. 25480 (Aug. 23, 2022) https://www.sec.gov/litigation/litreleases/2022/lr25480.htm

NOTES

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Outline: SEC Speaks 2022, Division of Trading and Markets

I. Markets

II. Broker-Dealer and Security-Based Swap Entity Activity

III. Broker-Dealer Financial Responsibility

IV. Trading Practices

V. Clearance and Settlement

VI. Derivatives Policy

I. MARKETS

A. Market Developments

1. Consolidated Audit Trail

   a. Rule 613 under the Securities Exchange Act of 1934 ("Exchange Act") required the self-regulatory organizations ("SROs") to submit a national market system ("NMS") plan to create, implement, and maintain a Consolidated Audit Trail ("CAT") that would capture customer and order event information for orders in NMS securities, across all markets, from the time of order inception through routing, cancellation, modification, or execution, as required by Rule 613. Securities Exchange Act Release No. 67457 (July 18, 2012), 77 FR 45721 (Aug. 1, 2012).

   b. The SROs submitted the required CAT NMS Plan on September 30, 2014 and thereafter submitted amendments on February 27, 2015, December 24, 2015, and February 8, 2016. The CAT NMS Plan, as amended, was published for comment in the Federal Register on May 17, 2016. On November 15, 2016, the Securities and Exchange Commission (the "Commission" or "SEC") approved the CAT NMS Plan with modifications. Securities Exchange Act Release No. 79318 (Nov. 15, 2016), 81 FR 84696 (Nov. 23, 2016).

   c. On May 15, 2020, the Commission adopted amendments to the CAT NMS Plan to address continued delays in CAT implementation. The proposed amendments are designed to promote: (1) increased transparency regarding the schedule for CAT implementation, in the form of a publicly-disclosed Implementation Plan and Quarterly Progress Reports that have been approved by a Supermajority Vote of the Operating Committee established by the CAT NMS Plan; and (2) increased financial accountability, by tying the Participants' ability to recover fees, costs, and expenses from Industry Members to the achievement of critical implementation milestones by specified deadlines. Securities Exchange Act Release No. 88890 (May 15, 2020), 85 FR 31322 (May 22, 2020).

   d. On August 21, 2020, the Commission proposed amendments to the CAT NMS Plan designed to enhance the security and confidentiality of CAT Data. The proposed amendments to the CAT NMS Plan would: (1) define the scope of the current information security program; (2) require the establishment of a security-focused working group; (3) require the Plan Processor to create secure analytical workspaces and require Participants to use such workspaces to access and analyze PII and CAT Data when using certain tools; (4) limit the amount of CAT Data that could be extracted using the online targeted query tool; (5) impose requirements relating to certain PII; (6) define a workflow process for customer and account attributes; (7) modify and supplement existing SRO policies and procedures relating to CAT Data confidentiality; (8) refine the existing requirement that CAT Data be used for only regulatory or surveillance purposes; (9) codify and enhance the security of connectivity to the CAT; (10) require corrective actions and breach notifications to impacted CAT Reporters; and (11) make other changes and clarifications to the CAT NMS Plan. Securities Exchange Act Release No. 89632 (Aug. 21, 2020), 85 FR 65990 (Oct. 16, 2022).

e. On December 18, 2020, the SROs filed an amendment to the CAT NMS Plan to allow for the inclusion of comprehensive limited liability provisions in CAT Reporter Agreements. Securities Exchange Act Release No. 90826 (Dec. 30, 2020), 86 FR 591 (Jan. 6, 2021). The Commission issued an order instituting proceedings to determine whether to approve or disapprove the amendment on Apr. 6, 2021. Securities Exchange Act Release No. 91487 (Apr. 6, 2021), 86 FR 19054 (Apr. 12, 2021). On October 29, 2021 the Commission disapproved the amendment. Securities Exchange Act Release No. 93484 (Oct. 29, 2021), 86 FR 60933 (Nov. 4, 2021).

f. On March 31, 2021, the SROs filed an amendment to the CAT NMS Plan to implement a revised funding model for the CAT, as well as to establish a fee schedule for the CAT fees to be charged to themselves. Securities Exchange Act Release No. 91555 (Apr. 14, 2021), 86 FR 21050 (Apr. 21, 2021). The Commission issued an order instituting proceedings to determine whether to approve or disapprove the amendment on July 20, 2021. Securities Exchange Act Release No. 92451 (July 20, 2021), 86 FR 40114 (July 26, 2021). On December 8, 2021, the SROs withdrew this funding model amendment. Securities Exchange Act Release No. 93817 (Dec. 17, 2021), 86 FR 72656 (Dec. 22, 2021).

g. On April 21, 2021, the Nasdaq and Cboe exchanges submitted proposed rule changes to adopt fee schedules to establish CAT fees applicable to their Industry Members in accordance with the amendment to the CAT NMS Plan that the SROs filed on March 31, 2021. The Commission temporarily suspended the proposed rule changes and instituted proceedings to determine whether to approve or disapprove the proposed rule changes on June 17, 2021. Securities Exchange Act Release No. 92207 (June 17, 2021), 86 FR 33448 (June 24, 2021). On December 16, 2021, the Nasdaq and Cboe exchanges withdrew the proposed rule changes. Securities Exchange Act Release No. 93814 (Dec. 17, 2021), 86 FR 73008 (Dec. 23, 2021).

h. On May 13, 2022, the SROs filed an amendment to the CAT NMS Plan to implement a revised funding model for the CAT and to establish a fee schedule for Participant CAT fees. Securities Exchange Act Release No. 94984 (May 25, 2022), 87 FR 33226 (June 1, 2022). The amendment proposes to establish an Executed Share Volume Model for determining fees pursuant to which, for each transaction in Eligible Securities (NMS stocks, listed options, and over-the-counter ("OTC") securities), the Clearing Broker for the buyer would pay 1/3 of the fee obligation, the Clearing Broker for the Seller would pay 1/3 of the fee obligation, and the Participant on whose trading center the execution occurred would pay 1/3 of the fee obligation. The filing is currently pending.

i. On May 20, 2022, the SROs filed an amendment to the CAT NMS Plan to allow for the inclusion of a forum selection clause, governing law and jury waiver provisions, and a disclaimer of warranties clause. The filing is currently pending.

2. Consolidated Equity Market Data

New NMS Plan Regarding Consolidated Equity Market Data

On January 8, 2020, the Commission issued a Notice of Proposed Order Directing the Exchanges and Financial Industry Regulatory Authority to Submit a New National Market System Plan Regarding Consolidated Equity Market Data. Securities Exchange Act Release No. 87906 (Jan. 8, 2020), 85 FR 2184 (Jan. 14, 2020). The Proposed Order set forth the Commission's concerns regarding the Equity Data Plan's provision of equity market data, its views regarding issues arising from the current governance structure of the Equity Data Plans, and the specific governance provisions that the Commission preliminarily believed would enable the New Consolidated Data Plan to address these concerns and issues. *See id.* at 2164.

On May 6, 2020, after carefully considering public comment received in response to the Notice, the Commission issued an Order Directing the Exchanges and Financial Industry Regulatory Authority to Submit a New National Market System Plan Regarding Consolidated Equity Market Data. Securities Exchange Act Release No. 88827 (May 6, 2020), 85 FR 28702 (May 13, 2020). The order directed the equities exchanges and the Financial Industry Regulatory Authority ("FINRA") to file with the Commission by August 11, 2020, a proposed NMS plan for consolidated equity market data containing certain specified provisions relating to plan governance.

On August 11, 2020, the equities exchanges and FINRA submitted a proposed plan, which the Commission published for comment on October 6, 2020. Securities Exchange Act Release No. 90096 (Oct. 6, 2020), 85 FR 64565 (Oct. 13, 2020). The Commission subsequently issued an Order Instituting Proceedings to Determine Whether to Approve or Disapprove a National Market System Plan Regarding Consolidated Equity Market Data. Securities Exchange Act Release No. 90885 (Jan. 11, 2021), 85 FR 4142 (Jan. 15, 2021).

On August 6, 2021, after considering public comments received, the Commission issued an Order Approving, as Modified, a National Market System Plan Regarding Consolidated Equity Market Data. Securities Exchange Act Release No. 92586 (Aug. 6, 2021), 86 FR 44142 (Aug. 11, 2021) (the "CT Plan Order").

On August 8, 2021, the Nasdaq Stock Market LLC, Nasdaq BX LLC, and Nasdaq PHLX LLC filed a petition with the U.S. Circuit Court for the District of Columbia Circuit, seeking review of the Commission's August 6, 2021, order. This petition was consolidated with similar petitions by members of the NYSE and Cboe exchange groups to become The Nasdaq Stock Market LLC, et al. v. Securities and Exchange Commission (Nos. 21-1167, 21-1168, 21-1169) (D.C. Cir.).

On August 19, 2021, the Nasdaq, NYSE, and Cboe equities exchange families filed with the Commission a motion to stay the effect of the CT Plan Order pending final resolution of their petitions for review filed in the U.S. Court of Appeals for the D.C.

Circuit ("D.C. Circuit"), which is available on the SEC's website. *See* Motion for Stay, *available at* https://www.sec.gov/rules/sro/nms/2021/34-92586-motion-for-stay.pdf. On September 17, 2021, the Commission denied the stay. *See* Securities Exchange Act Release No. 93051 (Sept. 17, 2021), 86 FR 52933 (Sept. 23, 2021).

Oral argument was held before the D.C. Circuit on March 24, 2022, and, as of June 28, 2022, the court has not decided in the matter.

3. LIBOR

   a. On July 12, 2019, the staffs of the Divisions of Trading and Markets, Corporation Finance, and Investment Management and the Office of Chief Accountant issued a staff statement relating to the expected discontinuation of the publication of LIBOR after 2021. The staff emphasized the responsibility of market participants, including, among others, broker-dealers, investment companies, investment advisers on behalf of their clients, and public companies, to prepare to transition from LIBOR to one or more alternative reference rates in order to minimize risk as well as potential negative impacts on shareholders and clients. *Available at* https://www.sec.gov/news/public-statement/libor-transition.

   b. This is a major potential issue that affects both derivatives and cash products. Market participants need to analyze and measure their risks and take action to mitigate them as appropriate.

   c. The statement discusses the importance of market participants preparing for the discontinuation of LIBOR, including: (i) analyzing existing and future contracts that may be affected and risks such discontinuation may pose to market participants; (ii) encouraging market participants to proactively deal with amending or replacing existing contracts if necessary, and ensuring that future contracts provide for an effective transition to an alternative reference rate; (iii) encouraging market participants to put appropriate policies, procedures, and operating systems in place in connection with the transition; and (iv) providing adequate disclosure to investors and shareholders regarding potential risks with respect to, and impacts of, LIBOR cessation and transition.

   d. On December 7, 2021, SEC staff issued an additional statement reminding investment professionals of their obligations when recommending LIBOR-linked securities and to remind companies and issuers of asset-backed securities of their disclosure obligations related to the LIBOR transition. SEC Staff Statement on LIBOR Transition—Key Considerations for Market Participants (Dec. 7, 2021), *available at* https://www.sec.gov/news/statement/staff-statement-libor-transition-20211207.

4. MEMX

The Commission granted the application of MEMX LLC for registration as a national securities exchange on May 4, 2020, bringing the number of registered national securities exchanges that trade equities to sixteen. *See* Securities Exchange Act Release No. 88806, 85 FR 27451 (May 8, 2020). MEMX was founded by a number of retail broker-dealers, banks, financial services firms, and market makers. It commenced trading on September 21, 2020.

B. Rulemakings

1. Proposed Amendments regarding the Definition of "Exchange" and Alternative Trading Systems ("ATSs") that Trade U.S. Treasury and Agency Securities, National Market System Stocks, and Other Securities. Securities Exchange Act Release No. 94062 (Jan. 26, 2022), 87 FR 15496 (March 18, 2022) (the "Proposal"). Among other things, the Proposal would:

   a. Amend Rule 3b-16 under the Exchange Act to include within the definition of "exchange" systems that offer the use of non-firm trading interest, as defined under the Proposal, and provide protocols to bring together buyers and sellers of securities. Under the Proposal, an organization, association, or group of persons would constitute, maintain, or provide an exchange if it: (1) brings together buyers and sellers of securities using trading interest; and (2) makes available established, non-discretionary methods (whether by providing a trading facility or communication protocols, or by setting rules) under which buyers and sellers can interact and agree to the terms of a trade and is not subject to an exception under Rule 3b-16(b).

   b. Eliminate the exemption from compliance with Regulation ATS for an ATS that limits its securities activities to U.S. Government securities or repurchase and reverse repurchase agreements on U.S. Government securities, and registers as a broker-dealer or is a bank. As a result, such ATSs would be required to comply with the conditions of the Regulation ATS exemption, as applicable.

c. Subject ATSs that trade U.S. Government securities ("Government Securities ATSs") to the Fair Access Rule under Regulation ATS with respect to trading in U.S. Treasury securities or agency securities. This proposal would help ensure the fair treatment of potential and current subscribers by a Government Securities ATS that has a large percentage of trading volume in U.S. Treasury securities or agency securities.

d. Require Government Securities ATSs to file public disclosures on Form ATS-N. This proposal is designed to enhance operational transparency by requiring Government Securities ATSs to file comprehensive public disclosures about potential conflicts of interests arising from trading activity of the ATS's broker-dealer operator or its affiliates on the ATS and the ATS's manner of operations, such as order types, priority rules, market data, and fees.

e. Enhance Commission oversight by providing a process for the Commission to review Form ATS-N filings by Government Securities ATSs and to, after notice and opportunity for hearing, declare a Government Securities ATS's Form ATS-N ineffective. The proposed review and effectiveness process would be the same as the review process for NMS Stock ATSs who currently file a Form ATS-N.

f. Amend Regulation SCI to apply to Government Securities ATSs that meet certain trading volume thresholds in U.S. Treasury securities or agency securities. The Proposal is intended to help address technological vulnerabilities and improve the Commission's oversight of the core technology of key entities in the markets for U.S. Government securities.

g. Update Form ATS and Form ATS-R to, among other things, require an ATS to disclose on Form ATS-R the transaction volumes in corporate bonds, sovereign debt securities, repurchase or reverse repurchase agreements, and listed options; require both forms to be filed with the SEC electronically through EDGAR; and eliminate confidential treatment of the types of securities that an ATS trades as disclosed on the ATS's Form ATS and Form ATS-R.

h. Amend the Fair Access Rule as applicable to ATSs that trade covered securities to: (1) provide minimum requirements for the reasonable written standards for granting, limiting, and denying access to ATS services that must be established, and applied, by an ATS that is subject to the Fair Access Rule, and require that, among other things, the ATS justify why each standard is fair and not unreasonably discriminatory; (2) aggregate the trading volume for a security or a category of securities for ATSs that are operated by a common broker-dealer or by affiliated broker-dealers for purposes of calculating the average transaction volume under the Fair Access Rule; and (3) remove an exclusion for compliance with the Fair Access Rule that is applicable to ATSs that are so-called "passive systems" that trade equities.

i. Amend Form ATS-N to provide additional disclosure for NMS Stock ATSs and to provide for disclosures applicable to Government Securities ATSs and entities that would newly fall within the amended Rule 3b-16, as proposed to be revised, and that would operate as NMS Stock ATSs and Government Securities ATSs.

2. Market Data Infrastructure

The Commission unanimously approved the Market Data Infrastructure rules on December 9, 2020. The rules: (1) expand the content of information that is required to be collected, consolidated, and disseminated as part of the national market system; and (2) amend the method by which such NMS information is collected, calculated, and disseminated by introducing a decentralized consolidation model with competing consolidators. While the rules became effective on June 8, 2021, the Commission adopted a three-phase transition period so that the rules can be implemented in an orderly fashion.

On November 5, 2021, pursuant to the Market Data Infrastructure Rules, the CTA/CQ Plans and UTP Plan filed with the Commission proposed amendments to the plans to make changes to plan language required by the rule and to proposed fees for consolidated market data under the decentralized model. *See* Securities Exchange Act Release No. 93615 (Nov. 19, 2021), 86 FR 67800 (Nov. 29, 2021) (File No. SR-CTA/CQ-2021-02) (non-fee amendment); Securities Exchange Act Release No. 93625

(Nov. 19, 2021), 86 FR 67517 (Nov. 26, 2021) (File No. SR-CTA/CQ-2021-03) (fee amendment); Securities Exchange Act Release No. 93620 (Nov. 19, 2021), 86 FR 67541 (Nov. 26, 2021) (File No. S7-24-89) (UTP Plan non-fee filing); Securities Exchange Act Release No. 93618 (Nov. 19, 2021), 86 FR 67562 (Nov. 26, 2021) (File No. S7-24-89) (UTP Plan fee amendment).

On February 24, 2022, the Commission instituted proceedings to determine whether to approve or disapprove these proposed amendments, and on May 19, 2022, the Commission extended the period within which to conclude these proceedings to July 24, 2022.

On May 24, 2022, United States Court of Appeals for the District of Columbia Circuit denied the petitions of Cboe, Nasdaq, and NYSE that had challenged the Market Data Infrastructure Rules.

II. BROKER-DEALER AND SECURITY-BASED SWAP ENTITY ACTIVITY

A. Rulemaking

1. Proposed Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer. Securities Exchange Act Release No. 94524 (Mar. 28, 2022), 87 FR 23054 (Apr. 18, 2022) (the "Proposed Dealer Rules"), *available at* https://www.govinfo.gov/content/pkg/FR-2022-04-18/pdf/2022-06960.pdf.

    a. The Proposed Dealer Rules would require market participants, such as proprietary (or principal) trading firms, that assume certain dealer-like roles, or that engage in certain levels of buying and selling government securities, to register with the SEC, become a member of an SRO, and comply with federal securities laws and regulatory obligations.

    b. New Rules 3a5-4 and 3a44-2 under the Exchange Act would further define the phrase "as a part of a regular business" in Sections 3(a)(5) and 3(a)(44) of the Exchange Act to identify certain activities that would cause persons engaging in such activities to be "dealers" or "government securities dealers" and subject to the registration requirements of Sections 15 and 15C of the Exchange Act, respectively.

    c. Rules 3a5-4 and 3a44-2 would set forth identical qualitative standards designed to identify market participants who assume certain dealer-like roles, in particular those who act as liquidity providers in the markets.

d. Rule 3a44-2 would set forth a quantitative standard under which a person engaging in certain specified levels of activity would be deemed to be buying and selling government securities "as a part of a regular business," regardless of whether it meets any of the proposed rule's qualitative standards.

e. The Proposed Dealer Rules do not seek to address all circumstances in which a person may be acting as a dealer or government securities dealer or to replace otherwise applicable interpretations and precedent. Under the Proposed Dealer Rules, no presumption would arise that a person is not a dealer solely because that person does not engage in the activities identified in the proposed rules.

f. The Proposed Dealer Rules would exclude: (1) any person that has or controls total assets of less than $50 million; and (2) investment companies registered under the Investment Company Act of 1940.

B. Sales Practices

1. Implementation of Regulation Best Interest and Form CRS

On June 5, 2019, as part of a package of rulemakings and interpretations designed to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers, the Commission adopted Regulation Best Interest ("Regulation BI") and Form CRS Relationship Summary ("Form CRS").

Regulation BI requires broker-dealers and natural persons who are associated persons of a broker-dealer to act in the best interest of their retail customers and not place their own interest ahead of the retail customer's when they make a recommendation of any securities transaction or investment strategy involving securities. Regulation BI is satisfied only if a broker-dealer complies with four specified component obligations: Disclosure, Care, Conflict of Interest, and Compliance. *See* Securities Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019), *available at* https://www.sec.gov/rules/final/2019/34-86031.pdf.

Form CRS requires registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors. The relationship summary is intended to inform retail investors about: the types of client and customer relationships and services the firm offers; the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; whether the firm and its financial professionals currently have reportable legal or disciplinary history; and how to obtain additional information about the firm. *See* Securities Exchange Act Release No. 86032; Advisers Act Release No. 5247 (June 5, 2019), 84 FR 33492 (July 12, 2019), *available at* https://www.sec.gov/rules/final/2019/34-86032.pdf.

The compliance date for Regulation BI and Form CRS was June 30, 2020. Since adoption of the rules, SEC staff have been proactive in providing guidance for firms on their implementation of, and compliance with, Regulation BI and Form CRS. For example, in December 2021 the Standards of Conduct Implementation Committee released a Staff Statement Regarding Form CRS disclosures. This Statement provides some of the Committee's observations with respect to both the specific disclosure topics required by the form's instructions as well as with respect to the general requirements pertaining to content, format, and website posting. These materials are available, along with the proposing and adopting releases, comment letters, speeches, press releases, and more on the SEC's Spotlight Page for "Regulation Best Interest, Form CRS and Related Interpretations." The webcast and transcripts of the Roundtable are also available on the SEC's Spotlight Page. *See* SEC Spotlight Page, *available at* https://www.sec.gov/regulation-best-interest.

Most recently, in March 2022 SEC staff released the first in an anticipated series of bulletins related to the obligations of broker-dealers and investment advisers when making account recommendations to retail investors, including rollover recommendations. In particular, this bulletin highlights broker-dealers' obligations under Regulation BI and investment advisers' obligations under the Investment Advisers Act fiduciary standard to act in retail investors' best interest and not to place their own interests ahead of the investor's interests. SEC staff are considering additional bulletins addressing conflicts and consideration of reasonably available alternatives, as well as costs and risks to investors. *Available at* https://www.sec.gov/tm/iabd-staff-bulletin.

2. Anti-Money Laundering ("AML") and Anti-Terrorist Financing Initiatives, and Economic and Trade Sanctions

The Commission, generally through its staff, works with other federal regulators, the SROs, and industry representatives to ensure that regulated entities implement vigorous programs to combat money laundering and terrorist financing and to examine whether regulated entities are in compliance with economic and trade sanctions administered by the U.S. Department of the Treasury's ("Treasury") Office of Foreign Assets Control. The Bank Secrecy Act requires all financial institutions (including broker-dealers and mutual funds) to establish and implement AML programs.

a. Technical Assistance

SEC staff provided technical assistance on various Treasury publications, including the 2022 National Strategy for Combating Terrorist and Other Illicit Financing (May 2022) ("2022 Illicit Finance Strategy"), *available at* https://home.treasury.gov/system/files/136/2022-National-Strategy-for-Combating-Terrorist-and-Other-Illicit-Financing.pdf, as well as the National Risk Assessments (Money Laundering, Terrorist Financing, and Proliferation Financing), *available at* https://home.treasury.gov/system/files/136/2022-National-Money-Laundering-Risk-Assessment.pdf. The 2022 Illicit Finance Strategy addresses the key risks from the National Risk Assessments and provides a comprehensive statement of Treasury's key priorities, goals, and plans for safeguarding the U.S. financial system against illicit activity. The National Money Laundering Risk Assessment identifies fraud (which may include securities fraud) as a driver of money laundering activity in terms of the scope of activity and magnitude of illicit proceeds.

SEC staff also are providing technical assistance to Treasury's Financial Crimes Enforcement Network to help facilitate the timely and effective implementation of the FY2021 National Defense Authorization Act ("NDAA"), which included significant reforms to the U.S. AML regime. The NDAA includes the Anti-Money Laundering Act of 2020 ("AML Act") and, within the AML Act, the Corporate Transparency Act ("CTA"). The AML Act seeks to strengthen, modernize, and streamline the existing AML regime by promoting innovation, regulatory reform, and industry engagement. The CTA establishes uniform beneficial ownership reporting requirements for corporations, limited liability companies, and other similar entities formed or registered to do business in the United States and will be implemented by a series of rulemakings that address the reporting, access, and disclosure requirements.

SEC staff continue to provide technical assistance to the Financial Action Task Force, which sets standards and promotes effective implementation of legal, regulatory, and operational measures for combatting money laundering, terrorist financing, and the financing of proliferation of weapons of mass destruction, and participated on subcommittees of the Treasury Bank Secrecy Act Advisory Group to help align U.S. AML programs to perceived compliance and illicit financing risk and implement certain requirements of the newly enacted AML Act.

3. Request for Information and Comment on Digital Engagement Practices

On August 27, 2021, the Commission published a request for information and public comment ("Request") on matters related to the use of digital engagement practices ("DEPs") by broker-dealers and investment advisers. These tools include behavioral prompts, differential marketing, game-like features (commonly referred to as gamification), and other design elements or features designed to engage with retail investors on digital platforms (*e.g.*, websites, portals, and applications), as well as the analytical and technological tools and methods used in connection with DEPs.

The Commission issued the Request, in part, to develop a better understanding of the market practices associated with firms' use of DEPs and the related analytical and technological tools and methods.

The Request was issued with the intent to provide a forum for market participants, including investors, and other interested parties to share their perspectives on the use of DEPs and the related tools and methods. This includes potential benefits that DEPs provide to retail investors, as well as potential investor protection concerns.

The Commission also issued the Request to assist the Commission and its staff in better understanding the nature of analytical tools and other technology used by investment advisers to develop and provide investment advice to clients, including: (1) oversight of this technology; (2) how investment advisers and clients have been affected by technology; (3) potential risks to investment advisers, clients, and the markets more generally related to this technology; and (4) whether regulatory action may be needed to enhance investor protection while preserving the ability of investors to benefit from investment advisers' use of technology.

The public comment period closed on October 1, 2021. *See* Securities Exchange Act Release No. 92766 (Aug. 27, 2021); 86 FR 49067 (Sept. 1, 2021), *available at* https://www.sec.gov/rules/other/2021/34-92766.pdf. The comments received from the Request will inform further rulemaking in this area.

C. Certain Commission Relief and SEC Staff Statements in Response to COVID-19 (see below for SRO Regulatory Relief in Response to COVID-19).

Relief from Fingerprinting Requirements. In March 2020, the Commission provided relief to transfer agents, broker-dealers, national securities exchanges and their members, and clearing agencies from, among other things, the statutory requirement that partners, directors, officers, and employees be fingerprinted. The Commission issued two subsequent orders extending the expiration date of this relief. The most recent order, issued in June 2020, provided that the relief shall be terminated on a date to be specified in a public notice from SEC staff, which date shall be at least two weeks from the date of the staff public notice. By staff statement dated June 6, 2022, SEC staff provided notice that this relief will terminate, effective September 6, 2022. As mentioned in the staff statement, persons who have any questions about this staff statement, are unable to come into compliance with their obligations before the relief is terminated, or are in need of additional assistance should contact Division of Trading and Markets staff. FINRA also provided frequently asked questions and other guidance to assist its members in coming into compliance with their fingerprinting obligations before the expiration of the relief. *See* Frequently Asked Questions Related to Regulatory Relief Due to the Coronavirus Pandemic, *available at* https://www.finra.org/rules-guidance/key-topics/covid-19/faq .

See Securities Exchange Act Release No. 88488 (Mar. 20, 2020), *available at* https://www.sec.gov/rules/exorders/2020/34-88448.pdf; Securities Exchange Act Release No. 88960 (May 27, 2020), *available at* https://www.sec.gov/rules/exorders/2020/34-88960.pdf; Securities Exchange Act Release No. 89170 (June 26, 2020), *available at available at* https://www.sec.gov/rules/exorders/2020/34-89170.pdf. *See also* Division of Trading and Markets Staff Statement Regarding

Termination Notice for Exemptive Relief for Transfer Agents and Other Persons Related to the COVID-19 Response (June 6, 2022), *available at* https://www.sec.gov/tm/tm-staff-statement-termination-covid-19-exemptive-relief.

Staff Statement on Paper Submissions, Manual Signatures, and Notarization Requirements. In early April 2020, Division of Trading and Markets staff issued a staff statement, effective through June 30, 2020, regarding certain paper submissions, manual signatures, and notarization requirements. The statement provided that Division of Trading and Markets staff would not recommend enforcement action if filers and registrants make alternate arrangements, as detailed in the statement, for delivery, execution, and notarization of certain paper filings. The statement was updated in June 2020 to indicate that the statement would terminate on the date specified in a public notice, which date will be at least two weeks from the date of the notice. These staff statements are available on the SEC's website. *See* Division of Trading and Markets Staff Statement Regarding Requirements for Certain Paper Submissions in Light of COVID-19 Concerns (April 2, 2020), *available at* https://www.sec.gov/tm/paper-submission-requirements-covid-19; Updated Division of Trading and Markets Staff Statement Regarding Requirements for Certain Paper Submissions in Light of COVID-19 Concerns (June 18, 2020), *available at* https://www.sec.gov/tm/paper-submission-requirements-covid-19-updates-061820.

Staff Statement on International Mail Service Suspensions to Certain Jurisdictions. In June 2020, the Divisions of Investment Management and Trading and Markets issued a joint staff statement regarding the requirements under the federal securities laws to mail certain regulatory communications to shareholders, clients, and customers who have not consented to electronic delivery and who have mailing addresses in international jurisdictions where common carriers have suspended mail service. The statement provides that the Divisions' staff would not recommend enforcement action if certain alternate arrangements are satisfied. This statement expires on the date, as applicable to each specific affected international jurisdiction, that common carriers resume mail delivery. This joint staff statement is available on the SEC's website. *See* Staff Statement Regarding Temporary International Mail Service Suspensions to Certain Jurisdictions Related to the COVID-19 Pandemic, *available at* https://www.sec.gov/tm/temporary-international-mail-service-suspension.

Staff Statement on Authentication and Retention Requirements of Rule 302(b) of Regulation S-T. The Divisions of Corporation Finance, Trading and Markets, and Investment Management issued a joint staff statement in March 2020 concerning the authentication and document retention requirements under Rule 302(b) of Regulation S-T (specifically, the creation and retention of manual signatures in electronically filed documents). Given that social distancing and other COVID-19 related effects continue, this statement has been updated to note that it will remain in effect until a date specified in a public notice, which date will be at least two weeks from the date of the notice. In November 2020, the Commission issued a final rule to permit the use of electronic signatures in signature authentication documents required under Rule 302(b), as well as amending certain other rules and forms under the Securities Act, Exchange Act, and Investment Company Act to allow the use of electronic signatures in other authentication documents. This joint staff statement is available on the SEC's website. *See* Staff Statement Regarding Rule 302(b) of Regulation S-T in Light of COVID-19 Concerns (June 22, 2020), *available at* https://www.sec.gov/corpfin/announcement/staff-statement-regarding-rule-302b-regulation-s-t-light-covid-19-concerns. *See also* Securities Exchange Act Release No. 33-10889 (Nov. 17, 2020), 85 FR 78224 (Dec. 4, 2020), *available at* https://www.sec.gov/rules/final/2020/33-10889.pdf.

D. Select SRO Rule Filings

1. Customer Account Statements

FINRA Proposed Rule Change to Amend FINRA Rule 2231 (Customer Account Statements) (File No. SR-FINRA-2021-024).

On June 1, 2022, the Commission approved by delegated authority a proposed rule change to amend FINRA Rule 2231 (Customer Account Statements) to, among other things, add new Supplementary Material .02 (Transmission of Customer Account Statements to Other Persons or Entities). Supplementary Material .02 prohibits member firms from sending customer account statements to third parties unless: (1) the customer provided written instructions to the member to send statements to such third parties; and (2) the member sends duplicate account statements directly to the customer either in paper format or electronically. Supplementary Material .02 provides that a FINRA member may cease sending duplicate account statements to a customer where a court of competent jurisdiction has appointed a guardian, conservator, trustee, personal representative, or other person with legal authority to act on a customer's behalf, and such court-appointed fiduciary provides written instructions to the member and furnishes to the member an official copy of the court appointment that establishes authority over the customer's accounts.

See Securities Exchange Act Release No. 95018 (June 1, 2022), 87 FR 34728 (June 7, 2022) *available at* https://www.govinfo.gov/content/pkg/FR-2022-06-07/pdf/2022-12169.pdf.

2. Financial Exploitation of Specified Adults

FINRA Proposed Rule Change to Amend FINRA Rule 2165 (Financial Exploitation of Specified Adults) (File No. SR-FINRA-2021-016).

On January 25, 2022, the Commission approved by delegated authority a proposed rule change to amend FINRA Rule 2165 (Financial Exploitation of Specified Adults) to: (1) permit member firms to place a temporary hold on a securities transaction, subject to the same terms and restrictions applicable to a temporary hold on disbursements of funds or securities under the rule, where there is a reasonable belief of financial exploitation of a "specified adult" as defined in the rule; (2) permit member firms to extend for an additional 30 business days a temporary hold, whether on a disbursement or a transaction, if the member firm has reported the matter to a state regulator or agency of competent jurisdiction, or a court of competent jurisdiction; and (3) require member firms to retain records of the reason and support for any extension of any temporary hold, including information regarding any communications with, or by, a State Authority.

See Securities Exchange Act Release No. 94016 (Jan. 25, 2022), 87 FR 4974 (Jan. 31, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-01-31/pdf/2022-01843.pdf.

3. Arbitration

Predispute Arbitration Clauses

FINRA Proposed Rule Change to Amend FINRA Rule 13000 Series (Code of Arbitration Procedure for Industry Disputes) to Align the Code with the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2021 (File No. SR-FINRA-2022-012).

On May 18, 2022, the Commission published by delegated authority, a Notice of Filing and Immediate Effectiveness for a proposed rule change to, among other things: (1) provide that a party alleging a sexual assault or sexual harassment claim who has agreed to arbitrate before the dispute arose may elect post-dispute not to arbitrate the claim under the Code; (2) provide that the claim may be arbitrated if the parties agreed to arbitrate it after the dispute arose; and (3) require firms to disclose to the associated person that a party alleging a sexual assault or sexual harassment claim that has agreed to arbitrate before the dispute arose may elect post- dispute not to arbitrate such a claim under the Code, and that such a claim may be arbitrated if the parties have agreed to arbitrate it after the dispute arose. FINRA proposed the rule to align the Code with the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2021.

See Securities Exchange Act Release No. 94942 (May 18, 2022), 87 FR 31592 (May 24, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-05-24/pdf/2022-11062.pdf.

4. Security-Based Swaps

FINRA Proposed Rule Change Relating to Security-Based Swaps (File No. SR-FINRA 2021-008).

On January 6, 2022, the Commission approved by delegated authority a proposed rule change to amend FINRA Rules 0180, 4120, 4210, 4220, 4240, and 9610 to clarify the application of FINRA rules to security-based swaps ("SBS") following the Commission's completion of its rulemaking regarding SBS dealers and major SBS participants.

See Securities Exchange Act Release No. 93914 (Jan. 6, 2022), 87 FR 1962 (Jan. 12, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-01-12/pdf/2022-00376.pdf.

5. Certain SRO Regulatory Relief in Response to COVID-19 (see above for Certain Commission Relief and SEC Staff Statements in Response to COVID-19)

   a. Procedural Requirements Relief

   FINRA Proposed Rule Change to Temporarily Amend Certain Timing, Method of Service and Other Procedural Requirements in FINRA Rules During the Outbreak of the Coronavirus Disease (COVID-19) (File No. SR-FINRA-2020-015).

   On May 20, 2020, the Commission published a Notice of Filing and Immediate Effectiveness for a proposed rule change to temporarily amend FINRA Rules 1012, 1015, 6490, 9132, 9133, 9146, 9321, 9341, 9349, 9351, 9522, 9524, 9525, 9559, and 9630 primarily to provide FINRA with temporary relief to: (i) allow, and in some instances require, FINRA to serve certain documents by electronic mail; (ii) require that applicants, respondents, and other parties file or serve documents by electronic mail in connection with specified proceedings and processes, unless the parties agree to an alternative method of service; (iii) provide extensions of time to FINRA staff, respondents and other parties in connection with certain adjudicatory and review processes; and (iv) allow for oral arguments before the National Adjudicatory Council ("NAC') to be conducted by video conference. FINRA has subsequently extended the expiration date of the temporary rule amendment in SR-FINRA-2020-015, most recently from March 31, 2022, to July 31, 2022. As noted in more detail further below, FINRA has since filed a proposed rule change to make permanent many of these temporary amendments to allow, and in some cases require, electronic service and filing of documents in disciplinary and other proceedings and appeals.

See Securities Exchange Act Release No. 94430 (Mar. 16, 2022), 87 FR 16262 (Mar. 22, 2022), *available at* https://www.finra.org/sites/default/files/2022-03/sr-finra-2022-004-nof-imm-eff.pdf.

b. Video Conferencing

FINRA Proposed Rule Change to Temporarily Amend FINRA Rules to Permit Hearings in Connection with Appeals of Membership Application Program Decisions, Disciplinary Actions, Eligibility Proceedings and Temporary and Permanent Cease and Desist Orders to Be Conducted by Video Conference (File No. SR-FINRA-2020-027).

On September 2, 2020, the Commission published a Notice of Filing and Immediate Effectiveness for a proposed rule change to temporarily amend FINRA Rules 1015, 9261, 9524, and 9830 to grant FINRA's Office of Hearing Officers and the NAC authority to conduct various hearings by video conference, if warranted by the current COVID-19-related public health risks posed by an in-person hearing. FINRA has subsequently extended the expiration date of the temporary rule amendment in SR-FINRA-2020-015 and SR-FINRA-2020-027, most recently from March 31, 2022, to July 31, 2022.

See Securities Exchange Act Release No. 94430 (Mar. 16, 2022), 87 FR 16262 (Mar. 22, 2022), *available at* https://www.finra.org/sites/default/files/2022-03/sr-finra-2022-004-nof-imm-eff.pdf.

Certain exchanges also filed similar temporary amendments to their respective rules, which were also immediately effective. *See, e.g.*, Securities Exchange Act Release No. 94610 (Apr. 5, 2022), 87 FR 21225 (Apr. 11, 2022) (SR-NASDAQ-2022-028), *available at* https://www.sec.gov/rules/sro/nasdaq/2022/34-94610.pdf; Securities Exchange Act Release No. 94666 (Apr. 11 2022), 87 FR 22607 (Apr. 15, 2022) (SR-NYSE-2022-17), *available at* https://www.sec.gov/rules/sro/nyse/2022/34-94666.pdf. The relevant exchanges also recently extended the expiration date of their temporary rule amendments from March 31, 2022 to July 31, 2022.

c. Remote Office Inspections

FINRA Proposed Rule Changes to Extend the Effectiveness of Temporary Supplementary Material .17 (Temporary Relief to Allow Remote Inspections for Calendar Years 2020 and 2021, and Through June 30 of Calendar Year 2022) under FINRA Rule 3110 (Supervision) (File No. SR-FINRA-2022-001).

On January 20, 2022, the Commission published by delegated authority a Notice of Filing and Immediate Effectiveness a proposed rule change to Extend the Effectiveness of Temporary Supplementary Material .17 (Temporary Relief To Allow Remote Inspections for Calendar Years 2020 and 2021, and Through June 30 of Calendar Year 2022) under FINRA Rule 3110 (Supervision) to include calendar year 2022 inspection obligations through December 31, 2022 within the scope of the supplementary material.

See Securities Exchange Act Release No. 94018 (Jan. 20, 2022), 87 FR 4072 (Jan. 26, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-01-26/pdf/2022-01467.pdf.

6. Permanent Changes to Procedural Requirements (Electronic Service and Filing)

As noted above, on April 6, 2022, FINRA filed a proposed rule change to make permanent many of the temporary amendments from FINRA-2020-015 to allow, and in some cases require, electronic service and filing of documents in disciplinary and other proceedings and appeals. The proposed rule change would make permanent changes to amend FINRA Rules 1012, 1015, 6490, 9132, 9133, 9135, 9146, 9321, 9341, 9349, 9351, 9522, 9524, 9525, 9559, and 9630. The proposed rule change was published for comment in the Federal Register on April 14, 2022. On May 25, 2022, FINRA consented to extend until July 13, 2022 the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change.

See Securities Exchange Act Release No. 94654 (Apr. 8, 2022), 87 FR 22264 (Apr. 14, 2022) (File No. SR-FINRA-2022-009), *available at* https://www.finra.org/rules-guidance/rule-filings/sr-finra-2022-009.

7. Continuing Education Transformation

FINRA Proposed Rule Changes to Amend FINRA Rules 1210 (Registration Requirements) and 1240 (Continuing Education Requirements) (File No. SR-FINRA-2021-015).

On September 21, 2021, the Commission issued an order approving the rule changes proposed in FINRA-2021-105 to, among other things: (1) require that the Regulatory Element of FINRA's continuing education program for registered persons of FINRA members be tailored to each registration category and completed annually rather than every three years; and (2) provide a way for individuals to maintain their qualifications following the termination of a registration through continuing education.

See Securities Exchange Act Release No. 93097 (Sept. 21, 2021), 86 FR 53358 (Sept. 27, 2021), *available at* https://www.finra.org/sites/default/files/2021-09/sr-finra-2021-015-approval-order.pdf.

Certain exchanges also filed similar amendments to their respective rules, many of which were also immediately effective. *See, e.g.*, Securities Exchange Act Release No. 94794 (Apr. 26, 2022), 87 FR 25683 (May 2, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-05-02/pdf/2022-09312.pdf and Securities Exchange Act Release No. 94400 (March 11, 2022), 87 FR 15286 (Mar. 17, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-03-17/pdf/2022-05597.pdf.

E. Other

Commission Rule of Practice 194

Commission Rule of Practice 194 ("ROP 194") provides a process for Security-Based Swap Entities ("SBS Entities") to file applications (or notices in lieu of an application if certain requirements are met) with the Commission seeking to allow statutorily disqualified associated persons to effect or be involved in effecting security-based swaps. In May of 2022, the Division of Trading and Markets issued staff guidance in the form of frequently asked questions related to ROP 194 and posted that guidance to a publicly available webpage on the SEC's website. *See* Applications and Notices by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or Be Involved in Effecting Security-Based Swap Transactions (Rule of Practice 194) (May 10, 2022), *available at* https://www.sec.gov/rule-practice-194-applications-and-notices. The ROP 194 webpage also includes the three notices submitted under ROP 194 to date. Additionally, SEC staff have received one application related to ROP 194.

III. BROKER-DEALER FINANCIAL RESPONSIBILITY

A. Implementation of Capital, Margin, Segregation, and Recordkeeping Requirements for Security-Based Swap Dealers ("SBSDs") and Major Security-Based Swap Participants ("MSBSPs")

On June 21, 2019, the Commission voted to amend existing rules and adopt new rules to implement capital and margin requirements for SBSDs and MSBSPs for which there is not a prudential regulator ("nonbank SBSDs and MSBSPs"), segregation requirements for SBSDs, and notification requirements with respect to segregation for SBSDs and MSBSPs. On September 19, 2019, the Commission adopted recordkeeping, reporting, and notification requirements for SBSDs and MSBSPs and additional recordkeeping requirements for broker-dealers to account for their SBS activities. The Commission also amended its existing cross-border rule to provide a mechanism for foreign nonbank SBSDs and MSBSPs to seek substituted compliance with respect to the capital, margin, and recordkeeping requirements, and to provide guidance on how it will evaluate requests for substituted compliance. The Commission also adopted rule-based requirements that address the application of the segregation requirements to cross-border SBS transactions.

The compliance date for these capital, margin, segregation, and recordkeeping rules was October 6, 2021. To assist potential applicants for substituted compliance under Rule 3a71-6 under the Exchange Act, SEC staff prepared guidance regarding applications for substituted compliance. In addition, the Commission has published the applications of five jurisdictions seeking substituted compliance.

See Exchange Act Substituted Compliance Applications for Security-Based Swap Markets (Oct. 18, 2021), *available at* https://www.sec.gov/page/exchange-act-substituted-compliance-and-listed-jurisdiction-applications-security-based-swap.

SEC staff also published a set of Frequently Asked Questions relating to the SBSD and MSBSP capital, margin, segregation, and recordkeeping requirements. *See* Responses to Frequently Asked Questions Regarding Financial Responsibility Requirements as Applied to Security-Based Swap Activities of Broker-Dealers and Security-Based Swap Dealers (Oct. 8, 2021), *available at* https://www.sec.gov/tm/faqs-financial-responsibility-req-applied-sbs.

B. Staff No-Action Letter Regarding Net Capital Treatment of Certain U.S. Treasury Exchange-Traded Funds

On June 2, 2022, SEC staff issued a no-action letter regarding the broker-dealer net capital rule, Rule 15c3-1 under the Exchange Act, in relation to certain U.S. Treasury Exchange-Traded Funds ("U.S. Treasury ETFs") held by some broker-dealers. Among other things, U.S. Treasury ETFs invest solely in cash and U.S. government securities that are eligible securities under paragraph (a)(11) of Rule 2a-7 under the Investment Company Act of 1940 ("1940 Act"). Currently, paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1 permits a haircut deduction of 2% for money market instruments described in Rule 2a-7 under the 1940 Act. Further, paragraph (c)(2)(vi)(A) of Rule 15c3-1 specifies haircuts for securities issued or guaranteed as to principal or interest by the United States or any agency thereof depending on the maturity, up to a maximum haircut deduction of 6% for such securities with a maturity of 25 years or more. Staff's letter stated that, pursuant to certain conditions, SEC staff would not recommend enforcement action to the Commission if broker-dealers elected to take: (a) the haircut deduction specified in paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1 (currently 2%) on the market value of the greater of the portion of the broker-dealer's long or short position in the size of a redemption unit (or multiple of a redemption unit) of U.S. Treasury ETF shares; and (b) the haircut deduction in paragraph (c)(2)(vi)(A) of Rule 15c3-1 (currently 6%) on the market value of the greater of the portion of the broker-dealer's long or short position held in a size other than a redemption unit (or multiple of a redemption unit) of U.S. Treasury ETF shares.

See letter to Kris Dailey from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets (June 2, 2022), *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2022/finra-060222-15c3-1.pdf.

C. SRO Proposed Rule Change on Covered Agency Transactions

On January 20, 2022, the staff of the Division of Trading and Markets approved by delegated authority a proposed rule change filed by FINRA to amend the margin requirements for Covered Agency Transactions under FINRA Rule 4210 (Margin Requirements). The proposed rule change would eliminate the maintenance margin requirements for Covered Agency Transactions, and permit a broker-dealer to take a capital charge in lieu of collecting variation margin, subject to a cap. *See* Securities Exchange Act Release No. 94013 (Jan. 20, 2022), *available at* https://www.sec.gov/rules/sro/finra/2022/34-94013.pdf. On February 3, 2022, a petition for Commission review of the staff's delegated action was filed. On April 14, 2022, the Commission granted the petition for review and requested that interested persons file statements in support of, or opposition to, the petition by May 10, 2022.

D. Proposal to Amend the Broker-Dealer Electronic Recordkeeping Requirements

On November 18, 2021, the Commission proposed amendments to the electronic recordkeeping requirements of Rules 17a-4, applicable to broker-dealers (including broker-dealers registered as SBSDs), and Rule 18a-6, applicable to SBSDs not registered as broker-dealers. Rule 17a-4 currently requires a broker-dealer to preserve electronic records exclusively in a non-rewriteable, non-erasable format (also known as a write once, read many ("WORM") format). The proposed amendments to Rule 17a-4 would add an audit-trail alternative to the WORM requirement, under which a broker-dealer would need to use an electronic recordkeeping system that preserves electronic records in a manner that permits the re-creation of an original record if it is altered, over-written, or erased. The proposed amendments to Rule 18a-6, which does not currently include a WORM requirement, would require SBSDs without a prudential regulator to use an electronic recordkeeping system to meet either the WORM or audit trail requirement.

Rule 17a-4 currently requires a broker-dealer using electronic recordkeeping to engage a third party who has independent access to a broker-dealer's records to undertake to furnish promptly to the Commission and other securities regulators the information necessary to download information kept on the electronic storage media to any medium acceptable under the rule. The proposed amendments to Rule 17a-4 would replace the current third-party undertakings requirement with a requirement that a senior officer of the broker-dealer provide the undertaking. Rule 18a-6 currently does not require a third-party undertaking, however, the proposed rule would add a requirement that a senior officer of the SBSD provide the undertakings. The proposed amendments would also require broker-dealers and SBSDs to produce records to regulators in a reasonably usable format and would eliminate the requirement in Rule 17a-4 that a broker-dealer notify its designated examining authority before employing an electronic recordkeeping system. (Rule 18a-6 does not currently have a parallel notification requirement.) Finally, the Commission proposed amendments to Rules 17a-4 and 18a-6 designed to make them more technology neutral.

IV. TRADING PRACTICES

A. Rule 15c2-11 Fixed Income Final No-Action Letter

On December 16, 2021, the staff of the Division of Trading and Markets issued a no-action letter extending the timeline for compliance with the amendments to Rule 15c2-11 under the Exchange Act (the "Amended Rule"). In the letter, the staff stated that it would not recommend enforcement action to the Commission under the Amended Rule for brokers or dealers that publish or submit quotations, including continuous quotations, in a quotation medium, for fixed income securities if the broker or dealer has determined that:

1. Phase 1 – the fixed income security or its issuer meets one of the criteria in Appendix A to the no-action letter (which address channels through which certain information about the security or issuer may be publicly available), or that there is current and publicly available financial information (consistent with Rule 15c2-11(b)) about the issuer. Phase 1 will be in place for a one-year period (from January 3, 2022 until, and including, January 3, 2023).

2. Phase 2 – the fixed income security or its issuer meets one of the criteria in Appendix B to the no-action letter (which are a subset of the criteria in Appendix A), or there is current and publicly available financial information about the issuer. Fixed income securities sold pursuant to Rule 144A that do not otherwise meet the criteria in Appendix B would no longer qualify for Phase 2 unless the broker or dealer determines that there is current and publicly available information about the issuer. Phase 2 will be in place for a one-year period (from January 4, 2023 until, and including, January 4, 2024).
3. Phase 3 – the fixed income security qualifies for Phase 2 and: (1) the fixed income security is foreign sovereign debt or a debt security guaranteed by a foreign government; or (2) there is a website link, on the quotation medium on which the security is being quoted, directly to the current and publicly available information about the issuer (consistent with Rule 15c2-11(b)), provided that the broker or dealer has determined at least on an annual basis that the website link and its underlying information is current. Phase 3 commences at the expiration of Phase 2 (on or after January 5, 2024).

Rule 15c2-11 governs the publication or submission of quotations for securities in a quotation medium other than on a national securities exchange. Since 1971, Rule 15c2-11 has applied to the publication or submission of quotations for any security (a defined term that has and continues to include fixed income securities) except "exempted securities," and Rule 15c2-11 has exempted municipal securities since 1976. The Commission also has stated that Rule 15c2-11 applies to fixed income securities.

Following adoption of the amendments on September 16, 2020, certain market participants began requesting additional time to complete operational and systems changes necessary to comply with Rule 15c2-11. The amendments to Rule 15c2-11 are designed to modernize it and to enhance investor protection by requiring that current and publicly available issuer information be accessible to investors. Accordingly, the phase-in approach outlined above should allow for brokers or dealers that publish or submit quotations for fixed income securities in a quotation medium to achieve the goals of Rule 15c2-11.

See Rule 15c2-11 Fixed Income No-Action Letter 2 (Dec. 16, 2021), *available at* https://www.sec.gov/files/fixed-income-rule-15c2-11-nal-finra-121621.pdf.

The December 16, 2021, no-action letter follows staff's September 24, 2021, no-action letter stating that the staff would not recommend enforcement action to the Commission under the Amended Rule until January 3, 2022, for quotations of fixed income securities published by brokers or dealers in quotation mediums, in order to allow for an orderly and good faith transition into compliance with the Amended Rule. *See* Rule 15c2-11 Fixed Income No-Action Letter (Sept. 24, 2021), *available at* https://www.sec.gov/files/rule-15c2-11-fixed-income-securities-092421.pdf.

B. Reporting of Securities Loans - Proposed Rule 10c-1 under the Exchange Act

On November 18, 2021, the Commission proposed a rule to increase the transparency and efficiency of the securities lending market by requiring any person that loans a security on behalf of itself or another person to report the material terms of those securities lending transactions and related information regarding the securities the person has on loan and available to loan to a registered national securities association ("RNSA"). The proposed rule would also require that the RNSA make available to the public certain information concerning each transaction and aggregate information on securities on loan and available to loan. *See* Securities Exchange Act Release No. 93613 (Nov. 18, 2021), *available at* https://www.sec.gov/rules/proposed/2021/34-93613.pdf.

On February 25, 2022, the Securities Commission reopened the comment period on proposed Rule 10c-1. The Commission reopened the comment period in light of the Commission's proposal of Rule 13f-2 under the Exchange Act regarding short sale disclosure (s*ee below)*. The reopened comment period specifically solicited comments regarding the potential impact and effects regarding short sale disclosure that the Commission should consider in determining whether to adopt proposed Rule 10c-1 regarding the reporting of securities loans. *See* Securities Exchange Act Release No. 94315 (Feb. 25, 2021), *available at* https://www.sec.gov/rules/proposed/2022/34-94315.pdf.

C. Short Position and Short Activity Reporting by Institutional Investment Managers - Proposed Rule 13f-2 and Proposed Form SHO / CAT NMS Plan Proposed Amendment

On February 25, 2022, the Commission proposed a new rule and related form pursuant to the Exchange Act, including Section 13(f)(2), which was added by Section 929X of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The proposed rule and related form are designed to provide greater transparency through the publication of short sale related data to investors and other market participants. Under the rule, institutional investment managers that meet or exceed a specified reporting threshold would be required to report, on a monthly basis using the proposed form, specified short position data and short activity data for equity securities. In addition, the Commission proposed a new rule under the Exchange Act to prescribe a new "buy to cover" order marking requirement, and proposed to amend the national market system plan governing the CAT created pursuant to the Exchange Act to require the reporting of "buy to cover" order marking information and reliance on the bona fide market making exception in the Commission's short sale rules. The Commission published the proposed text of the proposed amendments to the CAT NMS Plan in a separate notice (s*ee below)*. *See* Securities Exchange Act Release Nos. 94313 (Feb. 25, 2021), *available at* https://www.sec.gov/rules/proposed/2022/34-94313.pdf and 94314 (Feb. 25, 2021), *available at* https://www.sec.gov/rules/proposed/2022/34-94314.pdf.

D. Removal of References to Credit Ratings from Regulation M

On March 23, 2022, the Commission re-proposed amendments to remove the references to credit ratings included in certain Commission rules. The Dodd-Frank Act, among other things, requires the Commission to remove any references to credit ratings from its regulations. The Commission proposed to replace the exception for investment grade securities in Rule 101 under the Exchange Act with two separate exceptions based on different standards: an exception for nonconvertible securities based on probability of default as an indicator of creditworthiness and an exception for asset-backed securities pursuant to an effective shelf registration statement filed on Form S-3 or F-3. In regards to Rule 102 under the Exchange Act, governing the activity of issuers and selling security holders during a distribution, the Commission proposed to eliminate the exception for investment-grade nonconvertible debt, nonconvertible preferred securities, and asset-backed securities. *See* Securities Exchange Act Release No. 94499 (Mar. 23, 2021), *available at* https://www.sec.gov/rules/proposed/2022/34-94499.pdf.

V. CLEARANCE AND SETTLEMENT

A. Commission Rulemaking, Commission Policy Statements, and Staff Publications

1. Shortening the Securities Transaction Settlement Cycle

On February 9, 2022, the Commission proposed rules to shorten the standard settlement cycle to T+1 and improve the processing of institutional trades by broker-dealers, investment advisers, and certain clearing agencies. First, the Commission proposed to amend 17 CFR 240.15c6-1 ("Rule 15c6-1") to shorten the standard settlement cycle for most broker-dealer transactions from T+2 to T+1 and to repeal the T+4 standard settlement cycle for firm commitment offerings priced after 4:30 p.m. Second, the Commission proposed 17 CFR 240.15c6-2 ("Rule 15c6-2") to prohibit broker-dealers from entering into contracts with their institutional customers unless those contracts require that the parties complete allocations, confirmations, and affirmations by the end of the trade date, a practice the securities industry has commonly referred to as "same-day affirmation." Third, the Commission proposed to amend 17 CFR 275.204-2 ("Rule 204-2") to require investment advisers that are parties to contracts under Rule 15c6-2 to make and keep records of their allocations, confirmations, and affirmations described in Rule 15c6-2. Fourth, the Commission proposed 17 CFR 240.17Ad-27 ("Rule 17Ad-27") to require a clearing agency that is a central matching service provider to establish policies and procedures to facilitate straight-through processing. Securities Exchange Act Release No. 94196 (Feb. 9, 2022), 87 FR 10436 (Feb. 24, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-02-24/pdf/2022-03143.pdf.

B. Select Clearing Agency Rule Filings

1. Equity and Other Corporate Securities

   a. The Commission approved a proposed rule change filed by The Depository Trust Company ("DTC") to provide settlement services for transactions cleared through a new central clearing service for securities financing transactions. Securities Exchange Act Release No. 95012 (May 31, 2012), 87 FR 34325 (June 6, 2022) (File No. SR-DTC-2022-002), *available at* https://www.sec.gov/rules/sro/dtc/2022/34-95012.pdf.

   b. The Commission approved a proposed rule change and did not object to an advance notice filed by the National Securities Clearing Corporation ("NSCC") to establish a new service for central clearing of securities financing transactions. Securities Exchange Act Release Nos. 34998 (May 27, 2022), 87 FR 33528 (June 2, 2022) (File No. SR-NSCC-2022-801), *available at* https://www.sec.gov/rules/sro/nscc-an/2022/34-94998.pdf; 95011 (May 31, 2022), 87 FR 34339 (June 6, 2022) (SR-NSCC-2022-003), *available at* https://www.sec.gov/rules/sro/nscc/2022/34-95011.pdf.

   c. The Commission approved a proposed rule change filed by NSCC to provide for a passive acknowledgment process whereby any settling bank that does not timely acknowledge its intention to pay to or collect its settlement balance from NSCC, or refuse to settle for one or more members for which it is the designated settling bank and has not otherwise been in contact with NSCC, would be deemed to have acknowledged its settlement balances, amend the definition of AIP Settling Bank and remove AIP Settling Bank Only Member as a membership category, and codify certain settlement processes. Securities Exchange Act Release No. 93953 (Jan. 11, 2022), 87 FR 2650 (Jan. 18, 2022) (File No. SR-NSCC-2021-013), *available at* https://www.sec.gov/rules/sro/nscc/2022/34-93953.pdf.

   d. The Commission approved a proposed rule change filed by the Fixed Income Clearing Corporation ("FICC"), DTC, and NSCC to amend each respective clearing agency's rules relating to confidentiality requirements, Market Disruption Events, and procedures for disconnecting a participant from DTC's network. Securities Exchange Act Release Nos. 93279 (Oct. 8, 2021), 86 FR 57221 (File No. SR-DTC-2021-011), *available at* https://www.sec.gov/rules/sro/ficc/2021/34-93280.pdf; 93280 (Oct. 8, 2021), 86 FR 57208 (Oct. 14, 2021) (SR-FICC-2021-004), *available at* https://www.sec.gov/rules/sro/ficc/2021/34-93280.pdf; and 93278 (Oct. 8, 2021), 86 FR 57229 (Oct. 14, 2021) (SR-NSCC-2021-007), *available at* https://www.sec.gov/rules/sro/nscc/2021/34-93278.pdf.

e. The Commission approved a proposed rule change by FICC to remove the Early Unwind Intraday Charge from FICC's Government Securities Division's rules and to amend margin model change the treatment of Treasury securities with remaining time-to-maturities equal to or less than a year ("Short-Term Treasuries"). Securities Exchange Act Release No. 93234 (Oct. 1, 2021), 86 FR 55891 (Oct. 7, 2021) (SR-FICC-2021-007), *available at* https://www.sec.gov/rules/sro/ficc/2021/34-93234.pdf.

f. The Commission approved a proposed rule change filed by NSCC to revise the margin methodology set forth in its Rules & Procedures to remove institutional delivery transactions that are processed through the ID Net Service from the calculation of its members' required margin. Securities Exchange Act Release No. 93070 (Sept. 20, 2021), 86 FR 53125 (Sept. 24, 2021), *available at* https://www.sec.gov/rules/sro/nscc/2021/34-93070.pdf.

2. Options

a. The Commission approved a proposed rule change filed by Options Clearing Corporation ("OCC") to provide OCC's Board of Directors ("Board") with the discretion to elect either an Executive Chairman or a Non-Executive Chairman to preside over the Board, provide the Board and stockholders with the discretion to elect a Management Director, clarify the respective authority and responsibility of any Executive Chairman or Non-Executive Chairman, and make other clarifying, conforming, and administrative changes to OCC's rules. Securities Exchange Act Release No. 93102 (Sept. 22, 2021), 86 FR 53718 (Sept. 28, 2021) (OCC-2021-007), *available at* https://www.sec.gov/rules/sro/occ/2021/34-93102.pdf.

b. The Commission approved a proposed rule change and did not object to an advance notice filed by OCC to adopt to its rules OCC's policy regarding cash and related investments, and amend OCC's rule governing the use of Clearing Fund contributions to ensure access in the event of the failure of an investment counterparty with whom OCC has invested cash collateral. Securities Exchange Act Release No. 94304 (Feb. 24, 2022), 87 FR 11776 (Mar. 2, 2022) (OCC 2019-009), *available at* https://www.sec.gov/rules/sro/occ/2022/34-94304.pdf, and Securities Exchange Act Release No. 94270 (Feb. 17, 2022), 87 FR 11776 (Mar. 2, 2022) (OCC 2021-803), *available at* https://www.sec.gov/rules/sro/occ-an/2022/34-94270.pdf.

c. The Commission approved a proposed rule change filed by OCC to require that its Public Directors may not be affiliated with any designated contract market or futures commission merchant ("FCM"); allow its Board to delegate certain authorities to Board committees; remove language attributing an Exchange Director's vote to constitute stockholder consent; and apply additional conforming amendments to the Board charter and committee charters. Securities Exchange Act Release No. 94988 (May 26, 2022), 87 FR 33535 (June 2, 2022) (OCC-2022-002), *available at* https://www.sec.gov/rules/sro/occ/2022/34-94988.pdf.

d. The Commission approved a proposed rule change filed by OCC to accommodate the issuance, clearance, and settlement of flexibly structured options on exchange-traded funds that are cash-settled and not physically-settled (Cash-Settled Flex Exchange-Traded Fund Options). Securities Exchange Act Release No. 94910 (May 13, 2022), 87 FR 30531 (May 19, 2022) (OCC-2022-003), *available at* https://www.sec.gov/rules/sro/occ/2022/34-94910.pdf.

e. The Commission granted accelerated approval of a proposed rule change and a partial amendment filed by OCC to revise the start-of-day settlement time from 9:00 a.m. Central Time ("CT") to 8:00 a.m. CT that applies to daily payments made by Clearing Members satisfying their margin and Clearing Fund obligations. Securities Exchange Act Release No. 94950 (May 19, 2022), 87 FR 31916 (May 25, 2022) (OCC-2022-004), *available at* https://www.sec.gov/rules/sro/occ/2022/34-94950.pdf.

f. The Commission approved a proposed rule change filed by OCC to specify the value and identify the source of funds in assessing a non-defaulting Clearing Member's unsecured claims following a Partial Tear-Up, and cap the amount of the special charge that may be levied by the Board of Directors. Securities Exchange Act Release No. 94938 (May 18, 2022), 87 FR 31596 (May 24, 2022) (OCC-2022-005), *available at* https://www.sec.gov/rules/sro/occ/2022/34-94938.pdf.

3. Security-Based Swaps

   a. ICE Clear Credit

      i. The Commission approved a proposed rule change by ICE Clear Credit LCC ("ICC") to revise the ICE CDS Clearing: Back-Testing Framework to include additional description on the lookback period for backtesting and other clarifications. Securities Exchange Act Release No. 93388 (Oct. 20, 2021), 86 FR 59258 (Oct. 26, 2021) (ICC-2021-018), *available at* https://www.sec.gov/rules/sro/icc/2021/34-93388.pdf.

      ii. The Commission approved a proposed rule change to revise ICC's CDS Instrument On-boarding Policies and Procedures. Securities Exchange Act Release No. 93581 (Nov. 16, 2021), 86 FR 66382 (Nov. 22, 2021) (ICC-2021-019), *available at* https://www.sec.gov/rules/sro/icc/2021/34-93581.pdf.

      iii. The Commission approved a proposed rule change to revise ICC's CDS Clearing: Stress-Testing Framework and to adopt and formalize the ICC Indirect Participant Risk monitoring and Review Policy. Securities Exchange Act Release No. 93610 (Nov. 18, 2021), 86 FR 67097 (Nov. 24, 2021) (ICC-2021-020), *available at* https://www.sec.gov/rules/sro/icc/2021/34-93610.pdf.

      iv. The Commission approved a proposed rule change to adopt the ICC Counterparty Monitoring Procedures and the ICC Credit Rating System Model Description and Parameterization. Securities Exchange Act Release No. 93705 (Dec. 2, 2021), 86 FR 69699 (Dec. 8, 2021) (ICC 2021-021), *available at* https://www.sec.gov/rules/sro/icc/2021/34-93705.pdf.

      v. The Commission approved a proposed rule change to revise ICC's End-of-Day Price Discovery Policies and

Procedures. Securities Exchange Act Release No. 93795 (Dec. 15, 2021), 86 FR 72291 (Dec. 21, 2021) (ICC-2021-022), *available at* https://www.sec.gov/rules/sro/icc/2021/34-93795.pdf.

vi. The Commission approved a proposed rule change to revise ICC Rule 26R-319 and the ICC Exercise Procedures in connection with the clearing of credit default index options. Securities Exchange Act Release No. 94014 (Jan. 20, 2021), 87 FR 4069 (Jan. 26, 2022) (ICC-2021-023), *available at* https://www.sec.gov/rules/sro/icc/2022/34-94014.pdf.

vii. The Commission approved a proposed rule change to amend ICC's Risk Parameter Setting and Review Policy. Securities Exchange Act Release No. 94921 (May 16, 2022), 87 FR 31020 (May 20, 2022) (ICC-2022-002), *available at* https://www.sec.gov/rules/sro/icc/2022/34-94921.pdf.

viii. The Commission approved a proposed rule change to revise ICC's Governance Playbook. Securities Exchange Act Release No. 94980 (May 25, 2022), 87 FR 33220 (June 1, 2022) (ICC-2022-003), *available at* https://www.sec.gov/rules/sro/icc/2022/34-94980.pdf.

ix. The Commission approved a proposed rule change to revise ICC's Recovery Plan and Wind-Down Plan. Securities Exchange Act Release No. 94983 (May 25, 2022), 87 FR 33223 (June 1, 2022) (ICC-2022-004), *available at* https://www.sec.gov/rules/sro/icc/2022/34-94983.pdf.

b. ICE Clear Europe

i. The Commission approved a proposed rule change by ICE Clear Europe ("ICEEU") to adopt a new Clearing Membership Policy and new Clearing Membership Procedures. Securities Exchange Act Release No. 93178 (Sept. 29, 2021), 86 FR 55045 (Oct. 5, 2021) (ICEEU-2021-014), *available at* https://www.sec.gov/rules/sro/iceeu/2021/34-93178.pdf.

ii. The Commission approved a proposed rule change by ICEEU to adopt a new Counterparty Credit Risk Policy and new Counterparty Credit Risk Procedures and retire the existing Futures and Options Capital to Margin and Shortfall Margin Policy and existing Unsecured Credit Limits Procedures. Securities Exchange Act Release No. 93880 (Dec. 30, 2021), 87 FR 513 (Jan. 5, 2022) (ICEEU-2021-015), *available at* https://www.sec.gov/rules/sro/iceeu/2021/34-93880.pdf.

iii. The Commission approved a proposed rule change to make certain changes to ICEEU's existing Collateral and Haircut Procedures. Securities Exchange Act Release No. 93603 (Nov. 17, 2021), 86 FR 66607 (Nov. 23, 2021) (ICEEU-2021-018), *available at* https://www.sec.gov/rules/sro/iceeu/2021/34-93603.pdf.

iv. The Commission approved a proposed rule change to amend ICEEU's Liquidity Management Procedures and Investment Management Procedures. Securities Exchange Act Release No. 93845 (Dec. 21, 2021), 86 FR 73833 (Dec. 28, 2021) (ICEEU-2021-020), *available at* www.sec.gov/rules/sro/iceeu/2021/34-93845.pdf.

v. The Commission approved a proposed rule change to amend ICEEU's CDS Clearing Back-Testing Policy and CDS Clearing Stress-Testing Policy to remediate the findings of an independent validation. Release No. 94607 (April 5, 2022), 87 FR 21227 (April 11, 2022) (ICEEU-2022-004), *available at* www.sec.gov/rules/sro/iceeu/2022/34-94607.pdf.

vi. The Commission approved a proposed rule change by ICEEU to amend its Operational Risk Management Policy and add to ICEEU's rule framework the Risk Identification Framework. Release No. 95004 (May 27, 2022), 87 FR 33858 (June 3, 2022) (ICEEU-2022-008), *available at* www.sec.gov/rules/sro/iceeu/2022/34-95004.pdf.

c. LCH SA

i. The Commission approved a proposed rule change by LCH SA to expand the non-cash collateral that a Clearing Member may post with LCH SA to meet margin requirements. Securities Exchange Act Release No. 93176

(Sept. 29, 2021), 86 FR 55061 (Oct. 5, 2021) (LCH SA-2021-002), *available at* www.sec.gov/rules/sro/lchsa/2021/34-93176.pdf.

ii. The Commission approved a proposed rule change by LCH SA to amend the: (i) CDS Clearing Rule Book, (ii) CDS Clearing Supplement, (iii) certain CDS Clearing Procedures, and (iv) a Clearing Notice. Securities Exchange Act Release No. 94821 (April 29, 2022), 87 FR 26792 (May 5, 2022) (LCH SA-2022-002), *available at* www.sec.gov/rules/sro/lchsa/2022/34-94821.pdf.

iii. The Commission approved a proposed rule change by LCH SA to amend its CDS Clearing Supplement and certain CDS Clearing Procedures relating to the restructuring notification process for swaptions. Securities Exchange Act Release No. 94898 (May 12, 2022), 87 FR 30318 (May 18, 2022) (LCH SA-2022-003), *available at* www.sec.gov/rules/sro/lchsa/2022/34-94898.pdf.

4. International Standards

SEC staff continue to participate in international organizations, such as the Committee on Payments and Market Infrastructures ("CPMI"), the International Organization of Securities Commissions ("IOSCO"), and the Financial Stability Board ("FSB").

VI. DERIVATIVES POLICY

The Office of Derivatives Policy ("ODP") directs projects relating to key definitional terms and foreign regulatory issues under Title VII of the Dodd-Frank Act. ODP leads the agency's efforts to implement Title VII in part through leadership in the Security-Based Swap Joint Venture and has led the Division of Trading and Market's work on substituted compliance. ODP also provides interpretive advice on the regulatory treatment of novel derivative products under the Exchange Act, and administers the new product provisions contained in Sections 717 and 718 of the Dodd-Frank Act. In addition, ODP is tasked with implementing and administering Section 13 of the Bank Holding Company Act of 1956, also known as the Volcker Rule.

A. Substituted Compliance

Rule 3a71-6 permits non-U.S. SBS Entities to comply with certain requirements under the Exchange Act via compliance with foreign requirements that the Commission has determined will produce comparable regulatory outcomes. On November 25, 2019, the Commission published guidance regarding the contents of applications for "substituted compliance." The guidance is intended to facilitate complete applications that permit informed assessments regarding whether foreign requirements adequately reflect the interests and protections associated with the analogous Exchange Act requirements.

The guidance is available on the SEC's website. *See* Staff Guidance – Information Regarding Foreign Regulatory Requirements for Substituted Compliance Applications (Dec. 23, 2019), *available at* https://www.sec.gov/files/staff-guidance-substituted-compliance-applications.pdf.

Since December 2020, the Commission has issued substituted compliance determination orders for SBS Entities subject to regulation in Germany, France, Spain, Switzerland, and the UK.

All of the applications, Commission notices, and proposed and final determination orders and related memoranda of understanding are available on the SEC's website. *See* Exchange Act Substituted Compliance Applications for Security-Based Swap Markets (Oct 18, 2021), *available at* https://www.sec.gov/page/exchange-act-substituted-compliance-and-listed-jurisdiction-applications-security-based-swap.

B. Implementation of SBSD and MSBSP Registration and Regulation and Reporting of SBS Transactions to Security-Based Swap Trade Repositories

On December 18, 2019, the Commission adopted a package of amendments, guidance, and a related order addressing cross-border application of certain security-based swap requirements. The adoption of this package stood up the Commission's broad security-based swap regulatory regime by triggering the compliance date for SBS Entities to register with the Commission and the implementation period for previously adopted rules under Title VII of the Dodd-Frank Act. The first SBS Entities were required to register on November 1, 2021. As of June 24, 2022, 47 SBS Entities have conditionally registered with the Commission.

As of November 8, 2021, SBS transactions have been reported to two security-based trade repositories, DDR and ITV, and public dissemination of certain transaction information began on February 14, 2022.

The start date for reporting of SBS transactions is also known as the "data collection initiation date." That date is important for determining the "phase-in termination date" for the SBSD de minimis thresholds. The definition of "security-based swap dealer" excludes entities whose SBS dealing activity falls below de minimis thresholds of $3 billion for CDS (subject to a phase-in threshold of $8 billion) and $150 million for other SBS (subject to a phase-in threshold of $400 million). Rule 3a71-2 under the Exchange Act sets these phase-in thresholds to expire no later than five years after the data collection initiation date, which was November 8, 2021. Absent further Commission action, the phase-in termination date will be November 8, 2026. The Commission announced these dates on May 11, 2022 and published them in the Federal Register on May 17, 2022. *See* Securities Exchange Act Release No. 94896 (May 11, 2022), 87 FR 29986 (May 17, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-05-17/pdf/2022-10511.pdf.

C. SBS Fraud and Manipulation, Chief Compliance Officer Independence and SBS Position Reporting – Proposed Rules 9j-1, 15Fh-4(c) and 10B-1 and Proposed Schedule 10B

On December 15, 2021, the Commission re-proposed new Rule 9j-1 under the Exchange Act to prevent fraud, manipulation, and deception in connection with security-based swap transactions. The Commission also proposed new Rule 15Fh-4(c) under the Exchange Act to prohibit undue influence over the chief compliance officer of an SBS Entity. Finally, the Commission proposed new Rule 10B-1 under the Exchange Act, together with a new Schedule 10B, to require any person with a security-based swap position that exceeds a certain threshold to promptly file with the Commission a schedule disclosing certain information related to its position. *See* Securities Exchange Act Release No. 93784 (Dec. 15, 2021), *available at* https://www.sec.gov/rules/proposed/2021/34-93784.pdf.

D. Coordination with International Bodies and Foreign Authorities

1. FSB Group on UTI and UPI Governance

SEC staff participate in working groups of the FSB focused on monitoring the implementation of OTC derivatives market reforms and governance arrangements for the unique transaction identifier

("UTI") and unique product identifier ("UPI"), data standards that will be used in reporting OTC derivatives transactions to trade repositories.

2. IOSCO Committee 7 on Derivatives

Division of Trading and Markets staff participate in IOSCO's Committee 7 on Derivatives. Committee 7 focuses on issues related to all types of derivatives products and markets. Committee 7's membership consists of experts on exchange-traded and OTC derivatives, the G-20 reforms on OTC derivatives, and commodity derivatives.

Committee 7 was formed in 2017 by merging the former IOSCO Committee on Commodity Derivatives and the IOSCO OTC Derivatives Task Force, which the SEC co-chaired. To date, Committee 7 has carried out G-20 mandated projects on "Principles for Oil Price Reporting Agencies" and "Principles for the Regulation and Supervision of Commodity Derivatives Markets" and other important IOSCO projects, including "Efficient Resiliency," "Third Party Service Providers," and "Storage and Delivery Infrastructures."

3. Other Coordination Among OTC Derivative Authorities

Senior representatives from the Commission, the Commodity Futures Trading Commission, and a number of foreign authorities with responsibility for the regulation of OTC derivatives convene regularly to discuss cross-border issues related to the implementation of legislation and rules to govern the OTC derivatives markets in their respective jurisdictions.

SEC staff also participate in the OTC Derivatives Regulators' Forum ("ODRF"), which focuses on data quality and data usage. The technical working group of the ODRF provides a forum for regulators to discuss their use of data, share experiences, and support further standardization of data fields.

NOTES

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Compendium of Rulemaking and Public Statements Relating to the Developments in the Division of Corporation Finance

FINAL RULES

- Universal Proxy (Release No. 34-93596; Nov. 17, 2021), available at https://www.sec.gov/rules/final/2021/34-93596.pdf.
- Holding Foreign Companies Accountable Act Disclosure (Release No. 34-93701; Dec. 2, 2021), available at https://www.sec.gov/rules/final/2021/34-93701.pdf.
- Updating EDGAR Filing Requirements and Form 144 Filings (Release No. 33-11070; Jun. 2, 2022), available at https://www.sec.gov/rules/final/2022/33-11070.pdf.
- Proxy Voting Advice (Release No. 34-95266; Jul. 13, 2022), available at https://www.sec.gov/rules/final/2022/34-95266.pdf.
- Pay Versus Performance (Release No. 34-95607; Aug. 25, 2022), available at https://www.sec.gov/rules/final/2022/34-95607.pdf.

PROPOSED RULES

- Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation (Release No. 33-10998; Oct. 14, 2021), available at https://www.sec.gov/rules/proposed/proposedarchive/proposed2021.shtml.
- Updating EDGAR Filing Requirements (Release No. 33-11005; Nov. 4, 2021), available at https://www.sec.gov/rules/proposed/proposedarchive/proposed2021.shtml.
- Proxy Voting Advice (Release No. 34-93595; Nov. 17, 2021), available at https://www.sec.gov/rules/proposed/2021/34-93595.pdf.
- Share Repurchase Disclosure Modernization (Release No. 34-93783; Dec. 15, 2021), available at https://www.sec.gov/rules/proposed/2021/34-93783.pdf.
- Rule 10b5-1 and Insider Trading (Release No. 33-11013; Jan. 13, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11013.pdf.
- Reopening of Comment Period for Pay Versus Performance (Release No. 34-94074; Jan. 27, 2022), available at https://www.sec.gov/rules/proposed/2022/34-94074.pdf.
- Modernization of Beneficial Ownership Reporting (Release No. 33-11030; Feb. 10, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11030.pdf.

- Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure (Release No. 33-11038; Mar. 9, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11038.pdf.
- The Enhancement and Standardization of Climate-Related Disclosures for Investors (Release No. 33-11042; Mar. 21, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11042.pdf.
- Special Purpose Acquisition Companies, Shell Companies, and Projections (Release No. 33-11048; Mar. 30, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11048.pdf.
- Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation (Release No. 33-11071; Jun. 8, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11071.pdf.
- Substantial Implementation, Duplication, and Resubmission of Shareholder Proposals under Exchange Act Rule 14a-8 (Release No. 34-95267; Jul. 13, 2022), available at https://www.sec.gov/rules/proposed/2022/34-95267.pdf.

SPEECHES

- Renee Jones, The Shareholder Proposal Rule: A Cornerstone of Corporate Democracy (Mar. 8, 2022), available at https://www.sec.gov/news/speech/jones-cii-2022-03-08.

OTHER MATERIALS

- Sample Letter to China-Based Companies (Dec. 2021), available at https://www.sec.gov/corpfin/sample-letter-china-based-companies.
- Sample Letter to Companies Regarding Disclosures Pertaining to Russia's Invasion of Ukraine and Related Supply Chain Issues (May 2022), available at https://www.sec.gov/corpfin/sample-letter-companies-pertaining-to-ukraine.
- Shareholder Proposals: Staff Legal Bulletin No. 14L (Nov. 3, 2021), available at https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals.
- Announcement Regarding Staff Responses to Rule 14a-8 No-Action Requests (Dec. 13, 2021), available at https://www.sec.gov/corpfin/announcement/announcement-14a-8-no-action-requests-20211213.

- Announcement Regarding Personally Identifiable and Other Sensitive Information in Rule 14a-8 Submissions and Related Materials (Dec. 17, 2021) available at https://www.sec.gov/corpfin/announcement/announcement-14a-8-submissions-pii-20211217.

- The Divisions of Corporation Finance and Investment Management Ask that Paper "Courtesy Copies" No Longer Be Provided Unless Requested by the Staff (Jan. 21, 2022), available at https://www.sec.gov/corpfin/announcement/announcement-no-more-paper-courtesy-copies.

- Division of Corporation Finance Financial Reporting Manual (updated periodically), available at: http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml.

- Division of Corporation Finance Compliance and Disclosure Interpretations (updated periodically), available at: http://www.sec.gov/divisions/corpfin/cfguidance.shtml.

- Division of Corporation Finance No-Action, Interpretive and Exemptive Letters (updated periodically), available at: http://www.sec.gov/divisions/corpfin/cf-noaction.shtml.

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U.S. Securities and Exchange Commission, Paul Munter, Acting Chief Accountant, Office of the Chief Accountant, Public Statement, The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession (June 8, 2022)

Statement

The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession[1]

Paul Munter
Acting Chief Accountant

June 8, 2022

Introduction

High-quality audits are critical to the process of providing decision-useful financial information for the benefit of investors, and auditors[2] serve an important gatekeeping and investor protection function by helping to ensure that issues are promptly identified and addressed.[3] The Commission has long-recognized that audits by professional, objective, and skilled accountants that are independent of their audit clients contribute to both investor protection and investor confidence in the financial statements.[4] As such, the Commission's auditor independence rule is integral to its mandate to protect investors and is fundamental for promoting investor confidence in the quality of financial disclosures. Rule 2-01 of Regulation S-X sets forth the Commission's auditor independence requirements and emphasizes the importance of an accountant's independence from its audit client in both fact and appearance.[5]

We believe that auditor independence is grounded in an understanding of accounting as a profession rather than an industry, which is critical to serving the public interest. As a profession, accountants have a responsibility to the public interest and to act ethically and with integrity in every professional activity.[6] Such responsibility includes observance of both the form and spirit of the Commission's auditor independence rule, and consideration of the foundational objective to provide investors with financial statements that contain reliable and decision-useful financial information.[7]

In this Statement, we discuss (1) the critical importance of the auditor independence framework under Rule 2-01(b) of Regulation S-X ("Rule 2-01(b)" or the "general standard"); (2) OCA's approach to auditor independence consultations;[8] (3) certain recurring issues in recent auditor independence consultations; and (4) the paramount importance that accounting firms foster an ethical culture with respect to auditor independence and fulfil their professional responsibilities.[9]

The Auditor Independence Framework of Rule 2-01(b) of Regulation S-X

The general standard of Rule 2-01(b) is the heart of the Commission's auditor independence rule. This general standard is grounded in the auditor's objectivity and impartiality, and is measured by reference to the reasonable investor standard: "[t]he Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment of all issues encompassed within the accountant's engagement."[10]

The general standard of auditor independence does not end there, however, but states that when determining whether an accountant is independent the Commission takes into consideration "all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission."[11] As described in more detail in our recent statement,[12] the text of Rule 2-01(b) of Regulation S-X, together with the four guiding principles that the Commission specified in the introductory text to Rule 2-01, provides a framework for considering whether an accountant is independent with respect to an audit client.[13] Those four principles include a consideration as to whether all the relevant circumstances:

- Create a mutual or conflicting interest between the accountant and the audit client;
- Place the accountant in the position of auditing their own work;
- Result in the accountant acting as management or an employee of the audit client; or
- Place the accountant in a position of being an advocate for the audit client.[14]

The introductory text of Rule 2-01 goes on to specify that the application of these four guiding principles may depend on particular facts and circumstances.

The remainder of the Commission's auditor independence rule, beginning in paragraph (c), consists of a non-exclusive list of circumstances that are plainly inconsistent with the general standard. However, we caution that accountants, audit firms, registrants, and their audit committees should never make the mistake of assuming that just because a particular circumstance is not expressly prohibited in, or captured by, Rule 2-01(c), their independence analysis is over. Instead, accountants, audit firms, registrants, and their audit committees must always assess and approach auditor independence for purposes of considering, beginning, or continuing an audit engagement under Rule 2-01(b).[15]

Stated differently, compliance with the prohibitions enumerated in Rule 2-01(c) is necessary but not sufficient. The general standard requires an evaluation of auditor independence, including an assessment of independence both in fact and appearance from the perspective of a reasonable investor. Such a determination cannot be limited to a checklist compliance exercise under Rule 2-01(c). To reiterate: the general standard of Rule 2-01(b) is the heart of the Commission's auditor independence rule, it always applies, and the Commission investigates and enforces against violations of the general standard.[16]

We remind audit committees, registrants, and audit firms of the importance of understanding the applicability of the general standard to all relevant reporting periods. The Commission's 2020 amendments to the independence rule clearly emphasize that compliance with Rule 2-01(b) is required for all years included in a filing.[17]

OCA's Approach to Auditor Independence Consultations

Through its long-standing consultation process, OCA staff assist accountants, registrants, and audit committees with interpretation of, and compliance with, the Commission's auditor independence rule.[18] We believe that this consultation process promotes greater consistency in the application and interpretation of the Commission's auditor independence rule for the benefit of investors. OCA's auditor independence consultations provide a mechanism for accountants, registrants, and audit committees to consult with experienced and knowledgeable

OCA staff for assistance in assessing whether the auditor is and reasonable investors would believe they are able to act with objectivity and impartiality for either an existing set of facts or a specific contemplated circumstance such as a future merger or acquisition involving known parties. OCA staff do not, we should clarify, engage in a consultative process on issues of auditor independence premised on inchoate or unknown facts that are not describable, or hypothetical circumstances. OCA staff are available to discuss, on an informal basis, potential circumstances that may result from a contemplated arrangement or transaction.

As part of the consultation process, OCA staff routinely engage with existing registrants as well as private companies that are in the process of preparing for an initial public offering.[19] The OCA auditor independence consultation process enables accountants, registrants, and their audit committees to better evaluate potential auditor independence issues, and in so doing, potentially reduce the need for costly re-audits of historical financial statements that could erode investor confidence.

Critical to the effectiveness of the auditor independence consultation process is that any party seeking guidance communicate *all* relevant circumstances of their specific question to OCA staff.[20] When a formal, written submission is received, OCA staff consider, among other things, the conclusions reached by management of the registrant, the audit committee, and the accounting firm when evaluating the accountant's objectivity and impartiality, both in fact and appearance, with respect to the audit client. OCA staff may refer to prior consultations to assess any potential relevance to the current consultation, but in so doing, OCA staff will always also assess, among other things, (i) how recently such prior consultations occurred, (ii) risks presented to investors, and (iii) the impact of any rulemaking, judicial precedent, or legislation subsequent to any prior consultations. It is critical to recognize that in an independence consultation, OCA staff can only consider the specific facts and circumstances in the context of the Commission's auditor independence rule and other relevant legal authorities at the time of the consultation.

On occasion, OCA staff are asked to take into account certain historical OCA staff positions that were previously provided on purportedly similar circumstances. In any such consultation request, OCA staff first independently assess how similar the circumstances of the current consultation are with respect to a historical consultation and any other relevant prior consultations of which a party seeking guidance may be unaware. OCA staff always take into consideration the degree to which applicable legal requirements may have changed since the time of historical staff consultations. We therefore strongly discourage accountants from placing undue reliance on any historical OCA staff positions, which are necessarily limited to the particular circumstances of the consultation. We instead actively encourage accounting firms, registrants, and audit committees to consult with OCA staff on current auditor independence issues and questions on their own terms. We caution that developments, including risk to investors, may affect the applicability of prior OCA staff positions and note that prior OCA staff positions may not apply to your particular set of facts and circumstances—even if you think they may appear similar.

Certain Recurring Issues in Recent OCA Staff Auditor Independence Consultations

We frequently engage in external dialogue, including in our auditor independence consultations, with audit committees, auditors, and registrants.[21] Based on such dialogue, OCA staff have seen situations that reflect loosening attitudes toward the Commission's general standard of auditor independence in a few notable areas. The first, which we discussed earlier, is when accounting firms, registrants, and audit committees treat the Commission's auditor independence rule as a mere checklist of prohibitions under Rule 2-01(c) of Regulation S-X and ignore the general standard. This is not conducive to compliance, and the Commission investigates and enforces against violations of its general standard of auditor independence.[22]

Another notable and increasing area of concern involves the provision of non-audit services. While non-audit services are often not provided directly to the company being audited, OCA staff encounter circumstances in which the extent and magnitude of the non-audit services and business relationships between the accountant and affiliates and non-affiliates of the company being audited would make it difficult for a reasonable investor to conclude that the accountant could exercise objective and impartial judgment in its audit. In such circumstances, the accounting firm risks not being in compliance with the general standard of auditor independence.

Finally, numerous accounting firms have recently been engaging in increasingly complex business arrangements and, in some cases, attempting to facilitate these arrangements through restructurings and the use of alternative practice structures. Such arrangements have the potential to undermine auditor independence.[23] We caution firms to carefully consider the implications for auditor independence when considering alternative practice structures, as will the OCA.

Concluding Remarks on the Paramount Importance that Accounting Firms Foster an Ethical Culture with Respect to Auditor Independence and Fulfill Their Professional Responsibilities

It is of paramount importance that public accounting firms foster a culture of ethical behavior with respect to all aspects of their professional responsibilities, including auditor independence. As we noted at the outset, high-quality audits are critical to the process of disclosing financial information for the benefit of investors and serve an important gatekeeping function to help protect investors by ensuring that issues are promptly identified and addressed. The Commission has long-recognized that audits by professional, objective, and skilled accountants that are independent of their audit clients contribute to both investor protection and investor confidence. Any perceived erosion of auditor independence or the profession's ethics or integrity breaks down the critical gatekeeper role of public accountants and can, over time, lead to diminished investor confidence.

The examples of such erosion need not be as extreme as those instances that result in Commission enforcement action.[24] As we mentioned earlier, OCA staff have seen situations of decreased vigilance when it comes to auditor independence—what we describe as a "checklist compliance" mentality. This has, in turn, led to a deterioration in the ethical culture in some firms.[25] We caution leadership of accounting firms to remain focused on the trusted role that public accountants play in the disclosure of high-quality financial information to the investing public and to take compliance with all aspects of the Commission's auditor independence rule very seriously.

To preserve the critical role that accountants play in serving the public interest and fulfilling an investor protection mandate, audit firms should lead by example. They should, for example, prioritize auditor independence and a culture of ethical behavior in all professional activities, and where independence on an audit engagement is a close-to-the-line call, the firms must be willing to forego audit and review fees or potentially lucrative restructuring proposals to comply with their independence responsibilities. Further, firms should establish and maintain quality controls that adequately reckon with regulatory requirements and be vigilant about internal efforts to circumnavigate those requirements. Finally, firms should address auditor independence compliance with the seriousness and urgency it deserves.

Accountants serve a critical role in the integrity of our markets and the protection of investors, and audit professionals in particular have a difficult job—they are forced to sometimes make difficult determinations. But that is precisely how public accountants fulfill their gatekeeping function to help protect investors—by ensuring that issues are promptly identified and addressed. To maintain that function, and in training the next generations of public accountants, it is critical that our accounting firms foster and prioritize a culture of ethical behavior in all their professional activities, but especially with respect to auditor independence.

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[1] This Statement represents the views of the staff of the Office of the Chief Accountant ("OCA"). It is not a rule, regulation, or statement of the Securities and Exchange Commission ("SEC" or the "Commission"). The Commission has neither approved nor disapproved its content. This Statement, like all staff statements, has no

legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. "Our" and "we" are used throughout this Statement to refer to OCA staff.

[2] For purposes of this Statement, except where specified otherwise, the terms "accountant" and "auditor" are used interchangeably.

[3] *See* Paul Munter, Acting Chief Accountant, *The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors* (Oct. 26, 2021) (the "Staff Statement on High Quality Independent Audits").

[4] *Qualifications of Accountants*, SEC Release No. 33-10876 (Oct. 16, 2020) [85 FR 80508 (Dec. 11, 2020)] ("2020 Adopting Release"); *Revision of the Commission's Auditor Independence Requirements*, SEC Release No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)] ("2000 Adopting Release").

[5] 17 CFR § 210.2-01.

[6] *See, e.g.*, AICPA Code of Professional Conduct, ET § 0.300.030–040.

[7] *See id.* (stressing the accountant's role in "maintain[ing] the orderly functioning of commerce").

[8] "[R]egistrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in [Rule 2-01]." Introductory Text to 17 CFR § 210.2-01; *see also* 2000 Adopting Release at 128.

[9] 15 U.S. Code § 78d–3(a)(2); 17 CFR § 201.102(e)(1)(ii).

[10] 17 CFR § 210.2-01(b).

[11] *Id.*

[12] *See* Munter, *supra* note 3.

[13] We call this a framework because these four principles are what "the Commission looks [to] in the first instance" when considering the general standard, but the rule itself notes, as highlighted above, that the Commission will also "consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission." 17 CFR § 210.2-01(b).

[14] *See* Introductory Text to 17 CFR § 210.2-01.

[15] *See* 2020 Adopting Release at 21 (stressing that the responsibility of ensuring auditor independence is shared between auditors and their audit clients).

[16] We understand that, in the past decade, the Commission has brought four enforcement actions for "standalone" violations of the general standard of auditor independence, that is, where the settled charges stem principally from violations of Rule 2-01(b) but may be related to other violations, including, for example, secondary reporting violations. *See In re Ernst & Young LLP et al.*, SEC Release No. 34-92540 (Aug. 2, 2021) (addressing the violation of Rule 2-01(b) accompanied by the violation of Rule 2-02(b)(1) and causing the violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder); *In re Ernst & Young LLP et al.*, SEC Release No. 34-78873 (Sept. 19, 2016) (addressing the violation of Rule 2-01(b) accompanied by the violation of, or aiding and abetting or causing the violation of, Rule 2-02(b)(1), and causing the violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder); *In re Ernst & Young LLP et al.*, SEC Release No. 34-78872 (Sept. 19, 2016) (same); *In re Ernst & Young LLP*, SEC Release No. 34-7602 (July 14, 2014) (addressing the violation of Rule 2-01(b) accompanied by the violation of, or causing the violation of, Rule 2-02(b)(1), and causing the violations of Sections 13(a) and 14(a) of the Exchange Act, and Rules 12b-20, 13a-1, 13a-11, 13a-13, and 14a-9 thereunder) [hereinafter Standalone Actions].

[17] *See* 2020 Adopting Release at 52 (applying "Rule 2-01 to the most recent fiscal year, together with the application of the general independence standard in Rule 2-01(b) and the requirement to comply with applicable

independence standards for the earlier years"); *see also* 2020 Adopting Release at 17, 28–32 (emphasizing the importance of the general standard).

[18] SEC, Consulting with OCA: What to Expect (Sept. 28, 2018), https://www.sec.gov/page/oca-consulting-oca-what-expect.

[19] We note that as a result of increasingly complex business relationships, it is incumbent upon private companies actively seeking access to the public markets in the U.S., together with their audit committees, to consider early in the process the implications of all services or relationships provided by, or held with, their auditor (including services or relationships with affiliates of the audit client) during audit periods that will be included in an initial public registration filing. When a company is preparing to enter the public markets in the U.S., the company, its audit committee, and its auditor need to evaluate the impact to auditor independence as a result of the transition from local auditor independence rules to the Commission's auditor independence requirements. OCA staff emphasize that a violation of the Commission's auditor independence rule cannot somehow be mitigated by, or overcome with, safeguards or cures implemented by the company or the accountant—even where such measures would, perhaps, be permitted or considered by the AICPA rules or other regulators.

[20] *See* SEC, Form of Delivery and Content of Correspondence for OCA Consultations (Sept. 14, 2020), https://www.sec.gov/page/oca-form-delivery-and-content-correspondence-oca-consultations.

[21] The Commission's auditor independence requirement is foundational to the credibility of the financial statements, and, as the Commission has consistently noted, it is a shared responsibility among audit committees, management, and their independent accountants. 2020 Adopting Release at 21.

[22] *See* Standalone Actions, *supra* note 16.

[23] Jeff Drew, Private Equity's Push into Accounting, Journal of Accountancy (Oct. 6, 2021), available at https://www.journalofaccountancy.com/news/2021/oct/private-equity-push-into-accounting.html.

[24] *See, e.g.*, Standalone Actions, *supra* note 16.

[25] Such deterioration includes, for example, accounting firm scandals involving cheating on professional ethics exams by firm partners and professional staff, and accounting firm leadership viewing accounting errors and restatements as "business opportunities"—views that are antithetical to the trusted role accountants occupy as gatekeepers. *See, e.g.*, *In re KPMG LLP*, SEC Release No. 34-86118 (June 7, 2019).

NOTES

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U.S. Securities and Exchange Commission, Paul Munter, Acting Chief Accountant, Office of the Chief Accountant, Public Statement, Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors (March 9, 2022)

Statement

Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors

Paul Munter
Acting Chief Accountant

March 9, 2022

Introduction[1]

Under our federal securities laws, public companies are required to disclose certain financial and other information to investors. The basic premise of this disclosure-based regulatory regime is that if investors have timely, accurate, and complete financial and other information, they can make informed, rational investment decisions.

Accordingly, providing investors with high quality financial information, including financial statements prepared in compliance with generally accepted accounting principles ("GAAP"), should be the focus of all those involved in financial reporting. Management is responsible for providing investors with GAAP-compliant financial statements, so whenever a material error is identified in previously-issued financial statements,[2] investors must be notified promptly and the error must be corrected. The determination of whether an error is material is an *objective assessment* focused on whether there is a substantial likelihood it is important to the reasonable investor.[3]

Concept of Materiality and the Correction of Material Errors

Central to the process a registrant must follow when an error is identified in its historical financial statements is determining whether the error is *material* to those historical financial statements. The Supreme Court has held that a fact is material if there is:

"a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[4]

When an error is determined to be material to previously-issued financial statements, the error must be corrected by restating the prior-period financial statements.[5] This type of restatement is sometimes referred to colloquially as a reissuance restatement or a "Big R" restatement.

If the error is not material to previously-issued financial statements, but either correcting the error or leaving the error uncorrected would be material to the current period financial statements, a registrant must still correct the error, but is not precluded from doing so in the current period comparative financial statements by restating the prior period information and disclosing the error. This type of restatement is sometimes referred to colloquially as a revision restatement or a "little r" restatement.

It is important to note that both of these methods—reissuance and revision, or "Big R" and "little r"—constitute restatements to correct errors in previously-issued financial statements as those terms are defined in U.S. GAAP. [6] In either case, such errors should be transparently disclosed to investors.

Objective Assessment of Materiality

Since the concept of materiality is focused on the total mix of information from the perspective of a reasonable investor, those who assess the materiality of errors, including registrants, auditors, audit committees, and others, should do so through the lens of the reasonable investor. To be consistent with the concept of materiality, this assessment must be objective. A materiality analysis is not a mechanical exercise, nor should it be based solely on a quantitative analysis. Rather, registrants, auditors, and audit committees need to thoroughly and objectively evaluate the total mix of information. Such an evaluation should take into consideration all relevant facts and circumstances surrounding the error, including both quantitative and qualitative factors, to determine whether an error is material to investors.

An objective analysis should put aside any potential bias of the registrant, auditor, or audit committee that would be inconsistent with the perspective of a reasonable investor. For example, a restatement of previously-issued financial statements may result in the clawback of executive compensation, reputational harm, a decrease in the registrant's share price, increased scrutiny by investors or regulators, litigation, or other impacts. An assessment where a registrant's, auditor's, or audit committee's biases based on such impacts influenced a determination that an error is not material to previously-issued financial statements so as to avoid a Big R restatement would not be objective and would be inconsistent with the concept of materiality.

One area where the staff in OCA have observed an increased need for objectivity is in the assessment of qualitative factors. The interpretive guidance on materiality in SAB No. 99 speaks to circumstances where a quantitatively small error could, nevertheless, be material because of qualitative factors. However, we are often involved in discussions where the reverse is argued—that is, a quantitatively significant error is nevertheless immaterial because of qualitative considerations. We believe, however, that as the quantitative magnitude of the error increases, it becomes increasingly difficult for qualitative factors to overcome the quantitative significance of the error.

We also note that the qualitative factors that may be relevant in the assessment of materiality of a quantitatively significant error would not necessarily be the same qualitative factors noted in SAB No. 99 when considering whether a quantitatively small error is material. So it might be inappropriate for a registrant to simply assess those qualitative factors in reverse when evaluating the materiality of a quantitatively significant error. Such a scenario highlights the importance of a holistic and objective assessment from a reasonable investor's perspective.

Observations from Recent Interactions with Registrants and Auditors on Materiality

In considering recent restatement trends, we note that while the total number of restatements by registrants declined each year from 2013 to 2020, "little r" restatements as a percentage of total restatements rose to nearly 76% in 2020, up from approximately 35% in 2005.[7] While some attribute that trend primarily to improvements in the effectiveness of internal control over financial reporting ("ICFR") and audit quality, we continue to monitor this and other restatement trends to understand the nature and prevalence of accounting errors and how they are corrected.

Accounting Errors and Materiality

Through our monitoring of restatements, and recent discussions with registrants and auditors regarding their assessment of the materiality of accounting errors, we have observed that some materiality analyses appear to be biased toward supporting an outcome that an error is not material to previously-issued financial statements, resulting in "little r" revision restatements.

For example, the staff in OCA have, not infrequently, been presented with arguments that financial statements or specific line items in financial statements are irrelevant to investors' investment decisions. One variation of this argument is that certain elements of financial statements prepared in accordance with U.S. GAAP or International Financial Reporting Standards ("IFRS") do not provide useful information to investors, so an error in those elements cannot be material. A related argument is that historical financial statements, or specific line items in those financial statements, are irrelevant to investors' current investment decisions. We have not found these types of arguments to be persuasive because such views could be used to justify a position that many errors in previously-issued financial statements could never be material regardless of their quantitative significance or other qualitative factors. In this regard, we note that Commission rules generally require audited financial statements to be prepared in accordance with U.S. GAAP or IFRS, and to be included for each period specified in those rules. We also note that comparative financial statements facilitate an investor's trend analysis to identify changes in financial results of a registrant over time and to inform investment decisions. Accordingly, we view financial statements prepared in accordance with U.S. GAAP or IFRS, as required by Commission rules, to be the starting point for any objective materiality analysis.

However, this does not imply that the effects of errors on certain key non-GAAP measures that are important to users of the registrant's financial statements should not also be considered in the registrant's analysis. Rather, analysis of key non-GAAP measures, where applicable, should be performed in addition to, but not as a substitute for, the analysis of materiality to the financial statements.

OCA staff have also observed materiality analyses that argued that an error is not material to previously-issued financial statements because the error was also made by other registrants, and therefore reflects a widely-held view rather than an intention to misstate. This type of argument has been raised by registrants in various industries and with various structures, including special purpose acquisition companies. SAB No. 99 states that while the intent of management does not render a misstatement material, it may provide significant evidence of materiality. We have not found persuasive, however, arguments that attempt to apply that SAB No. 99 premise in reverse—that is, that the lack of intentional misstatement is viewed as providing evidence that the error is not material.

We further note that registrants often argue that an error is not material because its effect is offset by other errors. As noted in SAB No. 99, registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The aggregated effects should then also be considered to determine whether an otherwise immaterial error, when aggregated with other misstatements, renders the financial statements taken as a whole to be materially misleading. However, we do not believe this analysis of the aggregate effects should serve as the basis for a conclusion that individual errors are immaterial.

Accounting Errors and Internal Control over Financial Reporting

We note that the identification of an accounting error also impacts management's assessment of the effectiveness of ICFR, and that the principles mentioned here regarding an objective assessment similarly apply to the ICFR analysis as to the severity of the control deficiency. Management's ICFR effectiveness assessment must consider the magnitude of the potential misstatement that *could* result from a control deficiency, and we note that the actual error is only the starting point for determining the potential impact and severity of a deficiency. Therefore, while the existence of a material accounting error is an indicator of the existence of a material weakness, a material weakness may also exist without the existence of a material error. Management's assessment of the effectiveness of ICFR should therefore be focused on a holistic, objective analysis of what *could* happen in the context of current and evolving financial reporting risks.

We continue to emphasize the importance of identifying and communicating material weaknesses to investors promptly. We encourage ongoing attention, including audit committee participation and training, as needed, regarding the adequacy of and basis for a registrant's ICFR effectiveness assessment—particularly where there are close calls in the assessment of whether a deficiency is a significant deficiency (and only required to be reported to the audit committee) or a material weakness (required to be disclosed to investors).

Other Auditor Considerations

A registrant's auditor plays an important role in the assessment of the materiality of accounting errors. In addition to the observations noted above, when auditors evaluate the materiality of uncorrected misstatements, it is important for the audit firm to consider whether its systems of quality control are suitably designed to provide reasonable assurance that its professionals comply with applicable professional standards. For example, the audit firm should have policies and processes in place to ensure that the appropriate individuals are involved in the supervision and review in evaluating the significant judgments made about materiality and the effects of identified accounting errors. This includes the engagement quality reviewer[8] and other consulting parties, as appropriate. In this regard, audit firms need to ensure that their system of quality control includes policies and procedures to provide reasonable assurance that individuals being consulted have the appropriate levels of knowledge, competence, judgment, and authority.[9] We continue to emphasize the importance of effectively designed and implemented systems of quality control by audit firms in support of continued enhancements to audit quality.

Conclusion

In our disclosure-based regime, investors have a right to financial statements prepared in accordance with GAAP. When an error is identified, it is important for registrants, auditors, and audit committees to carefully assess whether the error is material by applying a well-reasoned, holistic, objective approach from a reasonable investor's perspective based on the total mix of information. To be objective, those involved in the process must eliminate from the analysis their own biases, including those related to potential negative impacts of a restatement, that would be inconsistent with a reasonable investor's view. Additionally, the objective analysis should consider all relevant facts and circumstances including both quantitative and qualitative factors.

When investor needs are not adequately considered, investors can lose confidence in financial reporting, threatening a foundational principle upon which our capital markets system is built. It is therefore imperative that registrants—including management, boards of directors, audit committees, and every individual involved in the registrant's financial reporting process—and their auditors each fulfill their respective financial reporting roles and responsibilities with investors' needs in mind.

The staff of OCA remain available for consultation on conclusions regarding the correction of accounting errors, and we encourage stakeholders to contact our office with questions.[10] We value our interactions with registrants and other stakeholders on issues they are facing, and we will continue to be informed by such feedback as we focus on investors' need for high quality financial information, consistent with the SEC's mission.

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[2] *See* Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 250, *Accounting Changes and Error Corrections*, which defines an "error in previously issued financial statements" as an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared.

[3] *See* Staff Accounting Bulletin ("SAB") No. 99, *Materiality* (Aug. 12, 1999); *see also* SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*

(Sept. 13, 2006).

[4] *TSC Industries v. Northway, Inc*., 426 U.S. 438, 449 (1976); *see Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (as the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him...." *TSC Industries*, 426 U.S. at 450); *see also* FASB, *Amendments to Statement of Financial Accounting Concepts No. 8—Conceptual Framework for Financial Reporting—Chapter 3, Qualitative Characteristics of Useful Financial Information* (Aug. 2018), available at https://fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171111614; *see also* SAB No. 99.

[5] *See* ASC Topic 250; s*ee also* Item 4.02(a) of Form 8-K, which requires timely disclosure when the registrant's board of directors, a committee of the board of directors, or the officer or officers of the registrant authorized to take such action if board action is not required, concludes that any previously-issued financial statements, covering one or more years or interim periods for which the registrant is required to provide financial statements under Regulation S-X (17 CFR 210) should no longer be relied upon because of an error, as addressed in ASC Topic 250, in such financial statements.

[6] *See* supra at n. 2; *see also* ASC Topic 250, which defines "restatement" as "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements."

[7] *See* Audit Analytics, *2020 Financial Restatements: A Twenty-Year Review* (November 2021).

[8] *See* Public Company Accounting Oversight Board ("PCAOB") AS 1220, *Engagement Quality Review*, paragraph .10.

[9]*See* PCAOB Quality Control Section 20 ("QC 20"),*System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, available at https://pcaobus.org/oversight/standards/qc-standards/details/QC20. As required by PCAOB QC 20.19, the audit firm's "policies and procedures should also be established to provide reasonable assurance that personnel refer to authoritative literature or other sources and consult, on a timely basis, with individuals within or outside the firm, when appropriate (for example, when dealing with complex, unusual, or unfamiliar issues). Individuals consulted should have appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation depends on a number of factors, including the size of the firm and the levels of knowledge, competence, and judgment possessed by the persons performing the work."

[10] More information about how to initiate a dialogue with OCA, what to expect from the consultation process, and what information should be included in a consultation submission in order for OCA to most quickly address a company's or auditor's question is available on OCA's webpage, available at https://www.sec.gov/page/communicating-oca.

NOTES

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U.S. Securities and Exchange Commission, Paul Munter, Acting Chief Accountant, Office of the Chief Accountant, Public Statement, Statement on the FASB's Agenda Consultation: Engagement with Investors and Other Stakeholders Vital to Development of High Quality Accounting Standards (February 22, 2022)

Statement

Statement on the FASB's Agenda Consultation: Engagement with Investors and Other Stakeholders Vital to Development of High Quality Accounting Standards

Paul Munter
Acting Chief Accountant

Feb. 22, 2022

Introduction[1]

In June 2021, the Financial Accounting Standards Board ("FASB") staff published an Invitation to Comment, *Agenda Consultation* ("ITC"),[2] to solicit broad stakeholder feedback about the FASB's standard-setting process and its future standard-setting agenda. In addition to feedback sought through the ITC, the development of the ITC itself involved significant outreach by the FASB staff and Board members to a cross-section of stakeholders, approximately one-third of whom were investors or other financial statement users.[3]

Over 500 stakeholders responded to the ITC during the comment period, which closed in September 2021. It is encouraging to see the volume of feedback provided to the FASB, with thoughtful responses from a diverse set of stakeholders, including many investors, and to see the FASB's communications regarding how it is considering the feedback received.[4]

It is critically important that the FASB, and the Trustees of the Financial Accounting Foundation (the "FAF") in its important oversight role over the FASB, continue to improve processes for obtaining and considering investor and other stakeholder feedback, and for clearly communicating with those stakeholders regarding how that feedback has impacted the standard-setting process. On behalf of Commission staff in OCA, in this statement, we highlight below why engagement with investors and other stakeholders is vital to the FASB's ability to develop high quality accounting and financial reporting standards, and we provide observations on the FASB's standard-setting process, its agenda consultation, and the related ITC feedback from investors and other stakeholders.

The Importance of Investors and Other Stakeholders to the Standard-Setting Process

The Commission has long recognized the importance of the FASB's role as an independent accounting standard setter.[5] Independence, however, does not mean isolation, but rather highlights the need for broad stakeholder engagement to enable the FASB to improve the accuracy and effectiveness of financial reporting and protect investors consistent with the federal securities laws[6] and the objective of general purpose financial reporting.[7] For example, an understanding of evolving investor needs can directly contribute to the FASB's ability to keep standards current in order to reflect changes in the business environment, and to promptly consider changes to accounting principles necessary to reflect emerging accounting issues and changing business practices.[8]

We continue to encourage all stakeholders to engage with the FASB early and often in the standard-setting process. Since the objective of financial reporting is to provide decision-useful information to investors and other users, we particularly encourage investors to share perspectives on what information is useful to them and how they could use that information. We also believe that investors and other stakeholders are more likely to dedicate the time and resources required to provide thoughtful feedback to the FASB when investors and other stakeholders understand how that feedback is considered by the FASB in its agenda prioritization and development of accounting standards, and the degree to which the resulting standards of the FASB respond to that input.

In this regard, we are appreciative of the FASB and its staff for its work in improving its processes regarding stakeholder, and particularly investor, feedback. We believe it is important that the FASB continue to focus on improvements in this area, including through increased transparency in its communications of:

- The types of investors or investor advocates the FASB engages with, both overall and on specific standards;
- The feedback investors have provided to the FASB, including the extent and nature of diversity in investor views and points where investors are aligned, such as the FASB's recent highlighting of investor feedback regarding the need for more disaggregated information; and
- How the FASB considered investor feedback in making its agenda decisions or developing a standard and the degree to which the standard responds to investor input, for example, through transparent discussion in the basis for conclusions of its Exposure Drafts and Accounting Standards Updates.

This focus on productive engagement between the FASB and investors, preparers, and other stakeholders will continue to be critical to the FASB's ability to produce high quality accounting and financial reporting standards.

Observations on the FASB's Agenda Consultation

The FASB's recently published summary of feedback received in response to the ITC is an example of its focus on transparent communications of its consideration of input from investors and other stakeholders. Of the respondents who provided broad feedback on the ITC, nearly 30% represented investors or other users.

Overall Feedback and Making the Case for Change

As noted in the FASB's summary of feedback, respondents frequently noted that the objective of financial reporting (to provide decision-useful information to investors and other users of financial reports) should be the FASB's focus, and that the FASB should be transparent about how projects would benefit investors and other financial statement users in line with this objective.

In its decisions to add projects to its agenda or make changes to its standards, the FASB should clearly make the case for change, whether through a preliminary yet robust analysis of the need for a project or through an explanation of its consideration of the expected costs and benefits of a change. In the FASB's consideration of what would provide decision-useful information to investors, and in making the case for change, it should consider costs to both preparers and users, including the costs to users from not making needed improvements to accounting and disclosure requirements.

Making the case for change should not be a one-time analysis since the FASB's agenda priorities may change based on the evolving needs of investors and other stakeholders. In other situations, as the FASB progresses on projects it previously identified as a priority, it may find that there is significant diversity in views of investors such that there is not a clear case for change. The FASB should regularly evaluate whether existing projects on its agenda warrant continued consideration.

As a current example of the need for such an ongoing analysis, we note the significant diversity in views expressed by investors and other stakeholders regarding the FASB's Identifiable Intangible Assets and Subsequent Accounting for Goodwill project—particularly regarding whether goodwill should be amortized. We emphasize the importance of a robust process and analysis to make the case for any changes in the accounting for goodwill, which would include, among other things, the extent to which international convergence in this area is necessary or appropriate in the public interest.

In making the case for change, we also believe the FASB should be careful not to place undue reliance on analyses performed under another framework such as the Private Company Decision-Making Framework, or related guidance issued by consensus of the Private Company Council, in its standard-setting process for standards applicable to public companies.

Disaggregation of Financial Reporting Information

Another area of frequent comment by investors and other financial statement users was the disaggregation of financial reporting information. We note there was general alignment among commenting investors that greater disaggregation of financial reporting information—in the income statement, in the statement of cash flows, or in the notes to financial statements—should be among the FASB's top priorities. We believe that the FASB, through responses to the ITC and other outreach, has received significant information on investor needs in this area and that prompt consideration of investor and other stakeholder input is merited to identify potential targeted improvements to financial reporting.

The FASB has an existing project that contemplates the disaggregation of certain income statement expenses, and the feedback provided by investors underscores the importance of making achievable, meaningful progress on this project in the near-term. In that regard, we note the FASB held its most recent public discussion on disaggregation in February 2022.

The process of determining an effective path forward on this project should consider how to balance timely, meaningful action while ensuring due process. It will also necessarily include an assessment of the costs to preparers of producing disaggregated information. We note that one important consideration for that assessment is that issuers are required by law to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.[9] Importantly, we note that feedback from preparers provided in years past regarding the cost of producing disaggregated information from such books, records, and accounts may be less relevant today, given technological advances. As such, we appreciate the continued efforts of the FASB to understand current feedback on the ITC and to perform additional outreach to preparers and other stakeholders regarding the current expected costs of both implementation and ongoing application of potential financial performance disaggregation proposals.

Climate-Related Transactions and Disclosures

Respondents to the ITC acknowledged that climate-related transactions may be limited currently, but urged the FASB to continue to monitor the business environment and suggested certain targeted issues for potential standard setting along with requests for broader disclosures regarding the impact of climate-related issues on the financial statements. Recently, the FASB added a project to its research agenda to explore accounting for and disclosure of financial instruments with climate-linked features,[10] and added a project to the Emerging Issues Task Force's agenda related to the accounting for investments in certain tax credit structures including renewable energy tax credit investments.[11]

Taking into account feedback received over the past year, we believe there may be opportunities for the FASB to take thoughtful action on targeted areas of accounting, disclosure, and financial reporting that are consistent with the objective of general purpose financial statements, in response to the evolving business environment, transactions, and investor needs regarding climate-related issues. For example, the near-term time horizon for financial statement disclosure requirements about risks and uncertainties[12] could be an additional area for consideration.

We encourage the FASB to continue to perform outreach with investors and other stakeholders and to monitor development of climate-related accounting and financial reporting issues. We also note the importance of clearly defining the scope of any standard-setting projects that emerge from the FASB's current research project or other climate-related efforts to ensure that standard setting is separated into meaningful yet achievable phases.

Digital Assets

A significant number of respondents identified digital assets as a priority for the FASB to consider. Many of the respondents suggested that the FASB should permit or require issuers to account for certain digital assets at fair value. Investors and preparers alike commented that digital assets are expected to increase in significance in the coming years, as evidenced by a rise in market participants holding digital assets, which has accelerated the pace at which publicly-traded companies have become involved in digital assets and blockchain technology.[13]

In response to feedback received, the FASB added a project to its research agenda on the accounting for exchange-traded digital assets and commodities.[14] Continuing stakeholder engagement and monitoring of the business environment will be crucial to the FASB's ability to both properly scope any standard-setting projects in this area, and determine the accounting and disclosures that would provide the most useful information to investors, particularly as the digital asset landscape continues to evolve. While digital assets raise a number of critical issues under the federal securities laws, and the industry continues to change at a rapid pace, we believe there may be opportunities for targeted changes to accounting or disclosure guidance that could provide useful information to investors.

Other Areas of Feedback

As the FASB considers feedback on other topics, we believe it should keep in mind the considerations noted above, including the importance of: 1) making the case for change; 2) appropriately scoping projects to make timely, meaningful, and achievable changes while ensuring appropriate due process is used throughout the standard-setting life cycle; and 3) continuing to seek investor and other stakeholder input.

Some of the other topics highlighted in the ITC and in stakeholder feedback include intangible assets (including software costs and human capital costs), consolidation guidance, and hedging—all of which are currently on the FASB's standard-setting or research agendas. Hedging has been an area where the FASB has already made a number of changes to improve the guidance. In deciding whether to make any proposed changes to hedging, we encourage the FASB to consider whether this topic is a priority for investors and engage in additional outreach to make the case for any such proposed changes, and in particular, to clearly understand what information would be most useful to investors to understand an entity's related risk exposure and risk management.

Certain issues, including hedging, may require significant time and resources due to the complexity of the arrangements or the existing guidance. Any prioritization of such projects should also consider the need to retain the capacity required to promptly address other emerging issues, including those identified through the FASB's post-implementation reviews ("PIRs"), to improve the operability of existing standards. The FASB's PIR process is a critical component of its standard-setting and implementation process, and addressing high-priority application challenges, including issues noted in the current PIR on revenue, is important to the FASB's ability to develop high quality standards.

Conclusion

The financial reporting system's collective objective of providing investors with high quality financial reporting demands that all stakeholders seek ways to improve and better address the needs of investors. In that regard, it is important that both the FAF and FASB focus on continued improvement in the fulfillment of their respective roles and responsibilities in the financial reporting system—especially in their efforts to more promptly address significant and evolving investor needs within the context of the financial statements. Doing so will clearly demonstrate that providing useful information to investors and other users is of foremost importance in the FAF's and FASB's work.

We are grateful for the efforts of the FAF and FASB, including the significant outreach performed through its ITC process to date, and we look forward to continued progress and improvements in these areas as the FASB continues to consider and incorporate investor and other stakeholder feedback in its standard-setting process.

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[1] This statement represents the views of the staff of the Office of the Chief Accountant ("OCA"). It is not a rule, regulation, or statement of the Securities and Exchange Commission ("SEC" or the "Commission"). The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. "Our" and "we" are used throughout this statement to refer to OCA staff.

[2] *See* FASB, *Invitation to Comment—Agenda Consultation* (Jun. 24, 2021), *available at* https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176176828145.

[3] *Id.*

[4] *See* FASB Press Release, *FASB Holds First Discussion on Agenda Consultation Feedback* (Dec. 15, 2021), *available* at https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176179121674&d=&pagename=FASB%2FFASBContent_C%2FNewsPage; *see also* FASB, *Feedback Summary on the 2021 Invitation to Comment, Agenda Consultation* (Dec. 15, 2021), *available at* https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176179121187&d=&pagename=FASB%2FDocument_C%2FDocumentPage.

[5] *See* SEC, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, Release No. 33-8221 (Apr. 25, 2003) [68 FR 23333 (May 1, 2003)], *available at* https://www.sec.gov/rules/policy/33-8221.htm.

[6] 15 U.S.C. 77s(b)(1).

[7] The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. *See* par. OB2 of FASB Statement of Financial Accounting Concepts No. 8 (As Amended), *Conceptual Framework for Financial Reporting—Chapter 1, The Objective of General Purpose Financial Reporting*.

[8] *See supra*, at n. 6.

[9] *See* Section 13(b)(2)(A) of the Securities Exchange Act of 1934.

[10] *See* FASB's "Objectives of Research Projects" webpage, *available at* https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176169433424&d=&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage.

[11] *See* FASB's "Project Update: EITF 21-A, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method" webpage, *available at* https://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdateExpandPage&cid=1176177658835.

[12] *See* FASB Accounting Standards Codification Topic 275, *Risks and Uncertainties*.

[13] *See supra*, at n. 4.

[14] *See supra*, at n. 10.

Modified: Feb. 22, 2022

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U.S. Securities and Exchange Commission, Paul Munter, Acting Chief Accountant, Office of the Chief Accountant, Public Statement, Statement on OCA's Continued Focus on High Quality Financial Reporting in a Complex Environment (December 6, 2021)

Statement

Statement on OCA's Continued Focus on High Quality Financial Reporting in a Complex Environment

Paul Munter
Acting Chief Accountant

Dec. 6, 2021

Introduction[1]

The events of the past year bring to mind the old saying that "change is the only constant in life." Our capital markets continue to evolve and adapt in response to changes in the economic environment, investors' needs for new types of information, and challenges related to the ongoing effects of the pandemic. Amidst these changes, the U.S. financial reporting system remains strong, largely due to the cumulative efforts of thousands of stakeholders who have exhibited resilience and adaptability, while remaining focused on the need for high quality financial reporting for the benefit of investors.

In this statement, we describe the Office of the Chief Accountant's ("OCA") role in the financial reporting system, sharing perspectives from our ongoing priorities and our work over the past year related to rulemaking activities, oversight of standard setting, implementation and application of standards, and application of auditor independence requirements. We then discuss the vital role of individual stakeholder groups, sharing observations regarding key areas of focus for each stakeholder group to promote a continued flow of high quality financial reporting to investors.

Upholding the Basic Bargain: OCA's Responsibilities and Priorities

SEC Chair Gary Gensler has often noted a basic bargain that was struck in our capital markets with the passing of federal securities laws in the 1930s—that investors get to decide what risks they wish to take, while companies raising money from the public have an obligation to share information with investors on a regular basis.[2] Fundamental to the functioning of this basic bargain is that the information companies provide to investors be of high quality, including financial statements that are (1) prepared in accordance with U.S. generally accepted accounting principles ("GAAP")[3] and (2) audited in accordance with Public Company Accounting Oversight Board ("PCAOB") standards by an independent public accounting firm registered with the PCAOB.

The Chief Accountant of the SEC is the principal advisor to the Commission on accounting and auditing matters arising in the administration of the federal securities laws.[4] As such, OCA supports the Commission's oversight of the Financial Accounting Standards Board ("FASB"), monitoring of the International Accounting Standards Board

("IASB"), enforcement of U.S. GAAP and International Financial Reporting Standards ("IFRS") requirements by issuers, oversight of the PCAOB, and application of the Commission's auditor independence requirements. Fulfilling these responsibilities requires us to regularly interact with investors, investor advocates, and each stakeholder group in the financial reporting system (management, audit committees, external auditors, standard setters, other regulators), domestically and internationally.[5] By engaging with each of these stakeholder groups, and facilitating communication and collaboration between stakeholder groups, we promote the flow of high quality financial information to investors, who depend on this information to make informed decisions.

OCA is committed to supporting the Commission in holding up that basic bargain agreed to nearly 90 years ago. By furthering each element of high quality financial reporting—high quality accounting standard setting, high quality implementation and application of those standards, and high quality audits—we seek to ensure that investors continue to have the information they need to make well-informed investment decisions. More specifically, OCA supports the Commission's (1) rulemaking activities, (2) oversight of accounting standard setting, (3) efforts to promote effective implementation and application of those accounting standards, and (4) oversight of the PCAOB, each of which we discuss in further detail.

Rulemaking Activities

Commission rulemaking is foundational to the overall soundness of the U.S. financial reporting system and investor protection. OCA plays an active role throughout the lifecycle of the Commission's rulemaking process, advising the Commission on the impact of proposed rules or rule amendments on accounting or auditing matters, and often playing a key role in developing rule proposals related to accounting or auditing matters for the Commission's consideration.

The SEC's rulemaking agenda[6] reflects the agency's current priorities in fulfilling its three-part mission.[7] While the agenda includes a number of potential rulemaking projects that relate to financial reporting and could have an impact on accounting or auditing matters, we would like to highlight the following rulemaking agenda items:

- Climate Risk Disclosures;
- Trading Prohibitions Under the Holding Foreign Companies Accountable Act ("HFCAA"); and
- Recovery of Erroneously Awarded Compensation.

Climate Risk Disclosures

Given the dynamic nature of our capital markets, the total mix of information requested by investors continues to evolve to include new types of information, such as climate risk disclosures. To this point, Chair Gensler has stated: "Occasionally, investors in our capital markets tell us that they…want something a little bit different. When it comes to climate risk disclosures, investors are raising their hands and asking regulators for more."[8] Chair Gensler has since directed the staff to develop a climate risk disclosure rule proposal, taking into account feedback received earlier this year.[9]

In addition, we note that the FASB staff published an educational paper in March 2021 to provide investors, issuers, and others with an overview of the intersections between environmental matters, including climate change, and existing U.S. GAAP requirements.[10] The IASB staff issued similar educational materials in November 2020.[11] In September 2021, the staff in the Division of Corporation Finance published an illustrative letter containing sample comments that the Division may issue to companies regarding their climate-related disclosure or the absence of such disclosure.[12] As stated in the sample comment letter, depending on the particular facts and circumstances, these disclosures may be required as part of a company's description of business, legal proceedings, risk factors, and management's discussion and analysis of financial condition and results of operations.

Given the global nature of our capital markets, OCA also actively monitors international developments on these topics. In September 2020, the IFRS Foundation issued a consultation paper on sustainability reporting[13] that presented the possible formation of a global sustainability standards board under the governance of the IFRS Foundation, which is also responsible for governance and oversight of the IASB and is accountable to the Monitoring

Board. Based on feedback received on that consultation paper and a related exposure draft published in April 2021,[14] the IFRS Foundation Trustees approved targeted amendments to the IFRS Foundation constitution and announced in November 2021 the formation of the International Sustainability Standards Board ("ISSB") to set IFRS sustainability disclosure standards.[15]

Trading Prohibitions under the HFCAA

On December 18, 2020, the HFCAA was signed into law and, as required by the statute, the Commission adopted final rules on December 2, 2021 to specify disclosure and submission requirements for affected issuers.[16] The Act also requires a trading prohibition for an issuer's securities if that issuer uses an audit firm that the PCAOB is unable to inspect or investigate completely for three consecutive years.

Under the HFCAA, the PCAOB is responsible for determining in which jurisdictions it is unable to inspect or investigate completely registered public accounting firms because of a position taken by an authority in that foreign jurisdiction. The PCAOB adopted a new rule on September 22, 2021, that provides the framework for the PCAOB to use in making this determination.[17] The new PCAOB rule was approved by the Commission on November 4, 2021 and is now effective.

In addition to rulemaking activities in this area, we continue to work diligently with other offices and divisions of the SEC to bring to the attention of investors other risks related to investments in emerging markets, including China. For example, we recently issued, along with the SEC's Office of Investor Education and Advocacy and Division of Corporation Finance, an investor bulletin describing some of the specific risks of investing in U.S.-listed companies with China-based operations.[18]

Recovery of Erroneously Awarded Compensation

On October 14, 2021, the Commission issued a release reopening the comment period for its 2015 proposed rules that would direct the national securities exchanges and national securities associations to establish listing standards that would require each issuer to develop and implement a policy providing for the recovery of incentive-based compensation received by current or former executive officers that was awarded based on financial information that required restatement, and require disclosure of the issuer's policy.[19] Under the proposed rules, incentive-based compensation received by an executive officer during the three fiscal years preceding the date on which the issuer is required to prepare an accounting restatement to correct a material error would be subject to recovery, or "clawback." The amount to be recovered is the incentive-based compensation that exceeds the amount the executive officer would have received had the incentive-based compensation been determined based on the restated financial statements.[20]

Accounting Standard Setting

High quality financial reporting cannot be achieved without high quality accounting standards. The objective of general purpose financial reporting is "to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity."[21] No matter how well standards are applied, investor trust in financial reporting cannot exist without confidence that the underlying accounting standards are designed to achieve that basic objective. Promoting the development of high quality accounting standards is one of OCA's core objectives, which we accomplish by assisting the Commission in its oversight of the FASB and engagement with the IASB in its development of IFRS standards.

Oversight of FASB Standard Setting

OCA leads the SEC's efforts to oversee the standard-setting activities of the FASB, in part, by:

- Providing feedback on FASB projects throughout the projects' life cycle, which is informed by our unique position in the financial reporting structure;
- Participating as an official observer of FASB-related meetings such as those of the Emerging Issues Task Force, Financial Accounting Standards Advisory Council, Small Business Advisory Committee, and Investor

Advisory Committee; and

- Working collaboratively with the FASB staff to share insights and perspectives on a variety of matters.

Most recently, we have been actively engaged with the FASB on its agenda consultation. We will continue to be actively engaged with the FASB as it evaluates feedback received and assesses which projects to add to its technical agenda.

The FASB received over 500 responses, including 100 original comment letters, to its Invitation to Comment—Agenda Consultation.[22] We recognize and appreciate the time and effort required to provide meaningful feedback on the FASB's agenda or individual projects, and we continue to believe that the standard-setting process benefits greatly from early, detailed engagement from all stakeholders.

In addition to our role in the oversight of the FASB's process leading to the issuance of a final standard, we also work closely with the FASB during the implementation of new accounting standards and the post-implementation review ("PIR") activities for those standards. We have spent a considerable amount of time in this area related to the implementation of revenue, leases, and current expected credit losses ("CECL") standards, and have shared observations on these standards with the FASB and FASB staff.

Promoting High-Quality International Financial Reporting Standards

Our activities related to accounting standard setting are not limited to U.S. GAAP. More than 500 foreign private issuers ("FPIs") report financial statement information to the Commission under IFRS as issued by the IASB, making the United States one of the largest markets in the world for the securities of IFRS-reporting issuers. Many U.S. companies also have an interest in IFRS standards due to statutory financial reporting requirements for their non-U.S. subsidiaries or when entering into transactions, including acquisitions and other investments, with entities that report under IFRS. Due to the importance of IFRS to both U.S. investors and issuers, we have a strong interest in monitoring the quality of IFRS standards.

We engage with the IASB in a number of different ways. Through our participation on the Monitoring Board, we monitor the governance of the IFRS Foundation and the IASB, the development of IFRS standards, and the application of IFRS. Through our involvement in the International Organization of Securities Commissions' ("IOSCO") Committee on Issuer Accounting, Audit and Disclosure ("Committee 1"), in which I serve as the vice-chair, we, along with other securities regulators, issue comment letters on IASB proposals. We also engage directly with the IASB and its staff, like we do with the FASB, on specific accounting matters, including sharing observations from our consultations on the application of IFRS or areas of U.S. GAAP that are substantially converged with IFRS. In addition, at the beginning of this year, I became an observer to the IFRS Interpretations Committee, which works with the IASB in supporting the application of IFRS standards. In this role, I attend IFRS Interpretations Committee meetings and participate in the discussion on behalf of IOSCO.

Similar to the FASB, the IASB is currently working on its own agenda consultation. The IASB's process was similar to the FASB's in that it conducted extensive outreach with stakeholders to receive input on additional standard-setting projects, and then used that feedback to prepare its Request for Information—Third Agenda Consultation, in which it requested feedback regarding the prioritization of topics for its agenda.

Implementation and Application of Accounting Standards

In addition to our oversight and monitoring of accounting standard setting, we are actively involved in the implementation and application of those accounting standards through our engagement with preparers, industry groups, auditors, audit committees, standard setters, other offices and divisions within the Commission, such as the Division of Corporation Finance, investors, and other regulators.

One of the most important ways in which we engage with stakeholders and support high quality implementation and application of accounting standards is through our accounting consultation process. Registrants, be they domestic registrants or foreign private issuers, and companies planning to enter our public capital markets can consult with OCA on complex, novel, or unique issues they face on accounting matters under both U.S. GAAP and IFRS. As part of the consultation process, we work collaboratively with management, auditors, audit committees, and others to understand unique fact patterns and the judgements made by management in applying accounting standards to those fact patterns. Through this process, we are able to provide the staff's view on the application of U.S. GAAP or IFRS to those fact patterns.

Observations from Recent Accounting Consultations

Our recent accounting consultations have addressed a wide range of issues including questions related to financial statement presentation, segment reporting, revenue recognition, distinguishing liabilities from equity, consolidation, business combinations, financial assets, compensation, and leases.

Consistent with the increased volume of capital raising transactions, we have received a large number of consultations on accounting issues identified as companies prepare to enter the public markets, including through IPOs and mergers with special purpose acquisition companies ("SPACs"). Earlier this year, we, along with the Division of Corporation Finance, issued two statements on SPACs and mergers of private companies with SPACs that were directly informed by our consultation activity: *Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs")*[23] and *Financial Reporting and Auditing Considerations of Companies Merging with SPACs*.[24] Since then, we have continued to see a range of other accounting and reporting issues that entities have been working through related to SPAC transactions, including additional issues relating to warrant accounting, earnings per share, temporary versus permanent equity classification, compensation, business combinations, and derivatives.

As it relates to companies that are entering, or planning to enter, the public markets, we want to reiterate the importance of ensuring that appropriate personnel and processes are in place to produce financial statements in accordance with U.S. GAAP applicable to public business entities, which would include the reversal of any previously-elected Private Company Council accounting alternatives available to private companies and, depending on the issuer's status, earlier effective dates for most standards.

One of the most frequent topics of accounting consultation continues to be revenue recognition, with many of these consultations coming from companies entering the public markets and seeking our views on accounting for emerging or unique business models or transactions. Similar to observations we have shared in the past, these revenue consultations often relate to the identification of the company's performance obligations, including the principal versus agent analysis, identification of the company's customer(s), and accounting for consideration payable to a customer.

Similar to the trend of revenue questions arising in emerging business models and companies accessing the public markets, we have received a number of consultations related to digital asset-related transactions or business models. These questions include, among others, when digital assets represent an asset or liability of the registrant, determining the cost basis for digital assets, and revenue recognition considerations. While we welcome constructive dialogue on whether accounting standards could be revised to better reflect the underlying economics of digital asset transactions or business models—and again, the FASB's and IASB's work to consider feedback from their respective agenda consultation processes will be important in this area—we remind stakeholders there is an existing accounting framework that is robust and provides a basis to account for and report these assets and related transactions. Application of the existing accounting guidance often requires judgment and depends on the issuer's specific facts and circumstances.

Additionally, recent consultations and broader engagement with investors and other stakeholders informed our issuance, along with the Division of Corporation Finance, of Staff Accounting Bulletin ("SAB") No. 120 on November 29, 2021. SAB 120 updates our existing SAB series to conform to share-based payment accounting guidance issued by the FASB and provides interpretive guidance on the accounting for certain share-based compensation arrangements commonly referred to as "spring-loaded awards."[25]

We remain available for consultation and encourage stakeholders to contact our office with questions.[26] We value our interactions with engaged stakeholders regarding issues they are facing, and we will continue to be informed by such feedback as we focus on investors' need for high quality financial information, consistent with the SEC's mission.

Independent Audit Oversight

Assurance provided by independent public accountants improves the quality of financial disclosures and is a strong contributor to investor confidence in and the strength of our capital markets.[27] The U.S. capital markets' disclosure regime is designed to promote high quality audits through the adherence of accountants to rigorous independence, quality control, and auditing standards and rules.

Promoting Auditor Independence

Similar to our accounting consultation process, we regularly receive consultations related to auditor independence under the Commission's and the PCAOB's independence rules. These questions are often raised by audit firms, but we also receive consultations from audit committees and management on independence matters that impact their filings. In cases where a question is raised by the auditor, we often also discuss the issue with the audit committee to understand its position on the matter.

Since the Commission adopted targeted amendments to the independence requirements in Rule 2-01 of Regulation S-X in October 2020,[28] the total number of auditor independence consultations we have received has increased. As described in more detail in our recent statement, *The Importance of High-Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors*,[29] the Commission views the text of Rule 2-01(b) of Regulation S-X together with the four guiding principles laid out in the Introductory Text of Rule 2-01 as a framework to be applied when considering matters that are not directly addressed in other parts of Rule 2-01. The guiding principles refer to whether a relationship or a provision of a service:

- Creates a mutual or conflicting interest between the accountant and the audit client;
- Places the accountant in the position of auditing his or her own work;
- Results in the accountant acting as management or an employee of the audit client; or
- Places the accountant in a position of being an advocate for the audit client.

In applying this principles-based standard, OCA staff has consistently provided the view that it would be a high hurdle to reach a conclusion that the accountant could be viewed as objective and impartial under the general standard when an auditor has provided services in any of the periods included in the filing that are contrary to one of these guiding principles.

We in OCA remain available for consultation on all auditor independence matters,[30] and we encourage stakeholders to contact us in advance of transactions or the provision of services that could raise independence questions.

Oversight of the PCAOB

The PCAOB plays a significant role in the financial reporting system, overseeing the audits of public companies and SEC-registered brokers and dealers to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The Commission oversees the PCAOB in accordance with the Sarbanes-Oxley Act, including the appointment of its board members, approval of PCAOB rules and standards, and approval of the PCAOB's budget and accounting support fees. OCA advises the Commission on these important oversight responsibilities, including through direct engagement with the PCAOB.

On November 8, 2021, the Commission announced the appointments of Erica Y. Williams as Chairperson of the PCAOB and Christina Ho, Kara M. Stein, and Anthony (Tony) C. Thompson as Board members.[31] Duane DesParte will continue his service as a Board member and will serve as Acting Chairperson until Erica Williams begins her service on the Board. The incoming Board brings a broad depth and diversity of experience and the SEC staff look forward to collaborating with the Board to further the PCAOB's vital mission to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

Promoting Quality in International Audits

OCA is also heavily involved in promoting quality in international audits through our leadership role on the Monitoring Group,[32] which is a group of international financial institutions and regulatory bodies committed to advancing the public interest in international audit, ethics, and independence standard setting and audit quality. This role provides us the ability to help guide the governance of the international auditing and ethics standard-setting system.

In July 2020, the Monitoring Group published a set of recommendations to strengthen the international audit and ethics standard-setting system.[33] Since the Monitoring Group's publication of these recommendations, OCA staff has been actively working with key stakeholders, including, among others, the Public Interest Oversight Board ("PIOB"), the International Audit and Assurance Standards Board ("IAASB"), the International Ethics Standards Board for Accountants ("IESBA"), and the International Federation of Accountants ("IFAC") to achieve consensus on both transition and implementation of the recommendations. Important upcoming milestones include the transition to Gabriela Figueiredo Dias as the next IESBA Chair effective January 1, 2022,[34] identifying members to fill the two open vacancies on the PIOB, and launching of the new structure, which will result in enhanced oversight of the standard-setting system by the PIOB.

We highly value the opportunities provided to us through our participation and leadership role within the Monitoring Group to engage globally in support of promoting audit quality. We also acknowledge the significant contributions from others across the globe in this inclusive, multi-stakeholder effort.

Key Areas of Focus for Each Stakeholder to Produce High Quality Financial Information for Investors

To maintain the strength of our U.S. financial reporting system, each stakeholder should constantly reassess its areas of focus in light of changing priorities, evolving investor needs, and updates to standards, rules, and regulations. This process must be intentional and ongoing, such that it results in continuous improvement to maintain the flow of high quality financial information to investors. OCA's unique position in the financial reporting system allows us to support each stakeholder in identifying relevant areas of focus.

Accounting Standard Setters

As noted earlier, high quality accounting standards are ones that are designed to provide decision-useful financial information to investors. The development of high quality accounting standards by the FASB, in its important role as the independent accounting standard-setter for U.S. GAAP, and by the IASB, whose IFRS standards may be used by FPIs, requires broad engagement with financial statement users, preparers, auditors, regulators, and others. Diverse stakeholder input, along with other research, enables the standard setters to better evaluate proposed standards and identify potential areas for improvement in their accounting and reporting requirements.

To maintain quality over time, accounting standards must evolve in response to changing circumstances and stakeholder feedback, particularly investor feedback, regarding the usefulness of the resulting financial information. To this end, it is critical that the FASB and IASB solicit and transparently incorporate investor feedback into standard-setting decisions. For example, while we note the extensive engagement that currently takes place between the FASB and investors, we believe that enhanced transparency of this engagement and the use of that input to its standard-setting process will allow stakeholders to better understand investor perspectives and how investor feedback is considered in the FASB's standard-setting process and decisions.

While it is certainly important that accounting standards evolve in response to changes in the total mix of information that investors find material, issuing new standards simply for the sake of change does not promote high quality financial reporting. Instead, the need for standard setting must be well-supported, with consideration of whether a change will provide more decision-useful information to investors, and whether the expected benefits resulting from any such change will outweigh its cost, including costs to investors from the change. We will continue to urge both the FASB and IASB to clearly articulate the case for any proposed changes to their standards, particularly where stakeholder feedback is mixed or a long-standing, well-understood, decision-useful framework exists.

It is also imperative that the FASB and IASB maintain active dialogue and information sharing practices to promote high quality accounting standards around the world. We encourage the FASB and IASB to continue to work collaboratively on areas of mutual interest, and believe their respective agenda consultation projects present a great opportunity to identify potential intersections between the future standard-setting agendas of the FASB and IASB.

Preparers

Preparers are responsible for properly implementing and applying accounting standards to accurately reflect the economics of underlying transactions in their financial statements. Therefore, responsibility for high quality financial reporting, including high quality financial statements, rests in the first instance with management.

In their preparation of financial information for the benefit of investors, we cannot overstate the importance of preparers making well-reasoned and supported judgments that are grounded in their particular facts, relevant rules, and accounting principles and that consider the usefulness and transparency of the resulting information provided to investors. Preparers should also ensure that significant judgments and estimates are disclosed in the financial statements in a clear and transparent manner that is understandable and useful to investors.

The ability to make well-reasoned accounting judgments and estimates and provide clear and transparent disclosures of those judgments and estimates is inextricably linked to the effectiveness of a company's internal control over financial reporting ("ICFR") and disclosure controls and procedures. In particular, management review controls often play an important role in addressing a company's financial reporting risk in areas of judgment. While there is no universal definition of a management review control, they are often considered to be reviews of aggregated financial information or estimates by knowledgeable personnel to detect misstatements at an appropriate level of precision. It is important for registrants to continually assess their financial reporting risks and evaluate whether their ICFR environment is effective, including a particular focus on the design, implementation, and operating effectiveness of management review controls involving areas of significant judgment. Additionally, in light of significant changes to many companies' operations, for example, changes to their financial reporting processes in a remote work environment, we remind preparers that if any change materially affects, or is reasonably likely to materially affect, an entity's ICFR, such change must be disclosed in quarterly filings in the fiscal quarter in which it occurred (or fiscal year in the case of a foreign private issuer).[35]

Further, if an error is identified in the financial statements, management must determine whether the error is material, which is based on what is important to the user. If that analysis indicates that previously issued financial statements are materially misstated, those financial statements would need to be restated and reissued. By comparison, if the error is not material to previously issued financial statements, but correcting the error in the current period would be material to the current period, an entity is not precluded from correcting the error in the current period comparative financial statements by restating the prior period information and disclosing the error, which is commonly referred to as a "little r" restatement. While the total number of restatements by U.S.-based public companies has declined each year for the past six years, we note that "little r" restatements as a percentage of total restatements rose to nearly 76% last year, up from about 35% in 2005.[36] In this regard, we note that under existing accounting guidance assessing whether an error is material to prior periods is not a mechanical exercise, nor is it based solely on a quantitative analysis. Rather, management must judiciously evaluate the total mix of information, taking into consideration both quantitative and qualitative factors to determine whether an error is material to investors and other users.[37]

We also emphasize the importance of identifying and communicating material weaknesses in ICFR before they become evident in the form of a restatement and reissuance. We encourage ongoing attention, including audit committee participation, regarding the adequacy of and basis for a company's effectiveness assessment, particularly where there are "close calls" in the assessment of whether a deficiency is a significant deficiency (and reported to the audit committee) or a material weakness (and also reported to investors).

Auditors

The independent auditor plays an important role in promoting transparent, accurate financial information and in maintaining investor confidence in that information by providing reasonable assurance to investors that the financial statements are free from material misstatement. As further described in our recent statement on audit quality,[38] the independence of the auditor, in both fact and appearance, is foundational to the credibility of the audit, and therefore to the confidence of investors in the quality of the financial statements.

Just as preparers are responsible for assessing the effectiveness of ICFR, it is important for audit firms to continually assess the effectiveness of their risk management and quality control systems, which serve as frameworks to anticipate and mitigate the risk of audit deficiencies.

One area that auditors must carefully monitor as part of their risk management and quality control systems is the scope of services being provided by the audit firm, including network firms, to avoid potentially independence-impairing situations for the accounting firm that issues the auditor's report.[39] This includes evaluating the impact of business relationships and non-audit services on both existing and prospective audit relationships. Entering into significant, multi-year non-audit service contracts or business relationship arrangements with non-audit clients can impact the auditor's ability to remain independent in certain future circumstances. For example, this type of service contract or relationship arrangement can be independence-impairing for the audit firm if an existing audit client merges with or acquires the non-audit client. While sourcing an independent auditor is a key responsibility of the audit committee,[40] compliance with auditor independence rules is a shared responsibility of the issuer, its audit committee, and the auditor.[41]

Additionally, for auditors that are part of global networks of firms, the assessment of the effectiveness of risk management and quality control systems also means focusing on strong global network governance and management to promote audit quality across all jurisdictions, including emerging markets, such as China, by considering both domestic and international audit-related standards. This involves having strong client acceptance and continuance policies, a robust internal inspection function, including cross-network reviews, continuous and consistent training, and audit quality benchmarking. We will continue to promote audit quality in emerging markets, including China, through ongoing discussions with global audit firm networks and other means as necessary.

Audit Committees

Audit committees make significant contributions to the financial reporting system through their oversight of a company's ICFR and related culture, the quality of financial reporting, and the quality of the independent, external audit process. As we have said time and time again, the measures related to audit committees have proven to be some of the most effective financial reporting enhancements included in the Sarbanes-Oxley Act.[42]

Without a doubt, today's audit committees have a lot on their plates. Increasingly, audit committees are being tasked with overseeing a company's cybersecurity policies; environment, social, and governance practices; legal and regulatory compliance; and tax risks. While these are most assuredly important issues, and audit committees may be adept at monitoring these risks, we believe it is important that audit committees assess whether the scope of their responsibilities is appropriate, achievable, and aligned with the experience of its members, and importantly, not lose sight of their core responsibility—oversight of financial reporting, including ICFR, engagement of the independent auditor, and oversight of the external audit process. We cannot overstate the importance of independent and diverse thinking brought by independent directors in fulfilling this responsibility.

We also continue to encourage audit committees to consider the sufficiency of the auditor's and the issuer's monitoring processes, including those that address corporate changes or other events that could affect auditor independence.[43] In addition to evaluating independence of the auditor, we believe it is foundational to high quality audits that audit committees give careful consideration to audit quality, and not merely focus on price, when appointing and retaining auditors.

Conclusion

The strength of our capital markets is built, in large part, on a foundation of trust. Each stakeholder must, therefore, remain keenly focused on quality in every aspect of the financial reporting process, with a central focus on providing high quality information to investors. We in OCA are committed to doing our part to support stakeholders in these efforts to produce high quality financial reporting and maintain the confidence of investors in our financial reporting system, and we express our sincere gratitude to all stakeholders who continue to fulfill their respective roles and responsibilities with the utmost integrity and professionalism in these challenging times.

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[1] This statement represents the views of the staff of the Office of the Chief Accountant ("OCA"). It is not a rule, regulation, or statement of the Securities and Exchange Commission ("SEC" or the "Commission"). The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. "Our" and "we" are used throughout this statement to refer to OCA staff.

[2] *See, e.g.,* Chair Gary Gensler, *Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs* (Sept. 14, 2021), *available at* https://www.sec.gov/news/testimony/gensler-2021-09-14.

[3] Foreign private issuers may prepare their financial statements under International Financial Reporting Standards as issued by the International Accounting Standards Board without reconciliation to U.S. GAAP. *See Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP*, SEC Release No. 33-8879 (Dec. 21, 2007), *available at* https://www.sec.gov/rules/final/2007/33-8879.pdf.

[4] 17 CFR 200.22.

[5] U.S. investors routinely invest in foreign companies to diversify their portfolios, whether through direct investments or through investments in funds with international exposure. As of December 31, 2020, U.S. holdings of foreign equities and debt was approximately $14.4 trillion. *See* Report on U.S. Holdings of Foreign Securities at End-Year 2020, *available at* https://home.treasury.gov/news/press-releases/jy0445.

[6] *See Agency Rule List – Spring 2021*, *available at* https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode&showStage=active&agencyCd=3235.

[7] The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

[8] *See* Chair Gary Gensler, *Prepared Remarks Before the Principles for Responsible Investment "Climate and Global Financial Markets" Webinar* (Jul. 28, 2021), *available at* https://www.sec.gov/news/speech/gensler-pri-2021-07-28.

[9] *See* SEC's "Comments on Climate Change Disclosures" webpage, *available at* https://www.sec.gov/comments/climate-disclosure/cll12.htm.

[10] *See* FASB Staff Educational Paper, *Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards* (Mar. 19, 2021), *available at* https://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176176379917.

[11] *See* IASB Staff Educational Paper, *Effects of Climate-related Matters on Financial Statements* (Nov. 2020), *available at* https://www.ifrs.org/content/dam/ifrs/supporting-implementation/documents/effects-of-climate-related-matters-on-financial-statements.pdf.

[12] *See* Division of Corporation Finance, "Sample Letter to Companies Regarding Climate Change Disclosures" (Sept 22, 2021) *available at* https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures.

[13] *See* IFRS Foundation, *Consultation Paper on Sustainability Reporting* (Sept. 30, 2020), *available at* https://www.ifrs.org/content/dam/ifrs/project/sustainability-reporting/consultation-paper-on-sustainability-reporting.pdf.

[14] *See* IFRS Foundation, Exposure Draft: *Proposed Targeted Amendments to the IFRS Foundation Constitution to Accommodate an International Sustainability Standards Board to Set IFRS Sustainability Standards* (Apr. 30, 2021), *available at* https://www.ifrs.org/content/dam/ifrs/project/sustainability-reporting/ed-2021-5-proposed-constitution-amendments-to-accommodate-sustainability-board.pdf.

[15] *See* IFRS Foundation, *IFRS Foundation announces International Sustainability Standards Board, consolidation with CDSB and VRF, and publication of prototype disclosure requirements* (Nov. 3, 2021), *available at* https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/.

[16] *See Holding Foreign Companies Accountable Act Disclosure*, SEC Release No. 34-93701 (Dec. 2, 2021), *available at* https://www.sec.gov/rules/final/2021/34-93701.pdf.

[17] *See Rule Governing Board Determinations Under the Holding Foreign Companies Accountable Act*, PCAOB Release No. 2021-004 (Sept. 22, 2021), *available at* https://pcaobus.org/about/rules-rulemaking/rulemaking-dockets/docket-048-proposed-rule-governing-board-determinations-under-holding-foreign-companies-accountable-act.

[18] *See* Office of Investor Education and Advocacy, Office of the Chief Accountant, and the Division of Corporation Finance, *Investor Bulletin: U.S.-Listed Companies Operating Chinese Businesses Through a VIE Structure* (Sept. 20, 2021), *available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-95.

[19] *See Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation,* SEC Release No. 33-10998 (October 14, 2021), *available at* https://www.sec.gov/rules/proposed/2021/33-10998.pdf.

[20] *See* FASB Accounting Standards Codification Topic 250, *Accounting Changes and Error Corrections*.

[21] FASB Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting*, paragraph OB2 and International Accounting Standards Board ("IASB") *Conceptual Framework for Financial Reporting*, paragraph 1.2.

[22] *See* FASB's "Online Comment Letters – Project: 2021-004 Agenda Consultation" webpage, *available at* https://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=2021-004.

[23] *See* John Coates, Acting Director, Division of Corporation Finance, and Paul Munter, Acting Chief Accountant, *Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs")* (Apr. 12, 2021), *available at* https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs.

[24] *See* Paul Munter, Acting Chief Accountant, *Financial Reporting and Auditing Considerations of Companies Merging with SPACs* (Mar. 31, 2021), *available at* https://www.sec.gov/news/public-statement/munter-spac-20200331.

[25] *See* Staff Accounting Bulletin No. 120, which is codified in SAB Topic 14: *Share-Based Payment* and SAB Subtopic 5.T: *Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)*. A share-based payment award granted when a company is in possession of material nonpublic information to which the market is likely to react positively when the information is announced is sometimes referred to as being "spring-loaded."

[26] More information about how to initiate a dialogue with OCA, what to expect from the consultation process, and what information should be included in a consultation submission in order for OCA to most quickly address a company or auditor's question is available on OCA's webpage, *available at* https://www.sec.gov/page/communicating-oca.

[27] The terms "accountants" and "auditors" are used interchangeably throughout this statement.

[28] *See Qualifications of Accountants,* SEC Release No. 33-10876 (October 16, 2020), *available at* https://www.sec.gov/rules/final/2020/33-10876.pdf.

[29] *See* Paul Munter, Acting Chief Accountant, *The Importance of High-Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors* (October 26, 2021), *available at* https://www.sec.gov/news/speech/munter-audit-2021-10-26.

[30] *See supra,* at n. 26.

[31] *See* SEC Press Release: *SEC Appoints New Chairperson and Board Members to the Public Company Accounting Oversight Board* (Nov. 8, 2021), *available at* https://www.sec.gov/news/press-release/2021-228.

[32] I have the honor of serving as the co-chair of the Monitoring Group, along with Mr. Jean-Paul Servais, Chairman of the Financial Services and Market Authority (FSMA), Belgium. Members of the Monitoring Group are the Basel Committee on Banking Supervision, European Commission, Financial Stability Board, International Association of Insurance Supervisors, International Forum of Independent Audit Regulators, International Organization of Securities Commissions, and the World Bank Group. *See* IOSCO's "The Monitoring Group" webpage, *available at* https://www.iosco.org/about/?subsection=monitoring_group.

[33] *See* The Monitoring Group, *Monitoring Group publishes its Recommendations to Strengthen the International Audit and Ethics Standard-Setting System* (July 14, 2020), *available at* https://www.iosco.org/about/monitoring_group/pdf/2020-07-Monitoring-Group-Recommendations-to-Strengthen-the-International-Audit-and-Ethics-Standard-Setting-System.pdf.

[34] *See* The Monitoring Group, *Monitoring Group Welcomes the Appointment of Ms. Gabriela Figueiredo Dias as Next IESBA Chair* (Oct. 6, 2021), *available at* https://www.iosco.org/news/pdf/IOSCONEWS619.pdf.

[35] *See* Securities Exchange Act of 1934, Rules 13a-15(d) and 15d-15(d); *see also* Regulation S-K, Item 308(c).

[36] *See* Audit Analytics, *2020 Financial Restatements: A Twenty-Year Review* (November 2021), *available at* https://go.auditanalytics.com/2020-Restatements-Report.

[37] *See* Codification of Staff Accounting Bulletins, Topic 1.M and Topic 1.N, *available at* https://www.sec.gov/interps/account/sabcodet1.htm.

[38] *See supra,* at n. 29.

[39] *See* 17 CFR 210.2-01(e)(3); *see also* paragraphs .09-.10 of PCAOB Quality Control Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, *available at* https://pcaobus.org/oversight/standards/qc-standards/details/QC20.

[40] The Sarbanes-Oxley Act mandates that audit committees be directly responsible for the oversight of the engagement of the company's independent auditor. *See* Section 10A(m) of the Securities Exchange Act of 1934 [15 USC 78j-1(m)].

[41] *See supra,* at n.28.

[42] *See supra,* at n. 29.

[43] *Id.*

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U.S. Securities and Exchange Commission, Paul Munter, Acting Chief Accountant, Office of the Chief Accountant, Public Statement, The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors (October 26, 2021)

Statement

The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors

Paul Munter
Acting Chief Accountant

Oct. 26, 2021

Introduction[1]

As we mark the upcoming twentieth anniversary of the enactment of the Sarbanes-Oxley Act of 2002 ("SOX"),[2] it is critical for all gatekeepers in the financial reporting ecosystem (auditors, management, and their audit committees) to maintain constant vigilance in the faithful implementation of the requirements of SOX by fulfilling their shared responsibilities to continue to produce high quality financial disclosures that are decision-useful to investors and maintain the public trust in our capital markets. An integral part of the faithful implementation of SOX is for audit firms to remain independent of their audit clients and for audit committees to take ownership of their oversight responsibilities with respect to the independent auditor.

While all gatekeeper roles in producing high quality financial disclosures are critical, it is undisputed that assurance provided by *independent* public accountants improves the quality of financial disclosures and, in turn, such assurance is a critical component of our capital markets.[3] Academic studies demonstrate that assurance provided by an independent auditor reduces the risk that an entity provides materially inaccurate information to external parties, including investors, by facilitating the dissemination of transparent and reliable financial information.[4] Research also shows that an independent, high quality audit improves the credibility of financial statements reducing risk to investors, thereby lowering the cost of debt[5] and the cost of equity[6] for the company.[7] Additionally, companies often benefit in other ways from the services of an independent auditor. In a recent survey, 77% of public company respondents stated that their independent auditor provided important insights about the company.[8]

Because of these benefits, historically even absent requirements for audited financials, many publicly-traded companies voluntarily released audited financial statements.[9] Similarly, external stakeholders for many other types of entities also require assurance over financial information because of the desire for increased confidence in the reliability and quality of the information. Research shows, similar to public companies, U.S. private companies that voluntarily release audited financial statements experience lower costs of debt than unaudited companies.[10] Apart from debt-related benefits, an audit may also help a private company prevent fraud[11] and aid in the evaluation of management.[12]

Notwithstanding the importance of assurance to all stakeholders, not all audits are created equal. In order for an audit to effectively protect investors, an objective, impartial, and skilled professional must perform the audit in accordance with an appropriate framework. The U.S. capital markets' disclosure regime is designed to promote high quality audits through the adherence of accountants to rigorous independence, quality control, and auditing standards performed under the oversight of an effective audit committee and subject to Public Company Accounting Oversight Board ("PCAOB") inspections.[13] The PCAOB's inspections program has successfully led to significant improvements in audit quality since it was first created by SOX nearly twenty years ago.[14]

The Importance of Auditor Independence

The independence of the auditor, in both fact and appearance, is foundational to the credibility of the financial statements.[15] While sourcing a high quality independent auditor is a key responsibility of the audit committee,[16] compliance with auditor independence rules is a shared responsibility of the issuer, its audit committee, and the auditor.

As we near the twentieth anniversary of SOX, it is critical for all gatekeepers to continue to vigilantly maintain the independence of auditors, in both fact and appearance. In this regard, auditors and audit clients must carefully consider the scope of their audit and any permissible non-audit engagements that have been pre-approved by the audit committee to guard against impairments of independence. As part of this responsibility, all gatekeepers in the financial reporting ecosystem should be especially mindful of the nature and the scope of any other services provided by the independent auditor. For instance, an auditor that provides extensive non-audit services to an entity that has an active mergers and acquisitions business model must continually monitor the impacts of all such transactions, and potential transactions, on its audit engagements to ensure that the auditor remains, in fact and appearance, independent of all of its audit clients.

Responsibility of Audit Committees and Management

We continue to encourage audit committees to consider the sufficiency of the auditor's and the issuer's monitoring processes, including those that address corporate changes or other events that potentially affect auditor independence.[17] This is particularly relevant in the current environment as companies seek to access public markets through new and innovative transactions, and audit firms continue to expand business relationships and non-audit services.

Management, the audit committee and the independent auditor should proactively seek to inform themselves of any potential impact to auditor independence, in fact and appearance, as companies negotiate potential transactions with third parties. This requires all parties to potential transactions to understand the filings that could be required by such transactions, the existing auditors' relationship with counterparties, and the potential impact of transactions and the auditor's relationships with the counterparty on the existing auditor's ability to continue to comply with the Commission's auditor independence rule applicable to such filings. This proactive monitoring requires management, the audit committee, and the independent auditor to each consider the potential effects of the auditor's existing business and service relationships with other companies on the auditor's ability to remain independent of the issuer if a contemplated transaction is consummated.

For example, it is important to understand what business relationships exist, including non-audit service relationships, between the audit firm and other entities that will, or in the future could, require an audit, become the existing audit entity's affiliates, or result in other companies that have significant influence over the entity.[18] Given the importance of independence as it relates to the audit of financial statements, these relationships and services and their implications to auditor independence should be carefully considered when management is negotiating the timing and substance of a transaction with third parties.

Responsibility of Audit Firms

Audit firms should carefully consider the impact of business relationships and non-audit services on existing and prospective audit relationships. Entering into significant, multi-year non-audit service contracts or business relationship arrangements with non-audit clients can impact the auditor's ability to remain independent of its existing audit clients in certain future circumstances. For example, prohibited business or service arrangements can be independence-impairing for the audit firm if an existing audit client merges with, acquires or sells a significant equity position to the non-audit client. Audit firms' risk management processes should use a firm-wide perspective to understanding the potential future consequences of such arrangements on their ability to remain independent of their existing audit clients. Ultimately, because an audit client is required to retain an independent auditor, audit firms should always consider the potential impacts of all their business relationships on their audit clients.

General Standard of Independence

Audit committees, issuers, and audit firms need to understand not only the specifically prohibited services and relationships, but also the application of the general standard of independence to all applicable reporting periods.[19]

The text of Rule 2-01(b) together with the four guiding principles laid out in the Introductory Text of Rule 2-01 serve as a framework to be applied when considering matters that are not directly addressed in other parts of Rule 2-01. The guiding principles refer to whether a relationship or a provision of a service:

- Creates a mutual or conflicting interest between the accountant and the audit client;
- Places the accountant in the position of auditing his or her own work;
- Results in the accountant acting as management or an employee of the audit client; or

- Places the accountant in a position of being an advocate for the audit client.[20]

We believe it would be a high hurdle to reach a conclusion that the accountant could remain objective and impartial when an auditor has provided services in any of the periods included in the filing that is contrary to any one of these guiding principles.

Importance of Audit Committee Oversight of the Independent Auditor

Audit committees play a vital role in the financial reporting systems of public companies through their oversight of financial reporting, including internal controls over financial reporting, and over the external, independent audit process.[21] Effective oversight by strong, active, knowledgeable and independent audit committees significantly furthers the collective goal of providing high quality, reliable financial information to investors.

An effective audit committee enhances the accountant's independence by, among other things, providing a forum apart from management where the accountants may discuss their concerns.[22] It facilitates communications among the board of directors, management, internal auditors and independent auditors. An effective audit committee also enhances auditor independence from management by exercising its responsibilities in appointing, compensating and overseeing the work of the independent auditors. Because audit committees have financial reporting and audit oversight authority and responsibility, they also are instrumental in setting the tone at the top for the quality of the issuer's financial reporting to investors. In selecting, retaining, and evaluating the independent auditor, the audit committee always should be focused, in the first instance, on audit quality.

Closing

Investors benefit to the extent that they have access to high quality financial information when making capital allocation decisions. The independent audit overseen by an active and effective audit committee is a critical step in providing that information to the capital markets. OCA staff continue to emphasize the importance of auditor independence in contributing to the credibility of audited financial statements. The staff also recognize the important role the regulatory framework plays in promoting audit quality. When the gatekeepers in the financial reporting ecosystem work together to promote trust and transparency in the quality of information reported for the benefit of investors, our public markets benefit as well.

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[1] This statement represents the views of the staff of the Office of the Chief Accountant ("OCA"). It is not a rule, regulation, or statement of the Securities and Exchange Commission ("SEC" or the "Commission"). The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. "Our" and "we" are used throughout this statement to refer to OCA staff.

[2] *See* Sarbanes-Oxley Act of 2002, 15 U.S.C. 7211, *Pub. L. 107-204. 750 Stat. 116. 30 July 2002*, available at https://www.congress.gov/bill/107th-congress/house-bill/3763/text.

[3] The terms "accountants" and "auditors" are used interchangeably throughout this statement.

[4] Mark Defond & Jieying Zhang, *A Review of Archival Auditing Research*, Journal of Accounting and Economics, 58, 275–326 (2014).

[5] Jeffrey A. Pittman & Steve Fortin, *Auditor Choice and the Cost of Debt Capital for Newly Public Firms*, Journal of Accounting and Economics, 37, 113–136 (2004).

[6] W. Robert Knechel, Gopal V. Krishnan, Mikhail Pevzner, Lori B. Shefchik &Uma K. Velury, *Audit Quality: Insights from the Academic Literature*, Auditing: A Journal of Practice and Theory, 32, 385–421 (2013).

[7] Risk determines an entity's costs of raising capital from investors. *See* Christine A. Botosan, *Disclosure Level and the Cost of Equity Capital*, The Accounting Review, 72, 323–349 (1997).

[8] *11th Annual Public Company Audit Fee Study, Financial Education & Research Foundation* (February 25, 2021), *available at* https://www.financialexecutives.org/Research/Publications/2021/11th-Annual-Public-Company-Audit-Fee-Study.aspx.

[9] S. A. Zeff, *How the U.S. Accounting Profession Got Where It Is Today: Part I*, Accounting Horizons 17, no. 3 (2003): 189–205.

[10] David W. Blackwell, Thomas R. Noland, & Drew B. Winters, *The Value of Auditor Assurance: Evidence from Loan Pricing*, Journal of Accounting Research, 36, 57–70 (1998). Michael Minnis & Nemit Shroff, *Why regulate private firm disclosure and auditing?* Accounting and Business Research, 47, 473–502 (2017).

[11] Gavin Cassar, *Discussion of the Value of Financial Statement Verification in Debt Financing: Evidence from U.S. Firms,* Journal of Accounting Research, 49, 507–528 (2011).

[12] Ann Vanstraelen & Caren Schelleman, *Auditing private companies: What do we know?* Accounting and Business Research, 47, 565–584 (2017).

[13] *See* U.S. Department of Treasury, Final Report of the Advisory Committee on the Auditing Profession D:2 (2008), https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf and Phillip T. Lamoreaux, *Does PCAOB Inspection Access Improve Audit Quality? An Examination of Foreign Firms Listed in the United States,* 61 J. Account. Econ.

[14] *See* Phillip T. Lamoreaux, *Does PCAOB inspection access improve audit quality? An examination of foreign firms listed in the United States*, 61 J. Acct. Econ. 313 (2016), https://reader.elsevier.com/reader/sd/pii/S0165410116000161?token=CDE756302B19F26FA11DB98DD24F6F6E1D3068762AD8EB3ED9DE9C954CDE6F011D1DF9761860E0711F3B5A329C5EE7C3 ("The positive effect of PCAOB inspection access on audit quality is observed in jurisdictions with, and without, a local audit regulator. Overall, the results are consistent with PCAOB inspection access being positively associated with audit quality"); *see also* Phillip T. Lamoreaux et al., *Audit Regulation and The Cost of Equity Capital: Evidence From the PCAOB's International Inspection Regime*, Contemp. Acct. Res. (2020), https://onlinelibrary.wiley.com/doi/epdf/10.1111/1911-3846.12599 (finding "that foreign SEC registrants with auditors from countries that allow PCAOB inspections enjoy a lower cost of capital, relative to foreign SEC registrants with auditors from countries that prohibit inspections").

[15] *See* SEC Release No. 33-7919, *Revision of the Commission's Auditor Independence Requirements* (November 21, 2000).

[16] The Sarbanes-Oxley Act requires that audit committees be directly responsible for the oversight of the engagement of the company's independent auditor. *See* Section 10A(m) of the Exchange Act [15 USC 78j-1(m)].

[17] *See* discussion of monitoring activities in COSO, *Internal Control – Integrated Framework*, 2013, available at www.coso.org.

[18] *See* 17 CFR 210.2-01(c)(3).

[19] The Commission adopted amendments to the independence requirements in Rule 2-01 of Regulation S-X (the "Rule") in October 2020, including amending the definition of the "audit and professional engagement period." See *SEC Updates Auditor Independence Rules*, Release No. 2020-261 (October 16, 2020).

[20] *See* Introductory Text to 17 CFR 210.2-01.

[21] *See* SEC Release No. 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence* (January 28, 2003).

[22] *Id.*

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U.S. Securities and Exchange Commission,
Division of Corporation Finance,
Staff Accounting Bulletin No. 121,
17 CFR Part 211, Release No. SAB 121
(April 11, 2022)

Staff Accounting Bulletin No. 121

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 211

[Release No. SAB 121]

Staff Accounting Bulletin No. 121

AGENCY: Securities and Exchange Commission.

ACTION: Publication of Staff Accounting Bulletin.

SUMMARY: This staff accounting bulletin expresses the views of the staff regarding the accounting for obligations to safeguard crypto-assets an entity holds for platform users.

EFFECTIVE DATE: April 11, 2022

FOR FURTHER INFORMATION CONTACT: The Office of the Chief Accountant at (202) 551-5300, or the Division of Corporation Finance's Office of the Chief Accountant, at (202) 551-3400, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

The statements in staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent staff interpretations and practices followed by the staff in the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws.

Dated:

Vanessa Countryman
Secretary

March 31, 2022

PART 211 — [AMENDED]

Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended as follows:

PART 211—INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS

1. The authority citation for 17 CFR 211 continues to read as follows: Authority: 15 U.S.C. 77g, 15 U.S.C. 77s(a), 15 U.S.C. 77aa(25) and (26), 15 U.S.C. 78c(b), 15 U.S.C. 78l(b), 15 U.S.C. 78m(b), 15 U.S.C. 80a-8, 15 U.S.C. 80a-29(e), 15 U.S.C. 80a-30, and 15 U.S.C. 80a-37(a).
2. Amend the table in subpart B by adding an entry for Staff Accounting Bulletin No. 121 at the end of the table to read as follows:

Subpart B—Staff Accounting Bulletins

Subject	Publication of Staff Accounting Bulletin No. 121
Release No.	SAB121
Date	[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]
Fed. Reg. Vol. and page	[INSERT FEDERAL REGISTER CITATION]

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Note: The text of Staff Accounting Bulletin No. 121 will not appear in the Code of Federal Regulations.

Staff Accounting Bulletin No. 121

The staff hereby adds Section FF to Topic 5 of the Staff Accounting Bulletin Series. This staff accounting bulletin ("SAB") adds interpretive guidance for entities to consider when they have obligations to safeguard crypto-assets held for their platform users. This SAB is applicable to entities that file reports pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 ("Exchange Act") and entities that have submitted or filed a registration statement under the Securities Act of 1933 ("Securities Act") or the Exchange Act that is not yet effective. The SAB is also applicable to entities submitting or filing an offering statement or post-qualification amendment thereto under Regulation A, entities subject to the periodic and the current reporting requirements of Regulation A, and private operating companies whose financial statements are included in filings with the SEC in connection with a business combination involving a shell company, including a special purpose acquisition company. Accordingly, the staff hereby amends the Staff Accounting Bulletin Series as follows:

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TOPIC 5: Miscellaneous Accounting

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The interpretations in this SAB express views of the staff regarding the accounting for entities that have obligations to safeguard crypto-assets held for their platform users.[1] In recent years, the staff has observed an increase in the number of entities that provide platform users with the ability to transact in crypto-assets. In connection with these services, these entities and/or their agents may safeguard the platform user's crypto-asset(s) and also maintain the cryptographic key information necessary to access the crypto-asset. The obligations associated with these arrangements involve unique risks and uncertainties not present in arrangements to safeguard assets that are not crypto-assets, including technological, legal, and regulatory risks and uncertainties. Specifically:

- **Technological risks** – there are risks with respect to both safeguarding of assets and rapidly-changing crypto-assets in the market that are not present with other arrangements to safeguard assets for third parties;
- **Legal risks** – due to the unique characteristics of the assets and the lack of legal precedent, there are significant legal questions surrounding how such arrangements would be treated in a court proceeding arising from an adverse event (e.g., fraud, loss, theft, or bankruptcy); and
- **Regulatory risks** – as compared to many common arrangements to safeguard assets for third parties, there are significantly fewer regulatory requirements for holding crypto-assets for platform users or entities may not be complying with regulatory requirements that do apply, which results in increased risks to investors in these entities.

These risks can have a significant impact on the entity's operations and financial condition. The staff believes that the recognition, measurement, and disclosure guidance in this SAB will enhance the information received by investors and other users of financial statements about these risks, thereby assisting them in making investment and other capital allocation decisions.

FF. Accounting for Obligations to Safeguard Crypto-Assets an Entity Holds for its Platform Users

Facts: Entity A's[2] business includes operating a platform that allows its users to transact in crypto-assets.[3] Entity A also provides a service where it will safeguard the platform users' crypto-assets,[4] including maintaining the cryptographic key information[5] necessary to access the crypto-assets. Entity A also maintains internal recordkeeping of the amount of crypto-assets held for the benefit of each platform user. Entity A secures these crypto-assets and protects them from loss or theft, and any failure to do so exposes Entity A to significant risks, including a risk of financial loss. The platform users have the right to request that Entity A transact in the crypto-asset on the user's behalf (e.g., to sell the crypto-asset and provide the user with the fiat currency (cash) proceeds associated with the sale) or to transfer the crypto-asset to a digital wallet for which Entity A does not maintain the cryptographic key information. However, execution and settlement of transactions involving the platform users' crypto-assets may depend on actions taken by Entity A.

Question 1: How should Entity A account for its obligations to safeguard crypto-assets held for platform users?

Interpretive Response: The ability of Entity A's platform users to obtain future benefits from crypto-assets in digital wallets where Entity A holds the cryptographic key information is dependent on the actions of Entity A to safeguard the assets. Those actions include securing the crypto-assets and the associated cryptographic key information and protecting them from loss, theft, or other misuse. The technological mechanisms supporting how crypto-assets are issued, held, or transferred, as well as legal uncertainties regarding holding crypto-assets for others, create significant increased risks to Entity A, including an increased risk of financial loss.[6] Accordingly, as long as Entity A is responsible for safeguarding the crypto-assets held for its platform users, including maintaining the cryptographic key information necessary to access the crypto-assets, the staff believes that Entity A should present a liability on its balance sheet to reflect its obligation to safeguard the crypto-assets held for its platform users.

As Entity A's loss exposure is based on the significant risks associated with safeguarding the crypto-assets held for its platform users, the staff believes it would be appropriate to measure this safeguarding liability at initial recognition and each reporting date at the fair value[7] of the crypto-assets that Entity A is responsible for holding for its platform users. The staff also believes it would be appropriate for Entity A to recognize an asset[8] at the same time that it recognizes the safeguarding liability, measured at initial recognition and each reporting date at the fair value of the crypto-assets held for its platform users.[9]

Question 2: Assume the same facts as Question 1. What disclosures would the staff expect Entity A to provide regarding its safeguarding obligations for crypto-assets held for its platform users?

Interpretive Response: In light of the significant risks and uncertainties associated with safeguarding crypto-assets, including the risks of loss associated with holding the cryptographic key information necessary to secure and transact in the crypto-asset, the staff believes the notes to the financial statements should include clear disclosure of the nature and amount of crypto-assets that Entity A is responsible for holding for its platform users, with separate disclosure for each significant crypto-asset, and the vulnerabilities Entity A has due to any concentration in such activities.[10] In addition, because the crypto-asset safeguarding liabilities and the corresponding assets are measured at the fair value of the crypto-assets held for its platform users, the entity would be required to include disclosures regarding fair value measurements.[11] The accounting for the liabilities and corresponding assets should be described in the footnotes to the financial statements.[12] In providing these disclosures, Entity A should consider disclosure about who (e.g., the company, its agent, or another third party) holds the cryptographic key information, maintains the internal recordkeeping of those assets, and is obligated to secure the assets and protect them from loss or theft.

Disclosures regarding the significant risks and uncertainties associated with the entity holding crypto-assets for its platform users may also be required outside the financial statements under existing Commission rules, such as in the description of business, risk factors, or management's discussion and analysis of financial condition and results of operation.[13] For example, to the extent it is material, Entity A may need to provide disclosure describing the types of loss or additional obligations that could occur, including customer or user discontinuation or reduction of use of services, litigation, reputational harm, and regulatory enforcement actions and additional restrictions. A discussion of the analysis of the legal ownership of the crypto-assets held for platform users, including whether they would be available to satisfy general creditor claims in the event of a bankruptcy should be considered. Further, Entity A may need to provide disclosure of the potential impact that the destruction, loss, theft, or compromise or unavailability of the cryptographic key information would have to the ongoing business, financial condition, operating results, and cash flows of the entity. As part of this disclosure, Entity A should also consider including, to the extent material, information about risk-mitigation steps the entity has put in place (e.g., insurance coverage directly related to the crypto-assets held for platform users).

Question 3: How and when should Company A initially apply the guidance in this Topic in its financial statements?

Interpretive Response: The staff would expect an entity that files reports pursuant to Section 13(a) or Section 15(d) of the Exchange Act, or an entity required to file periodic and current reports pursuant to Rule 257(b) of Regulation A, to apply the guidance in Topic 5.FF no later than its financial statements covering the first interim or annual period ending after June 15, 2022, with retrospective application as of the beginning of the fiscal year to which the interim or annual period relates.

The staff expects all other entities, including but not limited to entities conducting an initial registration of securities under the Securities Act or Exchange Act, entities conducting an offering of securities under Regulation A, and private operating companies entering into a business combination transaction with a shell company, including a special purpose acquisition company, to apply the guidance in Topic 5.FF beginning with their next submission or filing with the SEC (e.g., the initial or next amendment of the registration statement, proxy statement, or Form 1-A), with retrospective application, at a minimum, as of the beginning of the most recent annual period ending before June 15, 2022, provided the filing also includes a subsequent interim period that also reflects application of this guidance.[14] If the filing does not include a subsequent interim period that also reflects application of this guidance, then the staff expects it to be applied retrospectively to the beginning of the two most recent annual periods ending before June 15, 2022.

For all entities, in the financial statements that reflect the initial application of this guidance, the effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of the annual period specified above. Entities should include clear disclosure of the effects of the initial application of this guidance.[15]

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[1] This SAB expresses no view with respect to any other questions that these activities may raise for any of the entities involved, including the applicability of the registration or other provisions of the federal securities laws or any other federal, state, or foreign laws.

[2] References throughout this SAB to "Entity A" are inclusive of the entity as well as any agent acting on its behalf in safeguarding the platform users' crypto-assets.

[3] For purposes of this SAB, the term "crypto-asset" refers to a digital asset that is issued and/or transferred using distributed ledger or blockchain technology using cryptographic techniques.

[4] The service may be provided by Entity A or by an agent acting on Entity A's behalf.

[5] The guidance in this SAB is applicable regardless of whether the cryptographic key remains in the name of the platform user or is in the name of the Entity.

[6] *See generally* Report of the Attorney General's Cyber Digital Task Force: Cryptocurrency Enforcement Framework (Oct. 2020), at 15-16, available at https://www.justice.gov/ag/page/file/1326061/download.

[7] For U.S. generally accepted accounting principles ("U.S. GAAP"), refer to glossary definition provided in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 820. For International Financial Reporting Standards ("IFRS"), refer to glossary definition provided in IFRS 13.

[8] The asset recognized is similar in nature to an indemnification asset as described in FASB ASC 805 and IFRS 3. The measurement of the asset is on the same basis as the crypto-asset safeguarding liability assumed by the entity. The asset recognized by the entity is separate and distinct from the crypto-asset itself that has been transferred to and then held for the platform user.

[9] Similar to the guidance in FASB ASC 805 and IFRS 3, Entity A would need to evaluate whether any potential loss events, such as theft, impact the measurement of the asset.

[10] For U.S. GAAP, *see* FASB ASC 275-10-50. For IFRS, *see* IAS 1.

[11] For U.S. GAAP, *see* FASB ASC 820. For IFRS, *see* IFRS 13.

[12] For U.S. GAAP, *see* FASB ASC 235-10-50. For IFRS, *see* IAS 1.

[13] *See*, *e.g.*, Item 101 of Regulation S-K; Item 105 of Regulation S-K; Item 303 of Regulation S-K.

[14] For example, a calendar year-end company that submits a registration statement in January 2023 including financial statements as of and for the fiscal year ending December 31, 2021 and as of and for the nine months ended September 30, 2022 would apply the SAB to those periods.

[15] For U.S. GAAP, *see* FASB ASC 250-10-50-1 through 50-3; for IFRS, *see* IAS 8. *See also, e.g.,* Item 302 of Regulation S-K and PCAOB Auditing Standard 2820 (par. 8).

Modified: April 8, 2022

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U.S. Securities and Exchange Commission, Division of Corporation Finance Dear Issuer Letters, Sample Letter to Companies Regarding Disclosures Pertaining to Russia's Invasion of Ukraine and Related Supply Chain Issues (Modified May 3, 2022)

Sample Letter to Companies Regarding Disclosures Pertaining to Russia's Invasion of Ukraine and Related Supply Chain Issues [1]

Companies may have disclosure obligations under the federal securities laws related to the direct or indirect impact that Russia's invasion of Ukraine and the international response have had or may have on their business. To satisfy these obligations, the Division of Corporation Finance (the "Division") believes that companies should provide detailed disclosure, to the extent material or otherwise required, regarding (1) direct or indirect exposure to Russia, Belarus, or Ukraine through their operations, employee base, investments in Russia, Belarus, or Ukraine, securities traded in Russia, sanctions against Russian or Belarusian individuals or entities, or legal or regulatory uncertainty associated with operating in or exiting Russia or Belarus, (2) direct or indirect reliance on goods or services sourced in Russia or Ukraine or, in some cases, in countries supportive of Russia, (3) actual or potential disruptions in the company's supply chain, or (4) business relationships, connections to, or assets in, Russia, Belarus, or Ukraine. The financial statements may also need to reflect and disclose the impairment of assets, changes in inventory valuation, deferred tax asset valuation allowance, disposal or exiting of a business, de-consolidation, changes in exchange rates, and changes in contracts with customers or the ability to collect contract considerations. In addition, since Russia's invasion of Ukraine, many companies have experienced heightened cybersecurity risks, increased or ongoing supply chain challenges, and volatility related to the trading prices of commodities regardless of whether they have operations in Russia, Belarus, or Ukraine that warrant disclosure.

Companies also should consider how these matters affect management's evaluation of disclosure controls and procedures, management's assessment of the effectiveness of internal control over financial reporting, and the role of the board of directors in risk oversight of any action or inaction related to Russia's invasion of Ukraine, including consideration of whether to continue or to halt operations or investments in Russia and/or Belarus.

The Division selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 to monitor and enhance compliance with applicable disclosure requirements. The following illustrative letter contains sample comments that the Division may issue to companies based on their specific facts and circumstances. The sample comments do not constitute an exhaustive list of the issues that companies should consider. As always, companies should evaluate whether they have experienced or been impacted by matters characterized as potential risks and, if so, update disclosures accordingly. Any comments issued would take into consideration the disclosure that a company has provided in Commission filings or otherwise made publicly available. The Division encourages companies to contact the industry office responsible for the company's filings with any questions regarding the company's proposed disclosure on these topics.

May 2022

Name
ABC Corporation
Address

Dear Issuer:

We have reviewed your filing and have the following comments. Please revise or update your disclosure in response to our comments.

General

1. [You refer to your business in [Russia/Belarus/Ukraine]] OR [We note that a material portion of your operations or those of companies with which you do business is conducted through facilities located in [Russia/Belarus/Ukraine]]. Please describe the direct or indirect impact of Russia's invasion of Ukraine on your business. In addition, please also consider any impact:
    - resulting from sanctions, limitations on obtaining relevant government approvals, currency exchange limitations, or export or capital controls, including the impact of any risks that may impede your ability to sell assets located in Russia, Belarus, or Ukraine, including due to sanctions affecting potential purchasers;
    - resulting from the reaction of your investors, employees, customers, and/or other stakeholders to any action or inaction arising from or relating to the invasion, including the payment of taxes to the Russian Federation; and
    - that may result if Russia or another government nationalizes your assets or operations in Russia, Belarus, or Ukraine.

    If the impact is not material, please explain why.

2. Please describe the extent and nature of the role of the board of directors in overseeing risks related to Russia's invasion of Ukraine. This could include, but is not limited to, risks related to cybersecurity, sanctions, employees based in affected regions, and supply chain/suppliers/service providers in affected regions as well as risks connected with ongoing or halted operations or investments in affected regions.

Risks Related to Cybersecurity

3. To the extent material, disclose any new or heightened risk of potential cyberattacks by state actors or others since Russia's invasion of Ukraine and whether you have taken actions to mitigate such potential risks.

Management's Discussion and Analysis of Financial Condition and Results of Operations

4. Please disclose any known trends or uncertainties that have had or are reasonably likely to have a material impact on your cash flows, liquidity, capital resources, cash requirements, financial position, or results of operations arising from, related to, or caused by the global disruption from, Russia's invasion of Ukraine. Trends or uncertainties may include impairments of financial assets or long-lived assets; declines in the value of inventory, investments, or recoverability of deferred tax assets; the collectability of consideration related to contracts with customers; and modification of contracts with customers.
5. Please enhance your critical accounting estimate disclosures related to [impairment of assets, valuation of inventory, allowance for bad debt, deferred tax asset valuation allowance, or revenue recognition], as applicable, with both qualitative and quantitative information, to the extent the information is material and reasonably available, that addresses the following:
    - Why the critical accounting estimate is subject to uncertainty, including any new uncertainties related to the estimate, such as the asset, customer, or supplier is located in or reliant upon business(es) or operations in [Russia/Belarus/Ukraine];
    - The method used to develop the estimate and the significant assumptions underlying its calculation, such as discounted cash flow and the discount rate assumption;

- The degree to which the estimate and the underlying significant assumptions have changed over the current period or since the last assessment, including due to effects of changing prices, changes in exchange rates, changes in estimated cash flows due to loss of operations, etc.; and
- The sensitivity of the reported amount to the method and assumptions underlying its calculation. For example, if the cash flow estimates used were based on assumptions about the invasion or sanctions and those assumptions could significantly impact the estimate, then that should be disclosed along with how sensitive the estimate is to changes in those assumptions.

6. Disclose any material impact of import or export bans resulting from Russia's invasion of Ukraine on any products or commodities, including energy from Russia, used in your business, or sold by you. Disclose the current and anticipated impact on your business, taking into account the availability of materials, cost of needed materials, costs and risks associated with transportation in your business, and the impact on margins and on your customers.
7. Please disclose whether and how your business segments, products, lines of service, projects, or operations are materially impacted by supply chain disruptions, especially in light of Russia's invasion of Ukraine. For example, discuss whether you have or expect to:
    - suspend the production, purchase, sale, or maintenance of certain items;
    - experience higher costs due to constrained capacity or increased commodity prices or challenges sourcing materials [(e.g., nickel, palladium, neon, cobalt, iron, platinum or other raw material sourced from Russia, Belarus, or Ukraine)];
    - experience surges or declines in consumer demand for which you are unable to adequately adjust your supply;
    - be unable to supply products at competitive prices or at all due to export restrictions, sanctions, or the ongoing invasion; or
    - be exposed to supply chain risk in light of Russia's invasion of Ukraine and/or related geopolitical tension or have [sought][made or announced plans] to "de-globalize" your supply chain.

    Explain whether and how you have undertaken efforts to mitigate the impact and where possible quantify the impact to your business.

<u>Non-GAAP Measures</u>

8. We note your adjustment to add an estimate of lost revenue due to [Russia's invasion of Ukraine and/or supply chain disruptions]. Recognizing revenue that was not earned during the period presented results in the use of an individually tailored revenue recognition and measurement method which may not be in accordance with Rule 100(b) of Regulation G. Please remove these adjustments. Refer to Question 100.04 of the Division's C&DI for Non-GAAP Financial Measures.
9. We note your adjustment for certain expenses [such as compensation expense or bad debt expense] incurred related to your operations in Russia, Belarus, and/or Ukraine that appear to be normal and recurring to your business. Please tell us the nature of these expenses. Explain how you have considered Question 100.01 of the Division's C&DI for Non-GAAP Financial Measures and why you believe that the expenses excluded from your non-GAAP measures do not represent normal, recurring operating expenses.

<u>Disclosure Controls and Procedures</u>

10. Based on your disclosures, it appears that you may have had changes in or issues that arose impacting the effectiveness of your disclosure controls and procedures due to Russia's invasion of Ukraine [and/or supply chain disruptions]. Please tell us the impact of Russia's invasion of Ukraine on your design of disclosure controls and procedures and its impact on your conclusion of their effectiveness as of the end of the reporting period.

Internal Control Over Financial Reporting

11. Based on your disclosures, it appears that you may have had changes to your internal controls as a result of Russia's invasion of Ukraine [and/or supply chain disruptions]. Please disclose any changes in your internal control over financial reporting identified in connection with your evaluation that occurred during the last fiscal quarter (or your fourth fiscal quarter in the case of an annual report) that has materially affected or is reasonably likely to materially affect your internal controls over financial reporting. See Item 308(c) of Regulation S-K.

We remind you that the company and its management are responsible for the accuracy and adequacy of their disclosures, notwithstanding any review, comments, action or absence of action by the staff.

Sincerely,

Division of Corporation Finance

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[1] The statements in this guidance represent the views of the staff of the Division of Corporation Finance. This guidance is not a rule, regulation, or statement of the Securities and Exchange Commission (the "Commission"). The Commission has neither approved nor disapproved its content. This guidance, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

Modified: May 3, 2022

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U.S. Securities and Exchange Commission, Division of Corporation Finance Dear Issuer Letters, Sample Letter to Companies Regarding Climate Change Disclosures (Modified September 22, 2021)

Sample Letter to Companies Regarding Climate Change Disclosures[1]

The Commission has stated that a number of its disclosure rules may require disclosure related to climate change. [2] For example and depending on the particular facts and circumstances, information related to climate change-related risks and opportunities may be required in disclosures related to a company's description of business, legal proceedings, risk factors, and management's discussion and analysis of financial condition and results of operations. Disclosure matters discussed in the 2010 Climate Change Guidance include the following:

- the impact of pending or existing climate-change related legislation, regulations, and international accords;
- the indirect consequences of regulation or business trends; and
- the physical impacts of climate change.

Companies also must disclose, in addition to the information expressly required by Commission regulation, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."[3]

The Division of Corporation Finance selectively reviews filings made under the Securities Act and the Exchange Act to monitor and enhance compliance with applicable disclosure requirements. The following illustrative letter contains sample comments that the Division may issue to companies regarding their climate-related disclosure or the absence of such disclosure. The sample comments do not constitute an exhaustive list of the issues that companies should consider. Any comments issued would be appropriately tailored to the specific company and industry, and would take into consideration the disclosure that a company has provided in Commission filings.

September 2021

Name
ABC Corporation
Address

Dear Issuer:

We have reviewed your filing and have the following comments regarding compliance with the topics addressed in the Commission's 2010 Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (Feb. 2, 2010). In some of our comments, we may ask you to provide us with information so we may better understand your disclosure. Please respond to these comments by providing the requested information and/or revising or updating your disclosure as applicable. If you do not believe our comments apply to your facts and circumstances, please tell us why in your response.

<u>General</u>

1. We note that you provided more expansive disclosure in your corporate social responsibility report (CSR report) than you provided in your SEC filings. Please advise us what

consideration you gave to providing the same type of climate-related disclosure in your SEC filings as you provided in your CSR report.

Risk Factors

2. Disclose the material effects of transition risks related to climate change that may affect your business, financial condition, and results of operations, such as policy and regulatory changes that could impose operational and compliance burdens, market trends that may alter business opportunities, credit risks, or technological changes.
3. Disclose any material litigation risks related to climate change and explain the potential impact to the company.

Management's Discussion and Analysis of Financial Condition and Results of Operations

4. There have been significant developments in federal and state legislation and regulation and international accords regarding climate change that you have not discussed in your filing. Please revise your disclosure to identify material pending or existing climate change-related legislation, regulations, and international accords and describe any material effect on your business, financial condition, and results of operations.
5. Revise your disclosure to identify any material past and/or future capital expenditures for climate-related projects. If material, please quantify these expenditures.
6. To the extent material, discuss the indirect consequences of climate-related regulation or business trends, such as the following:
   - decreased demand for goods or services that produce significant greenhouse gas emissions or are related to carbon-based energy sources;
   - increased demand for goods that result in lower emissions than competing products;
   - increased competition to develop innovative new products that result in lower emissions;
   - increased demand for generation and transmission of energy from alternative energy sources; and
   - any anticipated reputational risks resulting from operations or products that produce material greenhouse gas emissions.
7. If material, discuss the physical effects of climate change on your operations and results. This disclosure may include the following:
   - severity of weather, such as floods, hurricanes, sea levels, arability of farmland, extreme fires, and water availability and quality;
   - quantification of material weather-related damages to your property or operations;
   - potential for indirect weather-related impacts that have affected or may affect your major customers or suppliers;
   - decreased agricultural production capacity in areas affected by drought or other weather-related changes; and
   - any weather-related impacts on the cost or availability of insurance.
8. Quantify any material increased compliance costs related to climate change.
9. If material, provide disclosure about your purchase or sale of carbon credits or offsets and any material effects on your business, financial condition, and results of operations.

We remind you that the company and its management are responsible for the accuracy and adequacy of their disclosures, notwithstanding any review, comments, action or absence of action by the staff.

Sincerely,

Division of Corporation Finance

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[1] The statements in this guidance represent the views of the staff of the Division of Corporation Finance. This guidance is not a rule, regulation, or statement of the Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its content. This guidance, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

[2] Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (Feb. 2, 2010) [75 FR 6290] (Feb. 8, 2010) ("2010 Climate Change Guidance").

[3] Rule 408 under the Securities Act of 1933 ("Securities Act") and Rule 12b-20 under the Securities Exchange Act of 1934 ("Exchange Act").

Modified: Sept. 22, 2021

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Press Release, SEC Announces Enforcement Results for FY 2021 (November 18, 2021)

Press Release

SEC Announces Enforcement Results for FY 2021

Agency Brought Significant Actions in Traditional and Emerging Areas; Whistleblower Program Surpassed $1 Billion in Awards

FOR IMMEDIATE RELEASE
2021-238

Washington D.C., Nov. 18, 2021 — The Securities and Exchange Commission today announced that it filed 434 new enforcement actions in fiscal year 2021, representing a 7 percent increase over the prior year. Seventy percent of these new or "stand-alone" actions involved at least one individual defendant or respondent. The new actions spanned the entire securities waterfront, including against emerging threats in the crypto and SPAC spaces. For example, the SEC charged a company for operating an unregistered online digital asset exchange, charged a crypto lending platform and top executives alleging a $2 billion fraud, and brought an action against a special purpose acquisition company, its merger target, top executives, and others for alleged misconduct in a SPAC transaction. The SEC's whistleblower program was critical to these efforts and had a record-breaking year.

The agency filed 697 total enforcement actions in fiscal year 2021, including the 434 new actions, 120 actions against issuers who were delinquent in making required filings with the SEC, and 143 "follow-on" administrative proceedings seeking bars against individuals based on criminal convictions, civil injunctions, or other orders. This represented a 3 percent decrease over the total actions filed in fiscal year 2020.

"The SEC's Enforcement Division is the cop on the beat for America's securities laws," said Chair Gary Gensler. "As these results show, we go after misconduct wherever we find it in the financial system, holding individuals and companies accountable, without fear or favor, across the $100-plus trillion capital markets we oversee."

"This year has seen a number of critically important and first-of-their-kind enforcement actions, as well as record-breaking achievements for our whistleblower program, which we expect will lead to even more successful actions in the future," said Gurbir S. Grewal, Director of the SEC's Division of Enforcement. "Undeterred by the challenges of the pandemic, the dedicated public servants in the Enforcement Division have continued to overcome obstacles to bring these cases that protect investors and promote market integrity."

In fiscal year 2021, which ended on Sept. 30, the SEC also obtained judgments and orders for nearly $2.4 billion in disgorgement and more than $1.4 billion in penalties, which represented a respective 33 percent decrease and 33 percent increase over amounts ordered in the prior fiscal year in these categories.

Fiscal year 2021 also was a record year for whistleblower awards, with the SEC awarding a total of $564 million to 108 whistleblowers. The whistleblower program also surpassed $1 billion in awards over the life of the program.

Overview of SEC Enforcement in Fiscal Year 2021

In fiscal year 2021, the SEC filed noteworthy enforcement actions across new areas, including a number of first-of-their-kind actions:

- Involving securities using decentralized finance, or “DeFi,” technology;
- Charging securities law violations on the “dark web”;
- Enforcing a key rule on the duties of municipal advisors;
- Involving Regulation Crowdfunding;
- Charging an alternative data provider with securities fraud;
- Involving failures to timely file and deliver Forms CRS; and
- Against an order and execution management system provider that facilitated electronic trading for failing to register as a broker-dealer.

In addition, the SEC filed impactful enforcement actions that spanned the securities markets, including the following matters:

- A case charging General Electric with violating the antifraud, reporting, disclosure controls, and accounting controls provisions of the securities laws;
- Actions charging Kraft-Heinz and two former executives with a years-long expense management scheme;
- A case against TIAA-CREF’s subsidiary for alleged violations in retirement rollover recommendations;
- An action against China-based Luckin Coffee for allegedly defrauding investors about its financial condition;
- A case charging Robinhood Financial with misleading customers about its compensation for routing customer orders;
- An action charging three media companies with illegal offerings of stock and digital assets;
- A litigated case charging AT&T and three investor relations executives with selectively providing information to Wall Street analysts;
- An auditor misconduct case against Ernst & Young and three partners;
- Insider trading cases against a global IT manager at a pharmaceutical company and an investment bank compliance analyst; and
- Cases charging entities for deficient cybersecurity procedures, cybersecurity disclosure controls failures, and misleading investors about a serious cyber breach.

Other examples of enforcement actions in key priority areas include:

Holding Individuals Accountable

- Charged corporate executives and other players, including the former CEO and Chairman of Wells Fargo and the former head of Wells Fargo’s Community Bank; the founder and former CEO of alternative fuel truck manufacturing company Nikola; the former CEO and CFO of WageWorks; and the former CEO and CFO of FTE Networks.
- Obtained bars from serving as public company officers or directors against numerous individuals, including: the CEO of Loci Inc. who was charged with misleading investors about the company’s digital asset securities business; the CEO of a human resources company charged with falsifying the company’s financial condition; an attorney and former president of a natural resources company charged with manipulative trading; and CEOs and other executives of various microcap companies.

Ensuring Gatekeepers Live Up to Their Obligations

- Suspended two former KPMG auditors for alleged improper professional conduct during the audit of the not-for-profit College of New Rochelle.
- Charged a CPA with failing to register his firm with the Public Company Accounting Oversight Board (PCAOB) and failures in auditing and reviewing the financial statements of a public company client.

- Charged an audit firm partner for allegedly engaging in improper professional conduct during audits of a public company client.
- Charged two attorneys – one of whom was previously disbarred – for their roles in an alleged scheme to fraudulently facilitate the sale of millions of shares of microcap securities to retail investors.
- Barred a securities lawyer from practicing or appearing before the SEC.

Rooting Out Misconduct in Crypto

- Charged entities and individuals with unregistered and/or fraudulent offerings of digital asset securities, including: fraud and unregistered offering charges against three individuals who founded and promoted digital asset companies; charges against an issuer and its founders for allegedly defrauding more than a thousand investors in an unregistered offering of digital asset securities; and charges against Ripple Labs and two of its executives alleging a $1.3 billion unregistered offering.
- Took action against other misconduct in the crypto market, including charging the operator of ICO listing website Coinschedule.com with unlawfully touting digital asset securities.

Policing Financial Fraud and Issuer Disclosure

- Brought a number of important actions against companies and executives, including: Under Armour; Sequential Brands Group; and SAExploration Holdings and four former executives.
- Rewarded cooperation and remediation by companies, including Gulfport Energy.
- Continued to use data analytics and other tools to uncover potential violations of the law, leading to charges against Healthcare Services Group in the Division's ongoing Earnings Per Share Initiative and charges against eight companies in an initiative focused on companies' notices of late filings of their quarterly or annual reports.
- Charged The Cheesecake Factory Incorporated with improper disclosures about the impact of the COVID-19 pandemic on its operations and financial condition.

Charging Improper Conduct by Investment Professionals

- Brought an action against UK-based investment adviser BlueCrest Capital Management for inadequate disclosures and other misstatements and omissions concerning its transfer of top traders to another fund, which will result in $170 million being returned to harmed investors.
- Charged investment advisers and their portfolio managers with misleading investors and others about their risk management practices over funds that lost more than $1 billion in two trading days.
- Charged a fund manager with fraudulently raising and misappropriating tens of millions of dollars in a private fund.
- Charged an unregistered investment adviser for allegedly defrauding a Puerto Rican municipality and misappropriating more than $7 million of taxpayer funds.
- Charged a rogue trader with causing millions of dollars of losses through unauthorized trading and bankrupting his broker-dealer firm.
- Charged a robo-adviser with breaching its fiduciary duties in connection with its investment of client assets into exchange-traded funds sponsored by its parent company.
- Charged an investment adviser for breaching its fiduciary duties in connection with its receipt of revenue sharing payments.

Protecting Market Integrity

- Charged S&P Dow Jones Indices for failures relating to a quality control feature of one of its volatility-related indices, which led S&P to publish and distribute stale index values during a period of unprecedented volatility.

- Charged former credit ratings agency Morningstar Credit Ratings with alleged disclosure and internal control violations in rating commercial mortgage-backed securities.
- Brought charges against UBS and other investment advisers and broker-dealers as part of the Division of Enforcement's Exchange-Traded Products Initiative, which utilizes trading data analytics to uncover potential violations of the securities laws.
- Charged a company, its principal, and its trader with causing broker-dealers to violate Reg SHO by mismarking trades and related issues.
- Charged a global securities pricing service with compliance deficiencies related to so-called single broker quotes.
- Charged a broker-dealer for failures related to filing Suspicious Activity Reports.

Cracking Down on Insider Trading and Market Manipulation

- Brought insider trading charges against numerous individuals, including:
  - A former biopharmaceutical company employee charged with insider trading in advance of his company's announcement that it would be acquired by pharmaceutical giant Pfizer Inc.
  - An insider trading ring that allegedly generated more than $3 million in profits by trading on confidential information about Netflix's subscriber growth.
  - A Silicon Valley insider trading ring charged with trading on confidential earnings information of two technology companies.
- Charged two individuals for alleged wash trading in the options of certain "meme stocks" in early 2021.
- Charged a quantitative analyst and a hedge fund trader for allegedly perpetrating front-running schemes, which were uncovered by the SEC's data analytics tools.
- Charged numerous individuals, including the chairman of a public company, for their roles in alleged long-running fraudulent schemes that generated hundreds of millions of dollars from unlawful stock sales and harmed retail investors in the U.S. and around the world.

Enforcing the Foreign Corrupt Practices Act

- Charged Goldman Sachs in connection with the 1Malaysia Development Berhad (1MDB) bribery scheme, resulting in the company paying more than $1 billion to settle the SEC's charges.
- Charged Deutsche Bank for internal control failures relating to its payments to third-party intermediaries that resulted in approximately $7 million in bribe payments or payments for unknown services.
- Charged WPP, the world's largest advertising group, with violating the anti-bribery, books and records, and internal accounting controls provisions of the FCPA, resulting in a more than $19 million settlement.
- Charged Brazilian meat producers with an extensive, multi-year bribery scheme, resulting in a nearly $27 million settlement to resolve the SEC's charges.

Guarding Against Public Finance Abuse

- Charged RBC Capital Markets and two individuals – the former head of municipal sales, trading, and syndication, and the former head of RBC's municipal syndicate desk – with unfair dealing in municipal bond offerings.
- Charged a broker dealer and its former CEO with unfair dealing in connection with the tender offer of municipal bonds.
- Charged a school district and its former chief financial officer with misleading investors who purchased $28 million in municipal bonds.

Pursuing Wrongdoing in Securities Offerings

- Charged an Israeli company and its former top executives with deceiving U.S. investors out of more than $100 million through fraudulent and unregistered sales of risky "binary option" securities.
- Charged two former executives of a subprime automobile finance company with misleading investors about the loans that backed their $100 million offering.
- Charged a company and two managing members with participating in a fraudulent, unregistered offering of securities in a purported "green" mining venture.
- Charged a top executive at two companies for allegedly defrauding investors by "scalping" (secretly selling stock while paying promoters to recommend retail investors buy the stock), misappropriating funds, and falsely promoting apps that he claimed would facilitate cryptocurrency transactions and help combat the coronavirus.
- Charged the co-founders of a San Francisco-based medical testing company for allegedly defrauding investors out of $60 million by falsely portraying the company as a successful start-up with a proven business model and strong prospects for future growth, and the former CEO of another Silicon Valley technology company for allegedly defrauding investors out of $80 million by falsely claiming strong and consistent growth.
- Brought actions against wrongdoers targeting affinity groups, including:
  - Charging a jewelry wholesaler with raising more than $69 million and operating a fraudulent Ponzi-like scheme targeting current and retired police officers and firefighters;
  - Charging a company and its CEO for an alleged $119 million securities fraud targeting members of the South Asian American community;
  - Charging a New Jersey resident with defrauding investors, most of whom were members of the Orthodox Jewish community; and
  - Charging a Florida payday loan company and its CEO with fraudulently raising at least $66 million from retain investors including members of the Venezuelan-American community.

Swiftly Acting to Protect Investors

- Obtained an asset freeze and other emergency relief in an enforcement action against a Los Angeles-based actor and his company in connection with an alleged $690 million Ponzi scheme.
- Obtained emergency relief in an action charging a New York-based real estate developer with fraudulently raising more than $229 million through EB-5 securities offerings.
- Filed an emergency action, and obtained a temporary restraining order and asset freeze against several defendants, in a case alleging a $110 million Ponzi scheme.
- Suspended trading in the securities of more than two dozen companies because of questions about increased trading activity and volatility connected to the winter's "memestock" trading.
- Took emergency action in numerous other cases, including:
  - to freeze assets in an alleged fraudulent scheme relating to a cryptocurrency trading fund;
  - to stop an alleged ongoing fraudulent offering by an investment adviser;
  - to freeze assets of an offshore fund and two related individuals;
  - to freeze assets of an investment professional and two investment firms engaged in an alleged "cherry-picking" scheme; and
  - to freeze assets of a trader who allegedly used social media to spread information about a defunct company while secretly profiting by selling his own holdings of the company's stock.

Achieving Success in Litigation

- Investment adviser World Tree Financial and co-owners Wesley Kyle Perkins and Priscilla Perkins were found liable for a fraudulent cherry-picking scheme and related misrepresentations.
- Investment adviser Richard Duncan was found liable for violating the anti-fraud provisions of the Investment Advisers Act for soliciting his clients' investments in an advance-fee scam.
- Final judgments were entered against investment adviser Westport Capital Markets and its owner, Chris McClure, ordering disgorgement and related interest of more than $820,000, and civil penalties of $500,000 against Westport and $200,000 against McClure. The final judgments follow a March 2020 jury verdict, as well as a prior grant of partial summary judgment, both in the SEC's favor.

Rewarding and Protecting Whistleblowers

- Gave the highest awards in the program's history, including a $114 million award to a whistleblower whose information and assistance led to the successful enforcement of an SEC action and related actions by another agency; and a $110 million award to another whistleblower who provided significant independent analysis that substantially advanced both the SEC's investigation and another agency's related investigation.
- Charged a broker-dealer with violating a whistleblower protection rule that prohibits taking any action to impede an individual from communicating directly with the SEC about a possible securities law violation.
- Charged a registered investment adviser with allegedly violating whistleblower protection laws by including language in termination and separation agreements that impeded individuals from coming forward to the SEC and by retaliating against a known whistleblower, along with charging that entity and others with running a Ponzi-like scheme that raised more than $1.7 billion from more than 17,000 retail investors.

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Related Materials

- Addendum: FY21 Enforcement Statistics

ADDENDUM TO
DIVISION OF ENFORCEMENT PRESS RELEASE
FISCAL YEAR 2021

Enforcement Summary Chart for FY 2021 by Primary Classification							
Primary Classification	Civil Actions	Standalone AP	Follow-On AP	Delinquent Filings	Total	% of Total Actions	% of Civil and Standalone APs
Broker Dealer	10 (23)	26 (32)	74 (77)	0 (0)	110 (132)	16%	8%
Delinquent Filings	0 (0)	0 (0)	0 (0)	120 (120)	120 (120)	17%	0%
Foreign Corrupt Practices Act	0 (0)	5 (8)	0 (0)	0 (0)	5 (8)	1%	1%
Insider Trading	19 (37)	9 (10)	0 (0)	0 (0)	28 (47)	4%	6%
Investment Advisers / Investment Companies	33 (85)	87 (108)	39 (40)	0 (0)	159 (233)	23%	28%
Issuer Reporting / Audit & Accounting	11 (26)	42 (61)	17 (17)	0 (0)	70 (104)	10%	12%
Market Manipulation	23 (71)	3 (6)	5 (5)	0 (0)	31 (82)	4%	6%
Miscellaneous	3 (3)	4 (5)	0 (0)	0 (0)	7 (8)	1%	2%
NRSRO	1 (1)	1 (1)	0 (0)	0 (0)	2 (2)	0%	0%
Public Finance Abuse	2 (3)	10 (12)	0 (0)	0 (0)	12 (15)	2%	3%
Securities Offering	123 (398)	19 (32)	8 (8)	0 (0)	150 (438)	22%	33%
SRO / Exchange	0 (0)	1 (1)	0 (0)	0 (0)	1 (1)	0%	0%
Transfer Agent	1 (2)	1 (1)	0 (0)	0 (0)	2 (3)	0%	0%
Total	226 (649)	208 (277)	143 (147)	120 (120)	697 (1,193)	100%	100%

Each action initiated has been included in only one category listed above, even though many actions involved multiple allegations and may fall under more than one category. The number of defendants and respondents is noted parenthetically.

A listing of the actions referenced in the table above is provided in the last section of this document.

Enforcement Actions Filed in Fiscal Years 2016 to 2021						
	FY 2021	FY 2020	FY 2019	FY 2018	FY 2017	FY 2016
Standalone Enforcement Actions	**434**	405	526	490	446	548
Follow-On Admin. Proceedings	**143**	180	210	210	196	195
Delinquent Filings	**120**	130	126	121	112	125
Total Actions	**697**	**715**	**862**	**821**	**754**	**868**

Standalone Enforcement Actions is a combined count of Civil Actions and Standalone APs.

Total Money Ordered (in millions)						
	FY 2021	FY 2020	FY 2019	FY 2018	FY 2017	FY 2016
Penalties	**$1,456**	$1,091	$1,101	$1,439	$832	$1,273
Disgorgement	**$2,396**	$3,589	$3,248	$2,506	$2,957	$2,809
Total	**$3,852**	**$4,680**	**$4,349**	**$3,945**	**$3,789**	**$4,083**

Money Distributed to Harmed Investors (in millions)					
FY 2021	**FY 2020**	**FY 2019**	**FY 2018**	**FY 2017**	**FY 2016**
$521	$602	$1,197	$794	$1,073	$140

FISCAL YEAR 2021 ENFORCEMENT CASES
LISTED BY PROGRAM AREA

Case Name	Type of Action	Release No.	Date Filed
BROKER-DEALER			
In the Matter of Alejandro Cortes	Follow-on Admin. Proc.	34-90069	10/01/20
In the Matter of Gary S. Wykle, a/k/a Gary S. Wyckel	Follow-on Admin. Proc.	34-90090	10/05/20
In the Matter of Anthony Goldstein	Follow-on Admin. Proc.	34-90097	10/06/20
In the Matter of Andrew Dale Ledbetter, Esq.	Follow-on Admin. Proc.	34-90238 & 34-90239	10/21/20
In the Matter of Christian J. Baquerizo	Follow-on Admin. Proc.	34-90237	10/21/20
In the Matter of Kevin Cardenas	Follow-on Admin. Proc.	34-90236	10/21/20
SEC v. Alex Duain Forester, et al.	Civil	LR-24952	10/26/20
In the Matter of Alan D. Seidel	Follow-on Admin. Proc.	34-90295	10/30/20
In the Matter of Conrad A. Coggeshall	Follow-on Admin. Proc.	34-90358	11/05/20
In the Matter of Salvatore Ciccone	Follow-on Admin. Proc.	34-90370	11/06/20
SEC v. Hughe Duwayne Graham, et al.	Civil	LR-24958	11/06/20
In the Matter of Joshua Stephens-Anselm	Follow-on Admin. Proc.	34-90374	11/09/20
In the Matter of Benjamin F. Edwards & Company, Inc.	Stand-alone Admin. Proc.	34-90413	11/13/20
In the Matter of American Portfolios Financial Services, Inc., et al.	Stand-alone Admin. Proc.	34-90411	11/13/20
In the Matter of Rajesh Taneja	Follow-on Admin. Proc.	34-90564	12/04/20
In the Matter of Ravi Iyer	Stand-alone Admin. Proc.	34-90628	12/10/20
SEC v. Karina Chairez	Civil	LR-24986	12/15/20
In the Matter of Robinhood Financial, LLC	Stand-alone Admin. Proc.	33-10906	12/17/20
In the Matter of Roger E. Dobrovodsky	Follow-on Admin. Proc.	34-90724	12/18/20
In the Matter of Robert Todd Seth	Follow-on Admin. Proc.	34-90725	12/18/20
In the Matter of John G. Wright, Jr.	Stand-alone Admin. Proc.	34-90727	12/18/20
In the Matter of Cormark Securities, Inc.	Stand-alone Admin. Proc.	34-90740	12/21/20
In the Matter of ITG Canada Corp., n/k/a Virtu ITG Canada Corp.	Stand-alone Admin. Proc.	34-90741	12/21/20
SEC v. Global Investment Strategy UK, Ltd., et al.	Civil	LR-24996	12/22/20
In the Matter of Larry Louis Matyas	Follow-on Admin. Proc.	34-90813	12/29/20
In the Matter of Christopher J. Ashby	Follow-on Admin. Proc.	34-90844	01/04/21
In the Matter of Scott W. Beynon	Follow-on Admin. Proc.	34-90845	01/04/21
In the Matter of Jordan S. Nelson	Follow-on Admin. Proc.	34-90843	01/04/21
In the Matter of Kerry L. Hoffman	Follow-on Admin. Proc.	34-90902	01/11/21
In the Matter of Thomas J. Robbins	Follow-on Admin. Proc.	34-90920	01/14/21
In the Matter of Daniel J. Merriman	Follow-on Admin. Proc.	34-90921	01/14/21
In the Matter of Richard Portillo, et al.	Follow-on Admin. Proc.	34-90950	01/19/21
In the Matter of Anthony Todd Johnson	Follow-on Admin. Proc.	34-91020	01/29/21
In the Matter of Green Bud Initiatives, LLC	Follow-on Admin. Proc.	34-91022	01/29/21
In the Matter of Jeremy Johnson	Follow-on Admin. Proc.	34-91021	01/29/21
In the Matter of Amogh Karney	Follow-on Admin. Proc.	34-91026	02/01/21
In the Matter of Lightspeed Trading, LLC	Stand-alone Admin. Proc.	33-10924	02/02/21
In the Matter of Anthony Killarney	Follow-on Admin. Proc.	34-91099	02/10/21
In the Matter of David Correia	Follow-on Admin. Proc.	34-91140	02/17/21
In the Matter of Craig A. Zabala	Follow-on Admin. Proc.	34-91201	02/24/21
In the Matter of Allan L. Lundervold	Follow-on Admin. Proc.	34-91209	02/25/21
In the Matter of Ross McLellan	Follow-on Admin. Proc.	34-91243	03/02/21
In the Matter of Kevin Graetz	Follow-on Admin. Proc.	34-91246	03/03/21
In the Matter of Jocelyn Murphy	Follow-on Admin. Proc.	34-91270	03/05/21
In the Matter of Minish "Joe" Hede	Follow-on Admin. Proc.	34-91289	03/10/21
In the Matter of Glen A. Stewart	Follow-on Admin. Proc.	34-91304	03/11/21

In the Matter of Michael Sean Murphy	Follow-on Admin. Proc.	34-91310	03/12/21
In the Matter of Ivan Ramos	Follow-on Admin. Proc.	34-91346	03/18/21
SEC v. Mintbroker International, Ltd., f/k/a Swiss America Securities Ltd. and d/b/a Suretrader, et al.	Civil	LR-25058	03/22/21
In the Matter of Andrew L. White	Follow-on Admin. Proc.	34-91392	03/23/21
In the Matter of Chris A. Dantin	Follow-on Admin. Proc.	34-91404	03/24/21
In the Matter of Christopher D. Dantin	Follow-on Admin. Proc.	34-91405	03/24/21
In the Matter of John Alexander van Arem	Follow-on Admin. Proc.	34-91511	04/08/21
In the Matter of Christopher Lee Hibbard	Follow-on Admin. Proc.	34-91591	04/16/21
In the Matter of Jaime M. Westenbarger	Follow-on Admin. Proc.	34-91613	04/19/21
In the Matter of Kenneth Ciapala	Follow-on Admin. Proc.	34-91739	05/03/21
In the Matter of Bradley J. Tennison	Follow-on Admin. Proc.	34-91749	05/04/21
In the Matter of Stephen J. Byrne	Follow-on Admin. Proc.	34-91811	05/10/21
In the Matter of Gregory P. Herlean	Follow-on Admin. Proc.	34-91814	05/10/21
In the Matter of GWFS Equities, Inc.	Stand-alone Admin. Proc.	34-91853	05/12/21
In the Matter of Clinton Maurice Tucker, II	Follow-on Admin. Proc.	34-91888	05/13/21
In the Matter of Seth A. Leyton	Follow-on Admin. Proc.	34-91924	05/18/21
In the Matter of Gil Beserglik, et al.	Follow-on Admin. Proc.	34-91938	05/19/21
SEC v. BTIG, LLC	Civil	LR-25092	05/19/21
In the Matter of Emil Botvinnik	Follow-on Admin. Proc.	34-91974	05/21/21
In the Matter of Stephen Michael Thompson	Follow-on Admin. Proc.	34-92066	05/28/21
In the Matter of Anthony Nicolosi, f/k/a Anthony Peluso	Follow-on Admin. Proc.	34-92187	06/16/21
In the Matter of Guggenheim Securities, LLC	Stand-alone Admin. Proc.	34-92237	06/23/21
In the Matter of Neovest, Inc.	Stand-alone Admin. Proc.	34-92285	06/29/21
In the Matter of DeAndre P. Sears	Follow-on Admin. Proc.	34-92309	07/01/21
In the Matter of Frederick M. Stow	Follow-on Admin. Proc.	34-92397	07/13/21
In the Matter of David Aaron Rockwell	Follow-on Admin. Proc.	34-92423	07/15/21
In the Matter of John Clifford Park	Follow-on Admin. Proc.	34-92427	07/16/21
In the Matter of Paul Hanson	Follow-on Admin. Proc.	34-92462	07/21/21
In the Matter of Executive Financial Services, Inc.	Follow-on Admin. Proc.	34-92463	07/21/21
In the Matter of Miguel Holguin	Stand-alone Admin. Proc.	34-92457	07/21/21
In the Matter of Birkelbach & Co.	Stand-alone Admin. Proc.	34-92489	07/26/21
In the Matter of Capital Portfolio Management, Inc.	Stand-alone Admin. Proc.	34-92490	07/26/21
In the Matter of Greentree Investment Services, Inc.	Stand-alone Admin. Proc.	34-92488	07/26/21
In the Matter of Tradier Brokerage, Inc.	Stand-alone Admin. Proc.	34-92486	07/26/21
In the Matter of ST Invest, LLC d/b/a Trade App	Stand-alone Admin. Proc.	34-92485	07/26/21
In the Matter of Bill Parker Agency	Stand-alone Admin. Proc.	34-92487	07/26/21
In the Matter of Shaun Greenwald, CPA	Follow-on Admin. Proc.	34-92510 & 34-92447	07/28/21
SEC v. Lupo Securities, LLC, f/k/a Alphagen Securities, LLC	Civil	LR-25152	07/29/21
In the Matter of Herbert J. Sims & Co, Inc.	Stand-alone Admin. Proc.	33-10959	07/30/21
In the Matter of Integral Financial, LLC, et al.	Stand-alone Admin. Proc.	33-10958	07/30/21
In the Matter of Erik Christian Jones	Follow-on Admin. Proc.	34-92642	08/11/21
In the Matter of Murchinson, Ltd., et al.	Stand-alone Admin. Proc.	34-92684	08/17/21
In the Matter of Alpine Securities Corporation	Follow-on Admin. Proc.	34-92775	08/26/21
In the Matter of Alexander Goldschmidt	Follow-on Admin. Proc.	34-92817	08/30/21
In the Matter of Michael Vax	Follow-on Admin. Proc.	34-92819	08/30/21
In the Matter of Michael A. Bressman	Follow-on Admin. Proc.	34-92875	09/02/21
SEC v. Eliseo Acosta	Civil	LR-25205	09/13/21
In the Matter of Coda Markets, Inc., et al.	Stand-alone Admin. Proc.	33-10985	09/20/21
In the Matter of Revere Securities, LLC, et al.	Stand-alone Admin. Proc.	34-93065	09/20/21
In the Matter of Kevin Drost	Follow-on Admin. Proc.	34-93085	09/21/21
In the Matter of Brian Koslow	Follow-on Admin. Proc.	34-93087	09/21/21
In the Matter of David Waltzer	Follow-on Admin. Proc.	34-93086	09/21/21
In the Matter of Mark Thomas Johnson	Follow-on Admin. Proc.	34-93084	09/21/21
In the Matter of Michael E. Noble	Follow-on Admin. Proc.	34-93116	09/23/21
In the Matter of Ivan Acevedo	Follow-on Admin. Proc.	34-93123	09/24/21

In the Matter of Jonah Engler, a/k/a/ Jonah Engler-Silberman	Follow-on Admin. Proc.	34-93126	09/24/21
SEC v. Carebourn Capital, L.P., et al.	Civil	LR-25223	09/24/21
In the Matter of Tradition Securities and Derivatives, LLC	Stand-alone Admin. Proc.	34-93154	09/28/21
In the Matter of John Howley	Stand-alone Admin. Proc.	34-93146	09/28/21
In the Matter of Dane R. Roseman	Follow-on Admin. Proc.	34-93170	09/29/21
In the Matter of Chad Thomas Mackland	Follow-on Admin. Proc.	34-93220	09/30/21
In the Matter of Spar Street	Follow-on Admin. Proc.	34-93207	09/30/21
In the Matter of LPL Financial, LLC	Stand-alone Admin. Proc.	33-10992	09/30/21
SEC v. Keith A. Wakefield	Civil	LR-25239	09/30/21

DELINQUENT FILINGS

In the Matter of Dougherty's Pharmacy, Inc.	Stand-alone Admin. Proc.	34-90493	11/23/20
In the Matter of All Grade Mining, Inc.	Stand-alone Admin. Proc.	34-91129	02/16/21
In the Matter of Long Blockchain Corp.	Stand-alone Admin. Proc.	34-91174	02/19/21
In the Matter of Apotheca Biosciences, Inc.	Stand-alone Admin. Proc.	34-91796	05/07/21
In the Matter of BioHemp International, Inc.	Stand-alone Admin. Proc.	34-91800	05/07/21
In the Matter of Alphacom Holdings, Inc.	Stand-alone Admin. Proc.	34-91819	05/10/21
In the Matter of Ameritek Ventures, Inc.	Stand-alone Admin. Proc.	34-91822	05/10/21
In the Matter of Cerebain Biotech Corp.	Stand-alone Admin. Proc.	34-91826	05/10/21
In the Matter of China Soar Information Technology, Inc.	Stand-alone Admin. Proc.	34-91828	05/10/21
In the Matter of FlatWorld Acquisition Corp.	Stand-alone Admin. Proc.	34-91842	05/11/21
In the Matter of Freestone Resources, Inc.	Stand-alone Admin. Proc.	34-91846	05/11/21
In the Matter of Gala Pharmaceutical, Inc.	Stand-alone Admin. Proc.	34-91848	05/11/21
In the Matter of MJ Biotech, Inc., f/k/a Michael James Enterprises, Inc.	Stand-alone Admin. Proc.	34-91850	05/11/21
In the Matter of Aedan Financial Corporation	Stand-alone Admin. Proc.	34-91855	05/12/21
In the Matter of AirXpanders, Inc.	Stand-alone Admin. Proc.	34-91856	05/12/21
In the Matter of Moregain Pictures, Inc.	Stand-alone Admin. Proc.	34-91879	05/12/21
In the Matter of Pledge Petroleum Corp.	Stand-alone Admin. Proc.	34-91882	05/12/21
In the Matter of Quantum Materials Corp.	Stand-alone Admin. Proc.	34-91867	05/12/21
In the Matter of Texas South Energy, Inc.	Stand-alone Admin. Proc.	34-91869	05/12/21
In the Matter of US-China Biomedical Technology, Inc.	Stand-alone Admin. Proc.	34-91889	05/13/21
In the Matter of Vilacto Bio, Inc.	Stand-alone Admin. Proc.	34-91891	05/13/21
In the Matter of Spectrascience, Inc.	Stand-alone Admin. Proc.	34-91899	05/17/21
In the Matter of Traqer Corp.	Stand-alone Admin. Proc.	34-91907	05/17/21
In the Matter of UBI Blockchain Internet, Ltd.	Stand-alone Admin. Proc.	34-91900	05/17/21
In the Matter of USA Zhimingde International Group Corp.	Stand-alone Admin. Proc.	34-91911	05/17/21
In the Matter of W O Group, Inc.	Stand-alone Admin. Proc.	34-91905	05/17/21
In the Matter of YBCC, Inc.	Stand-alone Admin. Proc.	34-91908	05/17/21
In the Matter of Echo Therapeutics, Inc.	Stand-alone Admin. Proc.	34-91928	05/18/21
In the Matter of Arias Intel Corp.	Stand-alone Admin. Proc.	34-91943	05/19/21
In the Matter of AtheroNova, Inc.	Stand-alone Admin. Proc.	34-91945	05/19/21
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In the Matter of Tyler C. Sadek	Stand-alone Admin. Proc.	IA-5707	03/24/21
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In the Matter of Peter J. DeCaprio	Stand-alone Admin. Proc.	IA-5732	05/10/21
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In the Matter of Roy Y. Gagaza	Follow-on Admin. Proc.	34-91993	05/25/21
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In the Matter of Gurprit Chandhoke, et al.	Stand-alone Admin. Proc.	34-92114	06/04/21
In the Matter of Michelle E. MacDonald	Stand-alone Admin. Proc.	IA- 5747	06/04/21
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In the Matter of Bingqing Yang	Follow-on Admin. Proc.	IA-5749	06/11/21
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In the Matter of TIAA-CREF Individual & Institutional Services, LLC	Stand-alone Admin. Proc.	33-10954	07/13/21
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In the Matter of Suneet Singal	Follow-on Admin. Proc.	IA-5783	07/21/21
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In the Matter of Frontier Wealth Management, LLC, et al.	Stand-alone Admin. Proc.	33-10978	09/03/21
In the Matter of David Wagner	Follow-on Admin. Proc.	IA-5851	09/07/21
In the Matter of Douglas E. Elstun	Follow-on Admin. Proc.	IA-5850	09/07/21
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In the Matter of HQDA Elderly Life Network, Corp.	Stand-alone Admin. Proc.	34-91723	04/29/21
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SEC v. Vuuzle Media Corp., et al.	Civil	LR-25017	01/27/21
SEC v. Viktor Gjonaj	Civil	LR-25018	01/28/21
SEC v. Kristijan Krstic, a/k/a Felix Logan, et al.	Civil	LR-25020	02/01/21
SEC v. Lev Parnas, et al.	Civil	LR-25023	02/04/21
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SEC v. Chatfield PCS, Ltd., et al.	Civil	LR-25055	03/03/21
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SEC v. Andrew L. White	Civil	LR-25053	03/17/21
SEC v. Seth P. Levine	Civil	LR-25054	03/18/21
SEC v. Jessica Richman, et al.	Civil	LR-25056	03/18/21
SEC v. John W. Fisher	Civil	LR-25057	03/22/21
SEC v. Jason P. Wootten, et al.	Civil	LR-25059	03/22/21
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SEC v. Harbor City Capital Corp., et al.	Civil	LR-25082	04/20/21
SEC v. Sheng-Wen Cheng	Civil	LR-25076	04/20/21
SEC v. Corbyn W. Jones, Esq.	Civil	LR-25079	04/22/21
SEC v. Peter R. Quartararo, et al.	Civil	LR-25083	04/27/21
SEC v. Rahsaan King, et al.	Civil	LR-25085	04/29/21
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SEC v. MJ Capital Funding, LLC, et al.	Civil	LR-25168	08/09/21
SEC v. Blessing K. Egbon	Civil	LR-25163	08/10/21
SEC v. The Movie Studio, Inc., et al.	Civil	LR-25166	08/13/21
SEC v. Battery Private, Inc., et al.	Civil	LR-25171	08/13/21
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SEC v. John J. Woods, et al.	Civil	LR-25181	08/20/21
SEC v. Carl Jensen, et al.	Civil	LR-25183	08/24/21
SEC v. Manish Lachwani	Civil	LR-25182	08/25/21
SEC v. William B. McHenry, Jr., et al.	Civil	LR-25184	08/26/21
SEC v. Jason Dodd Bullard, et al.	Civil	LR-25194	08/27/21
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SEC v. Dawson L. Davenport, et al.	Civil	LR-25193	08/31/21
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SEC v. Robert Samuel Shumake, Jr., et al.	Civil	LR-25210	09/20/21
SEC v. Leena Jaitley d/b/a Managed Options Trading and Options by Pros, et al.	Civil	LR-25211	09/20/21
In the Matter of Frederick Bauman, Esq.	Follow-on Admin. Proc.	34-93089	09/21/21
SEC v. Back to Green Mining, LLC, et al.	Civil	LR-25214	09/21/21
SEC v. Frantz Simeon, et al.	Civil	LR-25216	09/22/21
SEC v. James R. Collins, et al.	Civil	LR-25219	09/23/21

SEC v. Biogenic, Inc., et al.	Civil	LR-25217	09/23/21
In the Matter of Resolute Capital Partners LTD, LLC, et al.	Stand-alone Admin. Proc.	33-10987	09/24/21
SEC v. Star Chain, Inc., et al.	Civil	LR-25225	09/24/21
SEC v. Sky Group USA, LLC, et al.	Civil	LR-25234	09/27/21
SEC v. VerdeGroup Investment Partners, Inc., et al.	Civil	LR-25228	09/27/21
SEC v. Richard Xia, a/k/a Yi Xia, et al.	Civil	LR-25230	09/27/21
SEC v. C3 International, Inc., et al.	Civil	LR-25231	09/28/21
SEC v. Jaeson Birnbaum	Civil	LR-25232	09/28/21
SEC v. Gregory A. Ciccone, et al.	Civil	LR-25236	09/29/21
In the Matter of Victoria Chan, Esq.	Follow-on Admin. Proc.	34-93202	09/30/21
SEC v. Mark Allan Plummer, et al.	Civil	LR-25235	09/30/21
SEC v. Punch TV Studios, Inc., et al.	Civil	LR-25237	09/30/21

SRO / EXCHANGE

In the Matter of Poloniex, LLC	Stand-alone Admin. Proc.	34-92607	08/09/21

TRANSFER AGENT

In the Matter of OTR, Inc.	Stand-alone Admin. Proc.	34-90828	12/30/20
SEC v. Michael James Ferguson Jr. Foreign Private Trust, et al.	Civil	LR-25229	09/27/21

NOTES

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Hedge Fund Liquidity Management: Insights for Fund Performance (March 2022)

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HEDGE FUND LIQUIDITY MANAGEMENT:
INSIGHTS FOR FUND PERFORMANCE

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March 2022

ABSTRACT

Using Form PF filings over 2013–2017, we find that hedge funds maintain higher levels of cash holdings and available borrowing ("liquidity buffers") when they hold more illiquid assets, have shorter-term commitments from investors and creditors, and when market volatility is greater. Funds with low abnormal buffers – liquidity buffers below the level predicted by fund attributes – outperform their benchmarks. Stocks with greater ownership by managers with abnormally low buffers subsequently outperform other stocks, especially around earnings announcements. We conclude that managers with better investment opportunities utilize more of their capital and have lower liquidity buffers than their peers.

JEL Classification: G11; G23
Keywords: Liquidity buffer, hedge funds, fund performance, cash, borrowing.

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1. Introduction[1]

The 2008 financial crisis and turbulent market conditions of March 2020 highlight the importance of sound liquidity risk management to guarantee the viability of financial institutions during severe market downturns. Larger cash positions enable managers to meet funding shocks without having to engage in fire sales of its non-cash assets. Likewise, credit lines and other forms of available borrowing can provide a type of liquidity insurance that allows funds to avoid the costs of transacting in underlying securities markets, particularly when these become impaired. However, maintaining a larger liquidity buffer in normal times could entail significant opportunity costs for asset managers if doing so means foregoing profitable investment opportunities that require a more active use of fund capital and available borrowing. Such opportunity costs would be most onerous for managers with the greatest capacity for informed trading. In this paper, we take a fresh look at detecting skill in the hedge fund marketplace and propose a new predictor of fund performance based on a fund's liquidity buffer. We posit that managers with better investment opportunities will utilize more of the fund's capital and, hence, have lower liquidity buffers than their peers.

Our two main research questions are as follows. First, does a hedge fund manager's liquidity buffer – defined as a fund' unencumbered cash plus its unused borrowing capacity – vary across funds in a way that is consistent with liquidity risk management (e.g., choosing higher buffers when holdings are more illiquid or when investors are allowed to redeem their shares on a shorter notice)? Second, do managers that maintain *abnormally* low buffers – buffers below the level predicted by fund attributes – exhibit superior performance and a

[1] The Form PF information and statistics discussed in this study are aggregated and/or masked to avoid potential disclosure of proprietary information of individual Form PF filers.

greater capacity for informed trading? It is possible that an abnormally low buffer may reflect a fund manager's choice to exploit especially good investment opportunities by drawing down liquidity buffers to finance positions in undervalued securities.

Answers to these questions in a hedge fund setting are uniquely informative as hedge fund managers face few regulatory constraints on their illiquid asset holdings or borrowing. Our analysis uses information extracted from the quarterly filings of Form PF that are submitted confidentially by hedge fund managers to the SEC over 2013-2017.[2] These disclosures provide detailed information about several fund characteristics that are relevant to our analysis, including the level of unencumbered cash holdings, available borrowing (e.g., excess margins and lines of credit), and portfolio returns. We find that hedge funds maintain relatively large liquidity buffers of 41%, on average, which is the sum of cash holdings of 18% and available borrowing capacity of 23% as a percentage of net asset value (NAV). These estimates contrast sharply with those from the mutual fund literature. The average cash holdings of mutual funds range between 4-8% (Chernenko and Sunderam, 2016) and borrowing capacity is severely limited by virtue of regulation under the Investment Company Act. The fact that hedge funds typically maintain large liquidity buffers is broadly consistent with the conventional wisdom that cash and available borrowing provide a useful hedge against liquidity risk and that, compared to mutual funds, hedge funds face greater exposure to illiquid assets.

We then turn to our first research question and examine how liquidity buffers vary

[2] Other studies of Form PF filings include Aragon et al. (2017; 2021), Barth et al. (2020), Barth and Monin (2019) and Kruttli, Monin, and Watugala (2017; 2021; 2022). A more complete picture of hedge funds and advisers that file form PF is provided in the quarterly statistics produced by the SEC Division of Investment Management and available here: https://www.sec.gov/divisions/investment/private-funds-statistics.shtml.

across funds. For example, funds with shorter-term commitments from fund investors are more exposed to investor redemptions. For such funds, we would expect higher levels of unencumbered cash so that managers can quickly meet a large wave of redemptions without having to liquidate the fund's non-cash assets. Likewise, we would expect funds with a greater exposure to illiquid assets in the fund's portfolio maintain higher buffers to hedge against funding shocks from investors and creditors. Consistent with these predictions, we find that a one standard deviation drop in portfolio liquidity is associated with a higher buffer of 15.21 percentage points, which is about 40% of one standard deviation of buffer. Funds also maintain higher buffers when they are more exposed to investor redemptions (investor liquidity) and margin calls from their prime brokers (financing liquidity). We estimate 7.38% and 4.60% higher buffers per one standard deviation increases in investor and financing liquidity, respectively. Market conditions also matter: funds maintain higher liquidity buffers during periods of higher market volatility as measured by the CBOE Volatility Index (VIX). These results support a central prediction of theories that funds' cash and available borrowing provide a hedge against future financing constraints.[3]

Next, we turn to our second research question and test whether *abnormal* liquidity buffers – liquidity buffers above the level predicted by fund attributes – are related to funds' investment opportunities. Fig. 1 shows our main result: hedge funds with low abnormal buffers significantly outperform other funds. Specifically, funds with the lowest abnormal buffers earn positive and significant monthly net-of-fees risk-adjusted alphas of 0.28%, as compared to just -0.02% for funds with the highest abnormal buffers. The difference, 0.30%

[3] See, e.g., Boot, Thakor, and Udell (1987) and Holmstrom and Tirole (1998), Kashyap, Rajan, and Stein (2002), and Gatev and Strahan (2006). For a review of this literature see Almeida et al. (2014).

per month, is significant (t-statistic = 2.90). We also use multiple regressions to confirm that the negative buffer-performance relation is not just picking up other known predictors of hedge fund performance. Overall, our evidence supports the idea that managers respond to successful investment signals by actively deploying the funds' liquid capital and, hence, have abnormally lower buffers; in other words, abnormally low buffers signify greater investment opportunities.

Our post-crisis sample period covers a period of relatively low volatility and rising equity market valuations. Thus, a potential concern is that the outperformance of hedge funds with low abnormal buffers is not due to a greater ability to detect investment opportunities, but instead reflects merely luck due to having a greater exposure to risky securities during a bull market period. We address this concern in several ways. First, the performance we document is market-adjusted and goes above and beyond a fund's exposure to several market benchmarks, including a broad equity market index and option-based strategies. Second, our focus on *abnormal* liquidity buffers weakens the direct link between a fund's raw, unadjusted buffer and its factor exposures; e.g., many funds with low abnormal buffers have relatively high amount of cash holdings. As we show (Table 2), differences in factor exposures between funds in the highest and lowest abnormal buffer groups are insignificant for six out of the seven Fung and Hsieh (2004) factors. Third, the risk-adjusted returns of our low-minus-high buffer spread portfolio have a slight *positive* correlation with VIX, suggesting that low buffer funds tend to fare better, not worse, in more volatile markets.

To further exclude the possibility that higher returns among funds with lower abnormal buffers are simply being driven by lower "cash drag" on performance, we more directly measure the performance of stocks held in fund managers' portfolios using their disclosures contained in quarterly filings of Form 13F. We find that stocks held by managers with low abnormal buffers experience higher future stock returns. For example, a one standard deviation increase in low-buffer ownership predicts higher market-adjusted stock returns of 0.24% per month. An increase in ownership by low-buffer managers also predicts higher stock returns around earnings announcements. Thus, the equity positions of hedge fund managers with low abnormal buffers reflect information about future cash flow news. We further show that the predictability of low-buffer stock ownership for future stock returns is stronger among the subsample of equity-oriented managers and, therefore, managers for which stock positions contained in Form 13F are more representative of their overall portfolio. In sum, the analysis of stock holdings corroborates our story that abnormally low buffers reflect greater investment opportunities and, thus, are predictive of greater fund performance.

Our findings contribute to research showing that investment skill among mutual fund managers is related to measures of active portfolio management, such as a fund's portfolio turnover (Pastor, Stambaugh and Taylor, 2017) and the share of a fund's holdings that deviate from its benchmark index holdings (Cremers and Petajisto, 2009).[4] We follow this logic to the hedge fund setting and use a fund's abnormal liquidity buffer as a measure of (in)active portfolio management. Our evidence supports the basic idea that a manager with greater profit opportunities will utilize more of the fund's capital to finance positions in securities markets and, hence, have a lower liquidity buffer than what would be predicted by fund attributes. In contrast, a manager without such opportunities keeps more of the fund's capital parked as cash or available borrowing and, hence, maintain a higher buffer.

[4] See, also, Titman and Tiu (2011), Sun, Wang, and Zheng (2012), Jagannthan, Malakhov, and Novikov (2010), Duanmu, Malakhov, and McCumber (2018), Bali, Brown, and Caglayan (2011, 2012, and 2014). Kacperczyk, Sialm, and Zheng (2005, 2006), Alexander, Cici, and Gibson (2006), and Chen, Jegadeesh, and Wermers (2000).

Simutin (2014) finds that larger abnormal cash holdings predict better performance among mutual funds, but extremely high levels of cash predict worse performance. He concludes that abnormal cash allows funds to avoid costly fire sales and to capitalize on investment opportunities that may arise in the future, but too much cash is detrimental to performance. We build on this research and present the first analysis of liquidity buffers as a predictor of performance in hedge funds. Since hedge fund managers make significant use of leverage to finance their trading positions, we are careful to account for both cash holdings and available borrowing to build our measure of liquidity buffers. Our finding of a negative relation between abnormal buffers and future performance supports the view that managers with investment opportunities actively use their liquid capital rather than keeping it on hand as dry powder.[5]

Prior work shows that greater cash holdings by mutual funds can reduce the damage from redemptions by spreading flow-triggered trades over a longer period, and that funds hold more cash when they have illiquid portfolios. Consistent with this evidence, we show that hedge funds maintain greater cash holdings when they face a greater liquidity risk in the form of portfolio illiquidity and short-term financing commitments from investors. provide insurance against liquidity risk. Furthermore, given that hedge funds make significant use of leverage, we also consider a fund's available borrowing as an additional component of a fund's total liquidity buffer. We find that available borrowing constitutes over half of a hedge fund's total liquidity buffer, on average, and funds maintain greater available borrowing when

[5] Other papers on cash and mutual funds include Chordia (1996), Yan (2006), Chernenko and Sunderam (2016). Several papers highlight the role of cash in corporate liquidity management (e.g., Opler et al., 1999; Almeida, Campello, and Weisbach, 2004; Faulkender and Wang, 2006; Bates, Kahle, and Stulz, 2009; and Falato, Kadyrzhanova, and Sim, 2015).

they face shorter commitments from their prime brokers and creditors. This supports existing theories that credit lines and other forms of available borrowing provide insurance against liquidity risk.[6] To our knowledge, our paper is the first to provide empirical support for these theories in the hedge fund setting where leverage and liquidity management play important roles in fund operations.[7]

Finally, our results have implications for financial regulation as it pertains to financial stability and systemic risk. As we show, hedge fund managers maintain higher liquidity buffers when they have shorter-term financial commitments from investors and creditors, and when they hold more illiquid assets. This suggests that fund managers tend to align their cash holdings and unused borrowing with an aim to prevent asset fire sales resulting from funding shocks. Second, abnormally low buffers can reflect perceived profit opportunities by the fund manager. Thus, constraints on a fund's liquid capital aimed at improving fund's resilience (e.g., minimum cash holdings and available borrowing) could adversely impact price efficiency, since they would have more effect on managers with a capacity for informed trading and impair their ability to finance positions in undervalued securities.[8]

2. Data and summary statistics

[6] Empirically, Chen, Goldstein, and Jiang (2010) find greater cash holdings among mutual funds with greater asset illiquidity, while Agarwal, Aragon, and Shi (2019) find greater cash holding among funds of hedge funds with greater mismatch between assets and investor illiquidity. Jiang, Li, and Wang (2021) show that cash holdings are used strategically by corporate bond funds to dynamically manage their liquidity.

[7] In contemporaneous work, Kruttli, Monin, and Watugala (2017) find (as we do) that hedge funds maintain higher levels of cash holdings when they allow investors to redeem their shares more frequently. However, they do not examine a fund's available borrowing as a component of a hedge fund's overall liquidity buffer, nor do they examine the predictive power of liquidity buffers for fund performance.

[8] Generally, hedge funds have played a positive role in price discovery (Cao, Chen, Goetzmann, and Liang 2018) and improved stock market efficiency (Cao, Liang, Lo, and Petrasek 2018).

In this section, we describe the main databases used in our analysis and then explain and summarize the sample constructed.

2.1. Form PF filings

The main data come from quarterly filings of Form PF. Since mid-2012, Form PF filings are required by all Securities and Exchange Commission (SEC)-registered investment advisers with at least $150 million in private fund (PF) assets.[9] The information reported in Form PF is nonpublic and contains information about each individual private fund under management, including the fund's identity, investment strategy and performance, assets under management, cash holdings, and available borrowing capacity. Our analysis focuses on the subsample of private funds that report their fund type as "Hedge Fund" and answer Section 2b of Form PF.[10] Our final sample contains 10,666 quarterly filings over 2013Q1-2017Q2 made by 1,268 funds of 440 advisers.[11]

Section 2b of Form PF provides fund-level information that is central to our analysis. Unencumbered cash is reported in Question 30 and represents cash equivalent assets that have not been pledged as margin with the fund's counterparties. It is the portion of the fund's liquid assets that are unencumbered by counterparty obligations and available to be freely deployed to meet investor redemptions. Available borrowing is the difference between total

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[9] We use the terms "adviser" and "manager" interchangeably. As noted in the adopting release (17 CFR Parts 275 and 279 – Release No. IA–3308), "The information contained in Form PF is designed, among other things, to assist the Financial Stability Oversight Council in its assessment of systemic risk in the U.S. financial system."

[10] Only the so-called *Qualifying Hedge Funds*, which have at least $500 million in net assets, answer Section 2b. Note that the Form requires aggregating all master-feeder funds, parallel funds, and dependent parallel managed accounts associated with a fund to determine whether it is a Qualifying Hedge Fund or not. However, advisers are allowed to report fund level data separately as well as on an aggregated basis; thus, some Qualifying Hedge Funds may have net assets less than $500 million (see Form PF General Instructions for reporting and aggregation requirements).

[11] Our sample contains a cross-section of both small and large funds (see Table 1 for details).

available borrowing (i.e., used plus unused) and used borrowing. Total available borrowing is reported in Question 46(a), which asks each fund to report the "aggregate dollar amount of borrowing by and cash financing available to the reporting fund (including all drawn and undrawn, committed and uncommitted lines of credit as well as any term financing)." Used borrowing is the sum of the responses to the subcategories of Question 43, which relate to the dollar amounts of the fund's unsecured and secured borrowings.[12] Unused borrowing includes short-term credit facilities that can be used to meet investor redemptions, and any free credit balance in the fund's margin account. Such "excess margin" provides a buffer against margin calls from the fund's creditors.[13] We define a fund's liquidity buffer as its unencumbered cash plus available borrowing.

Section 2b of Form PF also provides information for other variables used in our analysis. Question 32 asks each fund to report the percentage of its non-cash assets that could be liquidated assuming no fire-sale discounting within each of the following intervals of days: 1 or fewer, 2-7, 8-30, 31-90, 91-180, 181-365, and 365 or more. We define *Portfolio liquidity* as the percentage of assets that can be liquidated in 90 days or less; 69% of a fund's non-cash assets are liquid under this classification. Questions 50 and 46(b) ask analogous questions regarding the duration of a hedge fund's investor capital and borrowing. Thus, we define *Investor liquidity* as the percentage of investor capital that is contractually committed to the

[12] If responses to Question 43 are missing, we use the response to Question 12. We also drop observations with negative values of unused borrowing, which we attribute to reporting error.

[13] Suppose a hedge fund has $100 worth of margin securities, a debit balance (i.e., margin borrowing) of $25, and the remaining $75 is equity. If the maintenance margin requirement is 50%, then the fund could withdraw cash up to $25, reduce its equity down to $50, and increase its debit balance to $50. Alternatively, if the margin requirement is only 25% the fund could withdraw cash up to $50, reduce its equity to $25, and increase its debit balance to $75. In other words, the fund has an excess margin, or, free credit balance, of $25 and $50, respectively. See Fortune (2000) for additional discussion of margin accounting.

fund for 90 days or less after accounting for redemption restrictions like lock-up periods, imposed gates, redemption frequency, and notice periods, and define *Financing liquidity* as the percentage of a fund's total available (i.e., used and unused) borrowing that has been contractually committed to the fund for 90 days or less (Question 46(b)).

We also obtain monthly returns, net asset values (*NAV*), and gross asset values (*GAV*) for each fund. Monthly returns are reported net of fees (*Net return*). We compute quarterly net flows (*Net flow*) in the usual way as the percentage change in *NAV* minus net of fees returns. *Leverage* is defined as the ratio of *GAV* and *NAV*. In our analysis of Form 13F filings, we classify advisers as "equity-oriented" if they allocate at least 50% of their assets towards equity strategies (Question 20). Finally, to control for the ownership concentration of a fund's investors we define *Top5Owner* as the percentage of a fund's equity owned by the top 5% of its owners (Question 15).

2.2. Other data sources

We obtain the stock positions of hedge fund managers in our sample from the Thomson Reuters 13F Database. This database contains the quarterly filings of Form 13F and are reported at the level of the hedge fund manager.[14] We identify 13F filings for our sample by manually matching the manager names in our Form PF sample with those in Thomson Reuters. We only include filings with at least five stock holdings, holdings that are common equity securities (share code 10 or 11), and stocks that trade on the New York Stock Exchange (NYSE), American Stock Exchange (AMEX), or NASDAQ (exchange code 1, 2, or 3). The

[14] All advisers who exercise investment discretion over accounts holding at least $100 million in Section 13(f) securities are required to file Form 13F. Section 13(f) securities consist mainly of common stock but also include American Depository Receipts (ADRs), exchange traded funds (ETFs) and other trusts, convertible bonds, and equity call and put options. See Section 13(f) of the Exchange Act of 1934 for more details. Only long positions in these securities are reportable in Form 13F.

final sample contains 2,618 quarterly filings of Form 13F over 2013Q1-2017Q2 made by 307 advisers.

We obtain monthly observations of the CBOE Volatility Index (VIX) from DataStream, historical stock returns and stock characteristics from the Center for Research in Security Prices (CRSP) and Compustat, and benchmark returns for the Fung and Hsieh (2004) model.[15] Finally, for our analysis of stock returns around earnings announcements, we obtain earnings announcement dates from IBES Summary History Files. All variables used in our analysis are defined in the Appendix.

2.3. Summary statistics

Panel A of Table 1 presents summary information of Form PF variables for the final sample of hedge funds. On average, cash and available borrowing total 18% and 23%, respectively, of a fund's net asset value (*NAV*). Combined, hedge funds maintain an average liquidity buffer (*Buffer*) of 41%, which is larger than mutual funds. For example, equity mutual funds have an average cash ratio of only 8% (Chernenko and Sunderam, 2016) and face restrictions on borrowing from the Investment Company Act of 1940. The sample mean of *Available borrowing*, 23%, is similar in magnitude to the average unused margin loan capacity of broker-dealer customers as reported to the New York Stock Exchange.[16] The fact that these two numbers are close makes sense since hedge funds' available borrowing reflects available lines of credit and/or free credit balance in margin accounts, and most hedge funds

[15]Fung-Hsieh benchmarks are available here: http://faculty.fuqua.duke.edu/~dah7/DataLibrary/TF-FAC.xls. The benchmarks correspond to the U.S. equity market, the return to small market capitalization stocks, credit and term structure spreads, and three option-based, trend-following factors as in (Fung and Hsieh, 2001).

[16] To compare, we divided the total credit balances in margin accounts (i.e., unused margin borrowing) by the total available margin borrowing (i.e., credit balances in margin accounts plus margin debt balances). The data are from the Margin Debt and Stock Loan, Securities Market Credit segment of the NYSE Facts and Figures website (http://www.nyxdata.com/nysedata/asp/factbook/main.asp).

are broker-dealer customers.

Panel A of Table 1 shows that 69% of a fund's non-cash assets (*Portfolio liquidity*) can be liquidated within 90 days without fire sale discounting, and 45% of a fund's investor capital (*Investor liquidity*) can be redeemed within 90 days. In contrast, mutual funds face restrictions on the amount of portfolio illiquidity and have much greater investor liquidity as investors may redeem their shares daily. Strikingly, the 25th percentile of *Financing liquidity* is 100%, indicating that a typical hedge fund's financing from creditors is short-term as it is committed for less than 90 days.[17] The median of *NAV* is \$1.07 billion and larger than the median size of hedge funds reporting to commercial databases (Agarwal, Daniel, and Naik, 2011; Aragon and Nanda, 2017). Thus, our sample contains larger funds compared to these prior studies.[18] Although our sample excludes many small funds, it captures the majority of assets under management of U.S. hedge funds. We estimate that our sample represents assets of \$2.525 trillion $(= \$1.99133\text{ billion} \times 1{,}268\text{ funds})$, or, about 84% of the \$3 trillion hedge fund industry at the start of 2017.[19] *Leverage* has a sample mean of 1.82, which is similar to Jiang's (2018) estimate of 1.92 for hedge fund leverage obtained from Form ADV filings over 2011-2013, and Ang, Gorovyy, and van Inwegen's (2011) estimate of 2.13 for hedge fund leverage. Average quarterly returns (1.50%) and net flows (0.20%) are positive,

[17] Some filers may report their financing terms as "1 day or less" despite having longer-term agreements in place. According to form PF instructions: "(If a creditor […] is permitted to vary unilaterally the economic terms of the financing or to revalue posted collateral in its own discretion and demand additional collateral, then the financing should be deemed uncommitted for purposes of this question. Uncommitted financing should be included under "1 day or less.")". The data do not allow us to distinguish between filers that agree on one-day-term loans vs. filers that agree on longer terms but are subject to daily revaluation of collateral.

[18] This is, of course, partially due to the fact that only QHFs (as defined in Form PF) are reported in Section 2b. This essentially places a soft floor of \$500 million on the NAV of the funds in our sample.

[19] Source: Hedge Fund Research, "Hedge Fund Industry Capital Surpasses Historic \$3 Trillion Dollar Milestone," published on 1/20/2017.

but there is considerable variation as the standard deviation of returns and flows are 6.5% and 13.8%, respectively. Equity strategies represent 42.13% of a hedge fund's assets, on average, suggesting that our 13F analysis of stock holdings captures a significant portion of a hedge fund's total (i.e., equity plus non-equity) portfolio. Finally, the median of *Top5Owner* is 57%, indicating that a typical fund's largest five investors account for a majority of its NAV.

The remaining panels of Table 1 summarize variables from our analysis of stock holdings disclosed in Form 13F filings. Most of these variables are computed at either the adviser-quarter or stock-quarter level since 13F filings and earnings announcements are measured at a quarterly frequency. For example, from Panel B we see that the median adviser holds around 31 stock positions ($= e^{3.43}$) with a dollar value of $1.39 billion ($= e^{21.05}$). We also see that the typical adviser has aggregate hedge fund NAV of $2.7 billion ($= e^{7.90} \times 1{,}000{,}000$), indicating that stock holdings in Form 13F typically represent a significant fraction of a hedge fund's total assets. At the stock level, Panel C shows that hedge funds own 6% of a stock's market capitalization, on average, which is similar to estimates reported in prior studies of hedge fund stock ownership (e.g., Cao et al., 2018).

2.4. External validation: Comparing Form PF and 13F variables.

Before proceeding to our main analysis, we use portfolio disclosures contained in Form 13F filings as an external validation check of the Form PF data and verify the relation between the characteristics of stocks held (i.e., in Form 13F data) and the characteristics of the adviser's overall portfolio as reported in Form PF. Specifically, we compute pairwise correlations between Form PF liquidity variables (aggregated to the adviser level each quarter) and measures of market liquidity of stock holdings reported in Form 13F (ownership-weighted average across all stock holdings in each 13F filing). Reassuringly, we find that hedge funds holding more liquid assets according to Form PF are associated with more liquid (i.e., less illiquid) stock holdings according to Form 13F, as measured by stocks with low bid-ask spreads, low Amihud (2002) illiquidity measures, and large stock market capitalizations. Thus, a fund manager's subjective assessment of portfolio liquidity reported in Form PF bears a strong relation with objective measures of stock market liquidity.

3. Hedge fund liquidity buffers

In this section we study hedge fund liquidity management practices by analyzing the determinants of funds' liquidity buffers. We also define our key variable – *Abnormal buffer* – used in the subsequent analysis of the paper.

3.1. Buffer determinants

We model a hedge fund's liquidity buffer using the following pooled regression:

$$Buffer_{iq} = b_0 + b_1 Portfolio\ Liquidity_{i,q} + b_2 Investor\ liquidity_{i,q} + b_3 Financing\ liquidity_{i,q} + b_4\, VIX_{i,q} + Controls + e_{iq} \qquad (1)$$

The unit of observation is fund-quarter and standard errors are clustered at the fund-level. The first four variables on the right-hand side of Eq. (1) are motivated by prior theories of liquidity management. The basic idea is that a fund manager's choice of buffer reflects a tradeoff between 1) the benefits of cash and available borrowing as a hedge against future financial distress and 2) the opportunity costs associated with low expected returns from holding cash and available borrowing.[20] Ceteris paribus, we expect greater buffers among funds with shorter-term capital commitments from investors and creditors. The reason is that, in the event of financial distress, such funds could experience investor redemptions and

[20] Cash can mitigate the need to liquidate assets to meet payments in the future (Chordia, 1996; Opler et al., 1999; and Zeng, 2017) and allow firms to avoid costly external finance (Froot, Scharfstein and Stein, 1993). Disadvantage of cash is the opportunity cost (i.e., "liquidity premium") and the possibility "free-cash flow" problems. Lines of credit allow firms to obtain funds when financing needs arise (Boot, Thakor, and Udell, 1987; Holmstrom and Tirole, 1998, Martin and Santomero, 1997, and Sufi, 2009).

margin calls, leading to a costly liquidation of fund assets. A finding that b_2 and b_3 are larger than zero would support this prediction. On the other hand, if the fund is holding relatively liquid non-cash assets, then the potential costs of distressed selling are lower. Thus, we would expect a negative relation between buffers and portfolio liquidity and, hence, $b_1 < 0$. Finally, during periods of market stress, there is a greater potential for large drawdowns and, hence, liquidity needs inside the fund. During such periods, therefore, we would expect fund managers to hold larger buffers (i.e., $b_4 > 0$).

Eq. (1) also includes several control variables that could drive variation in *Buffer*, including contemporaneous (i.e., quarter *q*) observations of *Leverage*, log(*NAV*), log(*AdvHFNAV*), log(*GNE*), *Top5Owner*, and lagged (i.e., quarter *q*-1) observations of *Net flow* and *Net return*. We allow for sign asymmetries in flows and returns since it is possible that negative values of returns and flows are signals of future distress and, hence, managers are more inclined to hold larger buffers in those situations (Zeng, 2017; Agarwal, Aragon, and Shi, 2019). Finally, we control for a fund's investment style by including variables that represent a fund's allocation to certain investment strategies, including equity, macro, relative value, event driven, credit, managed futures, and investment in other funds.

The regression results are reported in Table 2. The first column strongly shows that liquidity buffers are lower among funds with more liquid assets. For example, a one standard deviation increase in *Portfolio liquidity* is associated with an 8.39% drop in *Buffer* (*t*-statistic = -7.53). In addition, funds maintain larger buffers when they have shorter-term capital commitments from investors and creditors. A one standard deviation in *Investor liquidity* and *Financing liquidity* is associated with a higher *Buffer* of 7.92% and 5.59%, respectively. Both estimates are significant at the 1% level. The *R*-squared is 7.6%, indicating that a fund's exposure to liquidity risk explains a large portion of variation in liquidity buffers. Column

(3) shows that hedge fund buffers are larger during periods of higher market volatility; however, while significant (*t*-statistic = 3.22), the coefficient estimate of *VIX* is an order of magnitude smaller than those on the other three liquidity variables.

Column (5) of Table 2 presents the results for estimating the full model of Eq. (1), including all liquidity variables, *VIX*, and all control variables. Besides confirming our findings from Columns (1) and (3), this "kitchen sink" model delivers additional insights. First, buffers are larger among more levered funds, smaller funds and smaller advisers, and funds with greater investor ownership concentration.[21] Buffers are also larger among funds with negative returns and net flows during the prior quarter; however, the significance is weak (*t*-statistic = -1.96). Overall, these results provide additional support for liquidity management motives of buffers, to the degree that liquidity risk is greater among funds with greater leverage, less capital, more concentrated investor ownership, and recently poor performance and flows.[22]

3.2. Abnormal buffers

Liquidity buffers measure the amount of available "passive" capital that is not yet part of an active trading strategy. As we show above, a significant portion of *Buffer* can be explained by liquidity management motives; however, we focus the remaining analysis on buffers that cannot be predicted by fund attributes – i.e., its abnormal buffer.

We define *Abnormal buffer* as the residuals from the full specification in Eq. (1) (i.e.,

[21] Kruttli, Monin, and Watugala (2017) find greater cash holdings among hedge funds with greater investor concentration.

[22] We tried alternative specifications of Eq. (1) that also include measures of a fund's operational risk (e.g., the omega score of Brown, Goetzmann, Liang, and Schwarz, 2008, 2009), liquidity risk (Pastor and Stambaugh, 2003), and downside return risk (e.g., tail risk, value-at-risk of Liang and Park, 2007, 2010) as explanatory variables for liquidity buffer. Since none were significant when added to our kitchen sink specification of Column (5) of Table 2, we exclude them from Table 2 and our analysis of abnormal buffers below.

Column (5) of Table 2). However, unlike the one-time pooled regression estimates reported in Table 5, we estimate *Abnormal buffer* following a backward-looking, recursive strategy. Specifically, at the end of each quarter q, we estimate Eq. (1) using an expanding window that includes all available fund-quarter observations from the start of our sample through quarter q. We define a fund's abnormal buffer in quarter q as its estimated residual in quarter q. For example, the earliest quarter in which we can estimate abnormal buffers is 2013Q3, since our sample period starts in 2013Q1, Eq. (1) requires lagged values of quarterly flows, and flows require two consecutive quarterly observations of NAV (i.e., 2013Q1 and 2013Q2). Thus, abnormal buffers in 2013Q3 are based on estimating Eq. (1) using a cross-sectional regression of observations in 2013Q3 only. In the following quarter, 2013Q4, abnormal buffers are based on estimating Eq. (1) using a pooled regression of observations in the expanded sample combining 2013Q3 and 2013Q4, and so on. A recursive approach avoids forward-looking information, so that any evidence that abnormal buffers predict returns could potentially be of economic value to investors.

Before turning to our analysis of abnormal buffers and future performance, we run a simple check to support our main story. If a low abnormal buffer reflects a capacity for informed trading, then we would expect *Abnormal buffer* for a fund to persist over time, to the degree that such investment skill endures over the life of a fund. We sort funds into deciles based on their *Abnormal buffer* and track whether, say, funds with bottom-decile buffers remain in or drift from the bottom decile over subsequent quarters. We find that the *Abnormal buffer* of an individual fund is persistent over time. Decile rankings do not change much from year to year: the bottom decile ranking rises from 1 to 2.21 and the top decile falls from 10 to 8.90. Even over three years, bottom decile rank rises only to 3.28 from 1 while the top decile rank falls to 7.98 from 10. Hence, *Abnormal buffer* is a good predictor of *Abnormal* *buffer* next quarter, next year, and thereafter.

4. Abnormal liquidity buffers and investment opportunities

We now test whether hedge funds' abnormal liquidity buffers contain predictive power for fund performance and the performance of stocks that fund advisers hold.

4.1. Portfolio sorts

We investigate the monthly returns of portfolios of individual hedge funds while allowing for time variation in abnormal buffers. Specifically, we form 10 portfolios of hedge funds every quarter (with equal number of funds in each portfolio) using expanding window estimates of *Abnormal buffer* (i.e., the residuals in Eq. (1)). Since Eq. (1) is re-estimated every quarter, funds are kept in the portfolio for the three months following each quarter. As noted earlier, we estimate Eq. (1) residuals using a backward-looking approach that only uses information through quarter q. The results are robust to using a one-time estimation of Eq. (1) residuals using the entire sample; however, since the one-time approach is forward-looking, the returns are not investable in real-time. Portfolio formation therefore begins at the end of 2013Q3 with real-time tracking returns starting in October, November, and December of 2013. This portfolio approach makes it easy to compare abnormal buffers with the risks captured by the Fung-Hsieh factors. Such a comparison can be done by simply regressing the monthly *Abnormal buffer* portfolio returns on the seven hedge fund factors. The intercept of this regression is the Fung-Hsieh alpha.

Fig.1 plots the alpha of each *Abnormal buffer* decile (in dashed bars) along with the respective *t*-statistics (in circles). The figure shows that the lowest abnormal buffer portfolio has an average monthly alpha of 0.28% (*t*-statistic = 2.34) and the highest abnormal buffer portfolio has an average monthly alpha of -0.02% (*t*-statistic = -0.19). The difference, 0.30%, is significant (*t*-statistic = 2.90). The rest of the portfolio alphas generally decrease with abnormal buffer. The performance of the portfolio spread (solid bar) suggests that low abnormal buffer funds significantly outperform high abnormal buffer funds in the future, consistent with the interpretation that hedge fund managers maintain lower abnormal buffers when they have greater investment opportunities.[23]

An important consideration is whether low-buffer funds are simply lucky at timing the post-crisis bull equity market that covers our sample period. Note, however, that our alpha estimates are risk-adjusted returns that subtract off any additional premium related to exposures to the Fung and Hsieh (2004) factors, including a broad equity market index. Furthermore, Panel A of Table 3 compares factor exposures (betas) of the long and short legs of the spread portfolio. Aside from exposure to the returns from trend-following strategies in the bond market trend (PTFSBD), the exposures of the spread portfolio have no significant relation to the Fung-Hsieh factors. This helps to further reassure that the spread portfolio is not simply picking up an expected return premium to holding, say, equity or commodity price risk.

Panel B of Table 3 shows the results from sorting funds based on their raw liquidity buffers (i.e., *Buffer*), rather than sorting on *Abnormal buffer*. This would be of interest, for example, if investors find it easier to gauge a fund's raw buffer rather the level of a fund's buffer below that predicted based on a fund's other attributes. Again, we find a positive and significant spread in monthly returns between funds with the lowest and highest *Buffer* (coef.

[23] Our preferred model of benchmarking hedge fund returns is the Fung and Hsieh (2004) seven factor model; however, we also tried the following alternative models to benchmark hedge fund returns: 1) a simple market model using the S&P 500 Index return, 2) a lagged market model including the S&P 500 Index return and three monthly lags of the S&P 500 Index return, and 3) an expanded nine-factor Fung and Hsieh (2004) model that includes the original seven factors plus an emerging markets index and Pastor and Stambaugh's (2003) liquidity risk factor. These alternative models yield similar results to those tabulated using the Fung and Hsieh (2004) seven factor model.

= 0.28%; *t*-statistic = 3.18). Note that, in contrast to *Abnormal buffer*, funds in the lowest decile portfolio based on *Buffer* have considerably greater risk exposure to equity market risk (SNPMRF) than funds in the highest decile (0.2742 vs. 0.2020; *t*-statistic = 2.63). This is not surprising since funds with a large *Buffer* maintain large cash holdings and available borrowing and, therefore, tend to have less risk exposure. Thus, in comparison to *Abnormal buffer*, spread portfolios based on *Buffer* entail more factor risk exposure. Finally, Panels C and D show similar results on the ability of raw and abnormal buffers to predict fund performance for funds managed by advisers that file Form 13F. This subsample provides a closer comparison to the results from our later analysis of the performance of hedge funds' stock holdings report in Form 13F filings.

4.2. Cross-sectional regressions

One disadvantage of the portfolio-based approach is that it is difficult to simultaneously control for other characteristics that affect fund performance. However, as regression residuals to Eq. (1), abnormal buffers are orthogonal to several fund characteristics that are known to impact hedge fund returns, like fund size, share restrictions, and lagged returns. Nevertheless, to distinguish our main findings from competing explanations, we estimate Fama and Macbeth (1973) cross-sectional regressions on monthly hedge fund returns. Specifically, we first run cross-sectional regressions for each month. Then, we report the time series averages of the coefficient estimates and use the time series standard errors of the average slopes to draw inferences.

Specifically, we estimate the following month-by-month Fama and Macbeth cross-sectional regressions:

$$Net\ return_{iqm} - RF_{qm} = a + b Abnormal\ buffer_{i,q-1} + \text{Controls} + e_{iqm}, \quad (2)$$

where the dependent variable is fund i's net return during month m of quarter q (m=1,2,3), in excess of the one-month Treasury Bill rate (RF). The key independent variable is *Abnormal buffer* measured at the end of the prior quarter. A finding that $b < 0$ would indicate that greater abnormal buffers predict lower hedge fund returns and, therefore, support our earlier findings from the portfolio sorts. Control variables are measured at the end of the prior quarter and include quarterly net returns and net flows, investment strategy variables, *Portfolio liquidity*, *Investor liquidity*, *Financing liquidity*, *Top5Owner*, log(*Leverage*), log(*NAV*), and log(*AdvHFNAV*).

The results are reported in Columns (1)-(3) of Table 4. The coefficient on *Abnormal buffer* is negative and significant across all specifications, and ranges between -0.0273 and -0.0414. For example, a coefficient of -0.0333 in Column (2) indicates that a one standard deviation decrease in *Abnormal buffer* is associated with an increase in monthly excess returns of 1.10% (= 3.33% × 0.33). Again, we reach similar findings for the subsample of 13F funds (Column (3)). Consistent with prior literature, several other variables predict hedge fund returns, including past returns and funding liquidity.[24] Overall, the results in Table 4 support the portfolio-based evidence that abnormal buffers predict fund returns; we now know that this finding is unlikely to be driven by other known predictors of fund performance.

4.3. Pooled regressions

The above results show that abnormal buffers predict hedge fund returns after controlling for several fund characteristics, but do not control for differences in expected

[24] See, e.g., Liang (1999), Aragon (2007), Agarwal, Daniel, and Naik (2009), Jagannathan, Malakhov, and Novikov (2010), Aragon, Liang, and Park (2013), Sadka (2010), Teo (2011), Aragon, Martin, and Shi (2019), and Barth and Monin (2019). We also tried other control variables, including a fund's adjusted R-squared with respect to the seven-factor model of Fung and Hsieh (2004) (Titman and Tiu, 2011), a fund's strategy distinctiveness index (Sun, Wang, and Zheng, 2012), a measure of a manager's personal investment in the fund from Form ADV filings (Gupta and Sachdeva, 2019), and alternative definitions of *Portfolio liquidity*, *Investor liquidity*, and *Financing liquidity*; however, our qualitative results on the coefficient on *Abnormal buffer* remain the same.

return premiums related to factor risk. However, the evidence in Panel A of Table 3 show that exposures to the Fung-Hsieh factors are very similar among funds with the lowest and highest abnormal buffers. Thus, prima facie, it is unlikely that the predictive power of abnormal buffer for future returns is due to differences in factor exposures. To be sure, we account for differences in factor exposures using the pooled regression model:

$$Net\,return_{iqm} - RF_{qm} = a + b Abnormal\,buffer_{i,q-1} + \text{Controls} + \sum_{k=1}^{7} d_{ki,q-1} F_{km} + e_{im}, \quad (3a)$$

$$d_{ki,q-1} = d_{k0} + d_{ki} Abnormal\,buffer_{i,q-1}, \quad (3b)$$

where F_{km} is the monthly realization of the k'th Fung-Hsieh factor (k=1,…,7) and $d_{ki,q-1}$ is fund i's exposure to the k'th factor at the end of the prior quarter q-1. By allowing factor exposures to depend linearly on abnormal buffers in Eq. (3b), we follow prior studies that address potential misspecification in models relating returns with asset attributes, where variation in the attribute proxies for variation in the asset's exposure to factor risk (Ferson and Harvey, 1997, 1999).

The pooled regression results are reported in Columns (4)-(6) of Table 4. Standard errors are clustered at the month level. Consistent with the evidence from Fama-Macbeth regressions, we find a negative and significant coefficient on *Abnormal buffer* (i.e., $b < 0$). For example, from Column (5) we estimate that a one standard deviation decrease in *Abnormal buffer* predicts 0.88% higher excess returns (t-statistic = -2.33). The results are similar in Column (6) for the subsample of 13F hedge funds. Taken together, the results strongly show that low abnormal buffers predict higher hedge fund returns, and that this finding is not subsumed by other fund characteristics or a greater exposure to factor risk. While the evidence supports the view that low abnormal buffers reflect a greater capacity for informed trading, it does not directly look at hedge fund manager trades. We now turn to this topic in our analysis of stock holdings contained in public filings of Form 13F.

5. Abnormal liquidity buffers and stock trading performance

If hedge fund managers with low abnormal buffers are those with greater profit-making opportunities, then their stock holdings should contain information about stock fundamentals that is not already reflected in prices. We address this in two ways. First, given a manager's stock holdings as of quarter q, we test whether stocks that are held by managers with low abnormal buffers have higher stock returns over quarter q+1. Second, we test whether such low abnormal buffer ownership predicts greater earnings news by the stock, as measured by cumulative stock returns around the earnings announcement date. To implement these tests, we aggregate the abnormal buffers and other characteristics of all hedge funds run by the same adviser. This is because stock holdings are reported at the adviser level (i.e., aggregated across a manager's individual hedge funds). We compute adviser-level NAV as the total NAV summed across an adviser's hedge funds. All other adviser-level variables (e.g., abnormal buffer, leverage) are computed as NAV-weighted averages across funds.

5.1. The predictive power of holdings for quarterly stock returns

We first estimate pooled regressions of the following form:

$$Adjusted\ stock\ return_{iqm} = a + b_1 Low\ buffer\ HF\ ownership_{i,q-1} + b_2 High\ buffer\ HF\ ownership_{i,q-1} + \text{Controls} + e_{im} \quad (4a)$$

The unit of observation is stock-month. The dependent variable is stock i's benchmark-adjusted return during month m of quarter q (m=1,2,3). Adjusted returns are computed by subtracting from raw stock returns either the CRSP value-weighted stock index return (market-adjusted) or, following Daniel et al., (1997), the return on a stock index comprised of stocks with similar market capitalization, book to market ratio, and past stock returns

(DGTW-adjusted).

The key independent variables in Eq. (4a) are the percentages of the stock's market capitalization held by managers with low abnormal liquidity buffers (*Low buffer HF ownership*) and high abnormal liquidity buffers (*High buffer HF ownership*). Low and high buffer managers are those with abnormal liquidity buffers below and above the median across all managers during the quarter, respectively. Thus, if low abnormal buffers are indicative of informed trading, then stocks with greater ownership by low buffer managers should outperform (i.e., $b_1 > 0$), while stocks with greater ownership by high buffer managers should not (i.e., $b_2 = 0$). Finally, we include month dummies and several control variables (not tabulated) to account for differences in stock characteristics, including lagged quarterly observations of the logarithm of the stocks' market capitalization, return volatility, Amihud (2002) illiquidity variable, bid-ask spread, turnover, the stock's return over the prior year, and the average leverage of the stock's hedge fund owners. All right-hand-side variables are measured at the end of quarter q-1. Standard errors are clustered at the stock level.

The results are reported in Panel A of Table 5. Stocks with greater ownership by managers with low buffers significantly outperform other stocks. For example, Column (1) shows that a one standard deviation increase in *Low buffer HF ownership* is associated with a 0.21% per month ($= 0.0417 \times 0.05$) increase in market-adjusted stock returns. A similar finding is shown for DGTW-adjusted returns in Column (4). We also see that *High buffer HF ownership* has no significant relation to future stock returns. Thus, the evidence is consistent with informed stock trading by managers with low liquidity buffers, but not with high liquidity buffers. This helps explain our findings in Section 4 that low abnormal buffers predict a hedge fund's overall portfolio performance.

Hedge fund managers trade across several asset markets, not just equity markets.

Thus, we would expect our stock-level evidence from Form 13F filings to be concentrated mainly among managers that focus more of their investments in equity markets. This is exactly what we find. As shown in Column (2) of Panel A of Table 5, the coefficient on *Low buffer HF ownership* is negative and significant for the subsample of equity-focused managers (coef. = 0.0485; *t*-statistic = 3.67); in contrast, Column (3) shows that the coefficient is insignificant for managers that are not equity-focused (coef. = 0.0024; *t*-statistic = 0.14). These results are robust to the method of adjusting stock returns. Thus, the predictability of abnormal buffer ownership for future stock returns is driven precisely by the subset of managers that focus their investment strategies on equity markets.

Finally, we run an alternative test of the predictive power of low-buffer hedge fund stock ownership by estimating the following pooled regression:

$$Adjusted\ stock\ return_{iqm} = a + c_1 Average\ buffer\ of\ HF\ owners_{i,q-1} + c_2 HF\ ownership + \text{Controls} + e_{im} \quad (4b)$$

All variables are the same as in Eq. (4b), except we swap out *Low buffer HF ownership* and *High buffer HF ownership* and swap in *Average buffer of HF owners* and *HF ownership*, where *Average buffer of HF owners* is the ownership-weighted average abnormal buffer of all hedge funds that hold the stock. The reason is that *Average buffer of HF owners* provides a different measure (compared to *Low buffer HF ownership*) of the extent of stock ownership held by managers with low liquidity buffers. Also, similar to our control for *High buffer HF ownership* in Eq. (4a), we include *HF Ownership* to isolate the effects of our key variable from a generic hedge fund ownership effect. Our main point of interest is whether stocks held by hedge funds with low abnormal buffers outperform (i.e., $c_1 < 0$).

The results are reported in Panel B of Table 5. Consistent with our findings in Panel A, stocks held by hedge funds with low buffers significantly outperform other stocks. For example, Column (1) shows that a one standard deviation drop in *Average buffer of HF owners* is associated with a 9 basis points per month $(= -0.0058 \times 0.15)$ increase in market-adjusted stock returns. We also find a negative coefficient on *Average buffer of HF owners* using DGTW-adjusted returns in Column (4); however, the coefficient is not significant (*t*-statistic = –1.20). We also see that hedge fund ownership is a positive predictor of stock returns, which is consistent with existing results from hedge fund stock trading (Brunnermeier and Nagel, 2004; Aragon and Martin, 2012). Finally, in comparing Columns (2) and (3), we again find stronger results for the subsample of equity-focused managers, and that these results are robust to the method of adjusting stock returns.

5.2. The predictive power of holdings for earnings announcement returns

The evidence in Table 5 shows that that stocks that low-buffer hedge fund managers hold outperform other stocks. In this section, we run a complementary analysis in which we analyze how stocks perform at subsequent corporate earnings announcements. As noted by Baker et al., (2010), analyzing the earnings announcement returns of holdings may have more power to detect successful trading activities since it exploits specific events in which concentrated information about a firm's earning prospects is publicly disclosed.

We measure quarterly earnings announcement returns using cumulative adjusted stock returns over the period covering one day prior to three days after the day of the firm's earnings announcement day during quarter *q*. Adjusted returns are computed as the stock's raw return minus either the CRSP value-weighted stock market index (*Market-adjusted CAR*) or the return on the stock's DGTW-matched portfolio (*DGTW-adjusted CAR*). We exclude observations in which the duration between the announcement date and the consensus forecast data exceeds 90 days or is less than 15 days, and observation where the announcement date precedes the IBES Statistical Period.

Following our Table 5 analysis of quarterly stock returns, we estimate two pooled regression models:

$$Adjusted\ CAR_{iq} = a + b_1 Low\ buffer\ HF\ ownership_{i,q-1} + b_2 High\ buffer\ HF\ ownership_{i,q-1}$$
$$+\text{Controls} + e_{im} \quad (5a)$$

$$Adjusted\ CAR_{iq} = a + c_1 Average\ buffer\ of\ HF\ owners_{i,q-1} + c_2 HF\ ownership + \text{Controls} + e_{im} \quad (5b)$$

The main difference from the Table 5 analysis is that the unit of observation is stock-quarter (since earnings announcements occur once per quarter), and the dependent variable is either the *Market-adjusted CAR* or *DGTW-adjusted CAR* of stock *i* during quarter *q*. Our key predictions are the same: if low abnormal buffers are indicative of informed trading, then stocks with greater ownership by low buffer managers should outperform around earnings announcements (i.e., $b_1 > 0$), while stocks with greater ownership by high buffer managers should not (i.e., $b_2 = 0$). Likewise, in Eq. (5b), we are interested in testing whether stocks held by hedge funds with low abnormal buffers outperform around earnings announcements (i.e., $c_1 < 0$). Finally, we include quarter dummies and the same control variables as in Table 5 (not tabulated) Standard errors are clustered at the stock level.

The results are reported in Table 6. Stocks with greater ownership by managers with low buffers significantly outperform other stocks. For example, Column (1) of Panel A shows that a one standard deviation increase in *Low buffer HF ownership* is associated with a 0.33% per quarter ($= 0.0659 \times 0.05$) increase in market-adjusted stock returns. In contrast, *High buffer HF ownership* has no significant relation to future stock returns. In addition, the predictability of *Low buffer HF ownership* is only significant for equity-focused managers versus non-equity-focused managers (Column (2) vs. (3)). A similar set of results are reported in Columns (4)-(6) for DGTW-adjusted returns and in Panel B where earnings-related CARs are regressed on the average abnormal buffer of a stock's hedge fund owners.

Overall, the evidence in Table 6 complements our earlier findings on the predictability of stock holdings for future stock returns. This evidence is strongest precisely among the subset of managers that focus on equity strategies and, therefore, managers for which stock holdings are more representative of their overall portfolio.

5.3. Portfolio-level results: Do advisers with lower buffers outperform?

An alternative approach to testing the predictability of abnormal buffers for future stock returns is to track the performance of hedge fund advisers' stock portfolios. For each adviser and quarter, we compute one-quarter-ahead returns on the adviser's stock portfolio. We then run the following pooled regression:

$$Adjusted\ portfolio\ return_{i,q} = a + bAbnormalBuffer_{iq-1} + \text{Controls} + e_{i,q+1} \quad (6)$$

where the dependent variable is adviser i's adjusted portfolio return during q corresponding to stocks held at the end of quarter q-1. All right-hand side variables are measured at the end of quarter q-1. The key independent variable is the adviser's abnormal buffer. The finding, $b < 0$, would indicate that advisers with lower abnormal buffers are associated with outperformance in their stock portfolios. As control variables we include quarter dummies, adviser leverage, and natural logarithms of the adviser's *NAV* (summed *NAV* across the adviser's funds), dollar value of stock holdings, and number of stock holdings. We also include several variables (not tabulated) that control for the aggregate characteristics of stocks held, including the stock's return over the prior 12 months, quarterly return volatility, bid-ask spread, Amihud's (2002) illiquidity measure, turnover, and the natural logarithm of stock market capitalization. Standard errors are clustered at the adviser level.

The results are reported in Table 7 and show that abnormal buffers are negative predictors for future stock portfolio returns. For example, the coefficient on *Abnormal buffer* is -0.0070 (t-statistic = -2.14) and -0.0055 (t-statistic = -1.86) for market-adjusted and

DGTW-adjusted returns, respectively. The results are especially significant among equity-oriented managers: a one standard deviation decrease in abnormal buffer is associated with higher market-adjusted quarterly returns on their stock portfolios of 0.38% $(= -0.0116 \times 0.33)$. In contrast, we find no significant relation between buffers and returns for managers that are not focused on equity strategies. To further put the magnitudes of our results into perspective, note that the numbers in Tables 5-7 are effects on *unlevered* returns and, therefore, understate the contribution of stock performance to an adviser's actual portfolio returns, which reflect leverage. For example, a 0.38% quarterly return could translate into a 2:1 levered return of 0.76% per quarter. Taken together, the above results indicate that the stock holdings of advisers with low abnormal buffers contain information about stock fundamentals that are not already reflected into stock prices.

6. Conclusions

We examine the quarterly filings of Form PF over 2013-2017 to shed light on the liquidity management practices of hedge fund managers, and the implications of these practices for fund performance. We find that funds maintain higher liquidity buffers when they hold less liquid assets and when they have shorter-term financing commitments from their investors and creditors. In addition, abnormal buffers – i.e., cash and available borrowing that cannot be explained by funding needs or other characteristics – are predictive of fund performance. Funds with low abnormal buffers outperform their peers by 3% to 4% per year on a risk-adjusted basis, while stocks held by managers with low abnormal buffers earn higher risk-adjusted returns over the following quarter, especially around corporate earnings announcements.

Our findings have important implications for investors and policymakers. First, our evidence shows that hedge fund managers adopt a more conservative approach to their liquidity buffers when they face greater funding liquidity risk. Second, our evidence linking a fund's abnormal liquidity buffer with its investment opportunities suggests that potential constraints on hedge funds' liquidity buffer would be most disruptive to the trading activities of managers with a capacity for informed trading, since these managers make greater-than-normal use of liquid capital to finance positions in undervalued securities. Such disruptions to trading activity could prevent information from being impounded into prices and, hence, reduce market efficiency. Our results highlight the potential policy trade-offs between systemic risk-oriented policies requiring larger liquidity buffers to improve funds' resilience and the impairment of regular price discovery in financial markets.

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Appendix: Variable definitions

Variable	Description and data source
Abnormal buffer	Estimated residuals from pooled least squares regression of hedge fund liquidity buffer (see Eq. (1)) using the full specification corresponding to results in Column (5) of Table 2. Residuals in quarter q are estimated recursively using an expanding estimation window using all available data as of quarter q-1. Data are from Form PF and Datastream.
Average buffer of HF owners	Ownership-weighted average abnormal buffer of all hedge funds that hold the stock. Weights are based on quarter-end stock ownership. Data are from Form PF and 13F.
Available borrowing	Total borrowing available minus used borrowing, divided by NAV. Total borrowing available is from Form PF, Q46 (a). Used borrowing equals actual used borrowing and is from Form PF, Q43 or, if missing, then Q12. NAV is from Form PF, Q9.
Buffer	*Cash* plus *Available borrowing*.
Cash	Unencumbered cash divided by NAV. Form PF, Q33.
DGTW-adjusted CAR	Cumulative adjusted stock return over the period covering one day prior to three days after the day of the firm's earnings announcement day during quarter q+1. Adjusted returns are computed as the stock's raw return minus the return on the stock's DGTW-matched portfolio. Data are from Form 13F, IBES, and CRSP.
DGTW-adjusted portfolio return	Quarter q+1 return of stocks held at the end of quarter q. Returns are computed for each manager and quarter as weighted averages of stock returns in excess of the DGTW benchmarks. Data are from Form 13F, CRSP, and Compustat.
Equity	Percentage of fund's NAV following Equity strategy. Form PF, Q20.
Financing liquidity	Percentage of borrowing with a commitment period of 90 days or less.
HF ownership	Total stock ownership of all hedge fund managers. Ownership is measured at quarter-end. Data are from 13F filings.
High buffer HF ownership	Total stock ownership of hedge fund managers with above-median abnormal liquidity buffers. Ownership is measured at quarter-end. Data are from 13F filings.
Investor liquidity	Percentage of investor capital with a commitment period of 90 days or less.
Leverage	Fund leverage: GAV/NAV, where GAV is fund gross asset value. Form PF, Q8 and Q9.
Log(*AdvHFNAV*)	Natural logarithm of adviser HFs AUM.
Log(*GNE*)	Natural logarithm of fund gross notional exposure.
Log(*leverage*)	Natural logarithm of leverage.
Log(*NAV*)	Natural logarithm of fund NAV.
Log(*Number of stocks held*)	Natural logarithm of number of disclosed stock positions in Form 13F.

Log(*Value of stocks held*)	Natural logarithm of dollar value of disclosed stock positions in Form 13F.
Low buffer HF ownership	Total stock ownership of hedge fund managers with below-median abnormal liquidity buffers. Ownership is measured at quarter-end. Data are from 13F filings.
Market-adjusted CAR	Cumulative adjusted stock return over the period covering one day prior to three days after the day of the firm's earnings announcement day during quarter q+1. Adjusted returns are computed as the stock's raw return minus the CRSP value-weighted stock market index. Data are from Form 13F, IBES, and CRSP.
Market-adjusted portfolio return	Quarter q+1 return of stocks held at the end of quarter q. Returns are computed for each manager and quarter as weighted averages of stock returns in excess of the CRSP value-weighted stock market index. Data are from Form 13F and CRSP.
NAV	Net asset value ($ millions). Form PF, Q9.
Net flow	Quarterly net flows computed as [*NAV*(q)-*NAV*(q-1)*(1+*Net return*(q))]/*NAV*(q-1).
Net return	Quarterly net-of-fees returns computed as the product of (one plus) the monthly returns within the quarter, minus one.
Portfolio liquidity	Percentage of non-cash assets that need 90 days or less to be liquidated.
Prior 2 to 12 month return	Prior 2 to 12 month return of stock underlying disclosed position in Form 13F.
Top5Owner	Percentage of fund's equity own by top 5% owners. Form PF, Q15.
VIX	Level of CBOE Volatility Index. From Datastream.

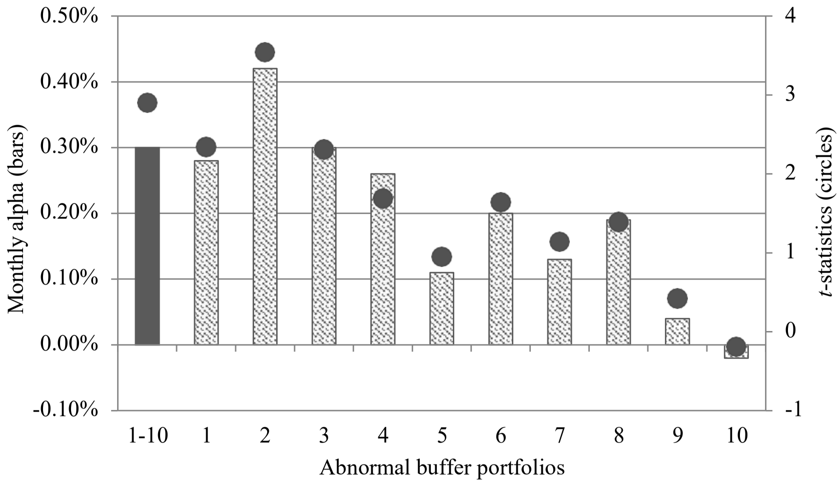

Figure 1: Monthly alphas of hedge fund portfolios. Fung and Hsieh (2004) alphas of hedge fund portfolios. Hedge funds are sorted quarterly into 10 portfolios according to *Abnormal buffer* (defined in Appendix) at the end of each quarter q-1. Monthly portfolio returns are computed as equally weighted net-of-fees fund returns during the following three months of quarter q. Each of the ten series of monthly portfolio returns is regressed on the Fung and Hsieh (2004) seven factors, which include benchmark returns corresponding to the U.S. equity market, the spread between small and big market capitalization stocks, credit spread, term structure spread, and three trend-following strategies. The intercept of each regression is the monthly Fung-Hsieh alpha. The analysis includes the hedge fund universe on Form PF for the period October 2013-June 2017. The dashed bars represent monthly Fung-Hsieh alphas. The circles present the respective t-statistics of the alphas. The figure also displays the alpha of the low-minus-high abnormal buffer spread portfolio (1-10, solid bar).

Table 1: Characteristics of the hedge fund sample over 2013Q2-2017Q3. This table reports summary statistics. All variables are defined in the Appendix.

Variable	N	mn	sd	p25	p50	p75
Panel A: Form PF variables (fund-quarter)						
Buffer	10,666	0.41	0.38	0.15	0.33	0.57
Cash	10,666	0.18	0.22	0.01	0.09	0.26
Available borrowing	10,666	0.23	0.32	0.00	0.11	0.38
Abnormal buffer	10,666	-0.01	0.33	-0.21	-0.05	0.14
Portfolio liquidity	10,666	0.69	0.31	0.51	0.79	0.95
Investor liquidity	10,666	0.45	0.45	0.00	0.25	1.00
Financing liquidity	10,666	0.87	0.29	1.00	1.00	1.00
Log(leverage)	10,666	0.45	0.48	0.09	0.32	0.62
Log(NAV)	10,666	6.87	1.37	6.24	6.97	7.72
Log(AdvHFNAV)	10,666	22.83	1.40	21.70	22.87	23.99
Log(GNE)	10,666	7.92	1.74	6.97	7.94	8.99
Equity	10,666	42.13	46.11	0.00	12.00	100.00
Top5Owner	10,666	60.88	27.62	37.00	57.00	90.00
Net flow	10,666	0.002	0.138	-0.042	-0.001	0.026
Net return	10,666	0.015	0.065	-0.007	0.016	0.038
VIX	10,666	15.56	3.32	13.29	15.29	18.21
NAV ($ millions)	10,666	1991.33	2657.57	514.74	1065.71	2244.75
Leverage	10,666	1.82	1.52	1.09	1.37	1.85

Panel B: Form 13F variables (adviser-quarter)						
Abnormal buffer	2,618	-0.01	0.29	-0.17	-0.03	0.13
Log(NAV)	2,618	8.06	1.11	7.27	7.90	8.84
Log(Value of stocks held)	2,618	21.11	1.52	20.26	21.05	21.97
Log(Number of stocks held)	2,618	3.84	1.48	2.77	3.43	4.60
Leverage	2,618	1.85	1.10	1.29	1.51	1.90
Market-adjusted portfolio return	2,618	0.00	0.06	-0.02	0.00	0.03
DGTW-adjusted portfolio return	2,618	0.00	0.05	-0.02	0.00	0.02
Panel C: Form Stock-level variables (stock-month)						
Average buffer of HF owners	136,012	-0.08	0.15	-0.15	-0.07	-0.01
Low buffer HF ownership	136,012	0.04	0.05	0.01	0.02	0.05
High buffer HF ownership	136,012	0.03	0.04	0.00	0.01	0.03
HF ownership	136,012	0.06	0.07	0.02	0.05	0.09
Market-adjusted portfolio return	136,012	0.00	0.14	-0.05	0.00	0.05
DGTW-adjusted portfolio return	136,012	0.00	0.13	-0.05	0.00	0.05
Panel D: Stock-level variables (stock-quarter)						
Market-adjusted CAR	38,518	0.00	0.11	-0.04	0.00	0.04
DGTW-adjusted CAR	38,518	0.00	0.11	-0.04	0.00	0.04

Table 2: Determinants of hedge fund liquidity buffers. Regressions of quarterly liquidity buffers (cash plus available borrowing). All variables are defined in the Appendix and standardized to have a zero mean and unit variance. *t*-statistics are in parentheses. Standard errors account for heteroskedasticity and fund-level clustering. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

	Dependent variable: $Buffer_{i,q}$				
	(1)	(2)	(3)	(4)	(5)
$Portfolio\ liquidity_{i,q}$	-0.0839***				-0.1521***
	(-7.53)				(-12.87)
$Investor\ liquidity_{i,q}$	0.0792***				0.0738***
	(8.63)				(7.59)
$Financing\ liquidity_{i,q}$	0.0559***				0.0460***
	(5.36)				(4.92)
$Leverage_{i,q}$		0.0240*			0.0392***
		(1.70)			(2.99)
$\text{Log}(NAV)_{i,q}$		-0.1341***			-0.0809***
		(-4.96)			(-2.88)
$\text{Log}(AdvHFNAV)_{i,q}$		-0.0368***			-0.0661***
		(-3.79)			(-6.47)
$\text{Log}(GNE)_{i,q}$		0.1311***			0.1072***
		(4.47)			(3.63)
$Top5Owner_{i,q}$			0.0315***		0.0279***
			(3.74)		(2.85)
VIX_q			0.0093***		0.0053**
			(3.22)		(2.03)
$Max(Net\ flow,0)_{i,q-1}$				-0.0014	-0.0085**
				(-0.33)	(-2.24)
$Min(Net\ flow,0)_{i,q-1}$				-0.0181***	-0.0087
				(-3.11)	(-1.60)
$Max(Net\ return,0)_{i,q-1}$				-0.0048	-0.0098*
				(-0.71)	(-1.84)
$Min(Net\ return,0)_{i,q-1}$				-0.0225***	-0.0095*
				(-3.70)	(-1.96)
Intercept	0.4155***	0.3927***	0.3591***	0.4091***	0.3256***
	(42.16)	(43.01)	(14.43)	(42.82)	(14.19)
Style controls?	No	No	Yes	No	Yes
N	10,666	10,666	10,666	10,666	10,666
R-squared	0.076	0.058	0.062	0.005	0.212

Table 3: Sorts on liquidity buffer

Hedge funds are sorted into deciles based on their liquidity buffer at the end of every quarter. Alpha is estimated using monthly net-of-fees portfolio returns relative to the Fung and Hsieh (2004) seven-factor model. Portfolio returns are equally-weighted. The Fung and Hsieh (2004) seven factors are Standard and Poor's 500 return minus the risk free rate (SNPMRF), Russel 2000 index minus Standard and Poor's 500 index returns (SCMLC), Barclays U.S. Treasury 7-10 Year index minus the risk free rate (BD10RET), Barclays Baa U.S. Corporate USD index minus Barclays Aaa U.S. Corporate index returns (BAAMTSY), bond PTFS (PTFSBD), currency PTFS (PTFSFX), and commodities PTFS (PTFSCOM), where PTFS is primitive trend following strategy. *t*-statistics are reported in parentheses. The evaluation period is from October 2013 to June 2017. Results are reported separately for abnormal buffer (Panels A and C) and raw buffer (Panels B and D), and for the subsample of funds that file Form 13F (Panels C and D). *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

	Excess return	Alpha	SNPMRF	SCMLC	BD10RET	BAAMTSY	PTFSBD	PTFSFX	PTFSCOM
Panel A: *Abnormal buffer*, full sample									
Q1	0.0059***	0.0028**	0.2314***	0.0255	0.0027	0.2142	-0.0264**	0.0115	-0.0033
	(3.54)	(2.34)	(5.48)	(0.61)	(0.02)	(1.68)	(-2.18)	(1.39)	(-0.38)
Q10	0.0020	-0.0002	0.2207***	0.0167	0.0532	0.1488	0.0007	0.0009	0.0002
	(1.34)	(-0.19)	(4.14)	(0.36)	(0.47)	(0.99)	(0.06)	(0.13)	(0.02)
Q1 − Q10	0.0039***	0.0030***	0.0107	0.0088	-0.0505	0.0654	-0.0272**	0.0106	-0.0036
	(3.90)	(2.90)	(0.36)	(0.29)	(-0.45)	(0.46)	(-2.48)	(1.50)	(-0.48)
Panel B: *Buffer*, full sample									
Q1	0.0059***	0.0028***	0.2742***	0.0442	0.0995	0.3240***	-0.0171	0.0077	0.0019
	(3.59)	(2.85)	(7.43)	(1.29)	(1.25)	(3.17)	(-1.62)	(1.15)	(0.28)
Q10	0.0017	-0.0000	0.2020***	-0.0083	0.1245	0.1957	0.0045	0.0056	0.0044
	(1.29)	(-0.04)	(4.07)	(-0.18)	(1.13)	(1.28)	(0.36)	(0.76)	(0.51)
Q1 − Q10	0.0042***	0.0028***	0.0722**	0.0525	-0.0250	0.1282	-0.0216**	0.0021	-0.0025
	(3.91)	(3.18)	(2.63)	(1.42)	(-0.29)	(0.93)	(-2.28)	(0.33)	(-0.44)

				Panel C: *Abnormal buffer*, 13F sample					
Q1	0.0060***	0.0024*	0.2849***	0.0144	0.0593	0.2249	-0.0285**	0.0129	0.0019
	(3.21)	(1.97)	(5.49)	(0.32)	(0.45)	(1.46)	(-2.22)	(1.54)	(0.18)
Q10	0.0016	-0.0012	0.3206***	0.0712	0.1090	0.1082	0.0084	-0.0008	0.0003
	(0.88)	(-0.85)	(6.02)	(1.47)	(0.80)	(0.58)	(0.54)	(-0.09)	(0.02)
Q1 − Q10	0.0043***	0.0036**	-0.0357	-0.0567*	-0.0498	0.1168	-0.0369**	0.0137*	0.0016
	(3.32)	(2.56)	(-0.93)	(-1.75)	(-0.35)	(0.64)	(-2.56)	(1.71)	(0.16)
				Panel D: *Buffer*, 13F sample					
Q1	0.0056***	0.0021	0.2823***	0.0774	0.0894	0.2652*	-0.0251*	0.0076	-0.0021
	(2.97)	(1.59)	(5.48)	(1.66)	(0.85)	(1.85)	(-1.71)	(0.83)	(-0.26)
Q10	0.0017	-0.0003	0.2450***	0.0141	0.1836	0.1285	0.0074	0.0069	0.0045
	(1.11)	(-0.21)	(4.73)	(0.28)	(1.28)	(0.62)	(0.51)	(0.80)	(0.48)
Q1 − Q10	0.0038***	0.0024**	0.0373	0.0632	-0.0942	0.1367	-0.0325***	0.0007	-0.0066
	(2.93)	(2.04)	(1.04)	(1.56)	(-0.81)	(0.92)	(-2.84)	(0.08)	(-0.92)

Table 4: Fama-Macbeth and pooled regressions of hedge fund performance

The table reports results from regressions of monthly hedge fund portfolio returns. The dependent variable is the net-of-fees return of hedge fund i during the m'th month of quarter q (m = 1,2,3) in excess of the risk-free rate. The key independent variable is the hedge fund's abnormal liquidity buffer (*Abnormal buffer*) at the end of quarter q-1. Additional controls are measured at the end of quarter q-1 and include *Leverage*, *Net return*, *Net flow*, *Top5Owner*, *Investor liquidity*, *Financing liquidity*, *Portfolio liquidity*, and natural logarithms of *NAV* and the aggregate hedge fund *NAV* of the fund's adviser. All variables are defined in the Appendix. Columns (1)-(3) report the average coefficient obtained from month-by-month, cross-sectional regressions in the spirit of Fama and Macbeth (1973). Columns (4)-(6) show estimated coefficients from pooled OLS regressions using the entire sample of monthly fund returns. Standard errors in pooled regressions are clustered at the month level. Columns (5) and (6) additionally include monthly observations of the seven factors of Fung and Hsieh (2004) and their interaction with *Abnormal buffer*. All regressions include strategy variables. Columns (1), (2), (4), and (5) present results for the full sample of hedge funds; Columns (3) and (6) present results for the subsample of hedge funds that file Form 13F. t-statistics are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

	Dependent variable: *Net return*$_{i,q,m}$ - Risk free rate$_{q,m}$					
	Fama Macbeth regressions			Pooled regressions		
	(1)	(2)	(3)	(4)	(5)	(6)
Abnormal buffer$_{i,q-1}$	-0.0414***	-0.0333***	-0.0273***	-0.0360***	-0.0267**	-0.0260**
	(-3.85)	(-3.11)	(-3.55)	(-3.79)	(-2.33)	(-2.64)
Log(*leverage*$_{i,q-1}$)	-	-0.0153	-0.0156	-	-0.0128	-0.0139
	-	(-1.05)	(-0.95)	-	(-0.79)	(-0.76)
Log(*NAV*$_{i,q-1}$)	-	0.0034	0.0055	-	0.0035	0.0007
	-	(0.22)	(0.53)	-	(0.23)	(0.07)
Log(*AdvHFNAV*$_{i,q-1}$)	-	0.0057	-0.0029	-	-0.0011	-0.0057
	-	(0.5)	(-0.23)	-	(-0.09)	(-0.41)
Net return$_{i,q-1}$	-	0.1552***	0.1671***	-	0.1518***	0.1667***
	-	(4.73)	(4.52)	-	(5.78)	(5.64)
Net flow$_{i,q-1}$	-	-0.0182*	-0.0167	-	-0.0085	-0.0099
	-	(-1.84)	(-1.6)	-	(-0.89)	(-1.03)
Top5Owner$_{i,q-1}$	-	-0.0009	-0.0027	-	0.0013	-0.0022
	-	(-0.1)	(-0.38)	-	(0.15)	(-0.29)
Investor liquidity$_{i,q-1}$	-	-0.0047	0.0056	-	-0.0007	0.0076
	-	(-0.53)	(0.64)	-	(-0.07)	(0.77)
Financing liquidity$_{i,q-1}$	-	-0.023***	-0.0292***	-	-0.0321***	-0.0409***
	-	(-2.8)	(-2.97)	-	(-3.90)	(-3.94)
Portfolio liquidity$_{i,q-1}$	-	-0.0202	-0.0118	-	-0.0228	-0.0148
	-	(-1.19)	(-0.7)	-	(-1.25)	(-0.82)
Observations	29,331	29,331	21,655	29,331	29,331	21,655
Adj. R-squared	0.004	0.170	0.187	0.115	0.106	0.129
Strategy controls?	Yes	Yes	Yes	Yes	Yes	Yes
Month dummies?	No	No	No	Yes	No	No
FH7 controls?	No	No	No	No	Yes	Yes
Sample	All funds	All funds	13F funds	All funds	All funds	13F funds

Table 5: Hedge fund ownership and future stock returns

The unit of observation is stock-month. Dependent variable is stock i's adjusted return during month m of quarter q (m=1,2,3). Adjusted returns subtract either the aggregate equity market return (1-3) or the Daniel, Grinblatt, Titman, and Wermers (DGTW, 1997) benchmark return (4-6). All independent variables are measured at the end of quarter q-1. In Panel A, the key independent variable is the stock ownership aggregated across all hedge fund owners with low liquidity buffers (*Low buffer HF ownership*). A hedge fund has a low buffer if its abnormal buffer is below the median abnormal buffer during the quarter. In Panel B, the key independent variable is the average abnormal buffer of the stock's hedge fund owners. *HF ownership* is the total number of shares held by all hedge fund managers dividedby shares outstanding. All other variables are defined in the Appendix. All regressions include month dummies and lagged quarterly observations of the logarithm of the stocks' market capitalization, return volatility, Amihud (2002) illiquidity variable, bid-ask spread, turnover, and the stock's return over the prior year. We also include the average leverage of the stock's hedge fund owners. Results arereported separately for the full sample, equity-oriented, and non-equity-oriented managers. Equity oriented managers have more than 50% of their aggregate net asset value invested in equity strategies. t-statistics are in parentheses. Standard errors account for heteroskedasticity and stock-level clustering. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Returns regressed on low versus high buffer ownership

	Market-adjusted returns$_{i,q,m}$			*DGTW-adjusted returns$_{i,q,m}$*		
	(1)	(2)	(3)	(4)	(5)	(6)
Low buffer HF ownership$_{i,q-1}$	0.0417***	0.0485***	0.0024	0.0363***	0.0404***	0.0051
	(3.46)	(3.67)	(0.14)	(3.17)	(3.19)	(0.28)
High buffer HF ownership$_{i,q-1}$	-0.0019	-0.0058	0.0045	-0.0004	-0.0010	0.0010
	(-0.17)	(-0.39)	(0.23)	(-0.03)	(-0.07)	(0.05)
Observations	136,012	128,683	130,537	136,012	128,683	130,537
R-squared	0.025	0.027	0.026	0.002	0.002	0.001
Month fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes
Stock control variables?	Yes	Yes	Yes	Yes	Yes	Yes
Subsample	Full sample	Equity	Non-equity	Full sample	Equity	Non-equity

Panel B: Returns regressed on average buffer of hedge fund owners

	Market-adjusted returns $_{i,q,m}$			*DGTW-adjusted returns* $_{i,q,m}$		
	(1)	(2)	(3)	(4)	(5)	(6)
Average buffer of HF owners $_{i,q-1}$	-0.0058**	-0.0063***	0.0059	-0.0032	-0.0049**	0.0060
	(-2.22)	(-3.20)	(1.36)	(-1.20)	(-2.51)	(1.39)
HF ownership $_{i,q-1}$	0.0246***	0.0317***	0.0032	0.0218***	0.0276***	0.0031
	(3.18)	(3.15)	(0.27)	(2.89)	(2.86)	(0.27)
Observations	136,012	128,683	130,537	136,012	128,683	130,537
R-squared	0.024	0.026	0.026	0.002	0.002	0.001
Month fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes
Stock control variables?	Yes	Yes	Yes	Yes	Yes	Yes
Subsample	Full sample	Equity	Non-equity	Full sample	Equity	Non-equity

Table 6. Hedge fund ownership and stock returns around earnings announcements. The unit of observation is stock-quarter. Dependent variable is stock *i*'s cumulative adjusted return (CAR) around its earnings announcement during quarter *q*. The event window covers one day before through three days after the announcement day [-1,+3]. Adjusted returns subtract either the aggregate equity market return (1-3) or the Daniel, Grinblatt, Titman, and Wermers (DGTW, 1997) benchmark return (4-6). All independent variables are measured at the end of quarter *q*-1. In Panel A, the key independent variable is the stock ownership aggregated across all hedge fund owners with low liquidity buffers (*Low buffer HF ownership*). A hedge fund has a low buffer if its abnormal buffer is below the median abnormal buffer during the quarter. In Panel B, the key independent variable is the average abnormal buffer of the stock's hedge fund owners. *HFownership* is the total number of shares held by all hedge fund managers divided by shares outstanding. All other variables are definedin the Appendix. All regressions include month dummies and lagged quarterly observations of the logarithm of the stocks' market capitalization, return volatility, Amihud (2002) illiquidity variable, bid-ask spread, turnover, and the stock's return over the prior year. We also include the average leverage of the stock's hedge fund owners. Results are reported separately for the full sample, equity-oriented, and non-equity-oriented managers. Equity oriented managers have more than 50% of their aggregate net asset value invested in equity strategies. *t*-statistics are in parentheses. Standard errors account for heteroskedasticity and stock-level clustering. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Earnings-related CARs regressed on low versus high buffer ownership

	Market-adjusted CARs$_{i,q}$			*DGTW-adjusted CARs$_{i,q}$*		
	(1)	(2)	(3)	(4)	(5)	(6)
Low buffer HF ownership$_{i,q-1}$	0.0659**	0.0748**	0.0221	0.0623**	0.0684*	0.0226
	(2.21)	(1.99)	(1.13)	(2.13)	(1.85)	(1.15)
High buffer HF ownership$_{i,q-1}$	0.0093	-0.0031	0.0355	0.0053	-0.0079	0.0260
	(0.53)	(-0.13)	(1.33)	(0.30)	(-0.37)	(0.92)
Observations	38,518	37,220	38,006	38,518	37,220	38,006
R-squared	0.004	0.004	0.003	0.002	0.002	0.002
Month fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes
Stock control variables?	Yes	Yes	Yes	Yes	Yes	Yes
Subsample	Full sample	Equity	Non-equity	Full sample	Equity	Non-equity

Panel B: Earnings-related CARs regressed on average buffer of hedge fund owners

	Market-adjusted $CARs_{i,q}$			*DGTW-adjusted $CARs_{i,q}$*		
	(1)	(2)	(3)	(4)	(5)	(6)
Average buffer of HF owners$_{i,q-1}$	-0.0102**	-0.0049*	-0.0027	-0.0101***	-0.0050*	-0.0016
	(-2.53)	(-1.65)	(-0.42)	(-2.58)	(-1.75)	(-0.25)
HF ownership$_{i,q-1}$	0.0435***	0.0488**	0.0278*	0.0398**	0.0429*	0.0240
	(2.73)	(2.11)	(1.84)	(2.53)	(1.90)	(1.53)
Observations	38,518	37,220	38,006	38,518	37,220	38,006
R-squared	0.004	0.004	0.003	0.002	0.002	0.002
Month fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes
Stock control variables?	Yes	Yes	Yes	Yes	Yes	Yes
Subsample	Full sample	Equity	Non-equity	Full sample	Equity	Non-equity

Table 7: Quarterly returns of managers' stock portfolios.
The unit of observation is manager-quarter. The dependent variable is the quarterly adjusted return of adviser *i*'s stock portfolio during quarter *q*. Adjusted returns subtract either the aggregate equity market return (1-3) or the Daniel, Grinblatt, Titman, and Wermers (DGTW, 1997) benchmark return (4-6). All independent variables are measured at the end of quarter *q*-1. The key independent variable is the manager's abnormal buffer. Additional control variables include the adviser's leverage and the natural logarithms of aggregate hedge fund *NAV*, dollar value of stock holdings, and number of stocks held. All regressions include quarter dummies and portfolio-weighted, quarterly observations of stock portfolio control variables, including quarterly return volatility, Amihud (2002) illiquidity measure, bid-ask spread, turnover, prior year's stock return, and the natural logarithm of stock market capitalization. Results are reported separately for the full sample, equity-oriented managers, and non-equity-oriented managers. Equity oriented managers have more than 50% of their aggregate net asset value invested in equity strategies. Standard errors are clustered by managers; t-statistics are reported in parentheses. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

	Market-adjusted portfolio return$_{i,q}$			*DGTW-adjusted portfolio return$_{i,q}$*		
	(1)	(2)	(3)	(4)	(5)	(6)
Abnormal buffer$_{i,q-1}$	-0.0070**	-0.0116***	0.0024	-0.0055*	-0.0104***	0.0057
	(-2.14)	(-3.07)	(0.43)	(-1.86)	(-3.04)	(1.19)
Log(NAV$_{i,q-1}$)	-0.0029**	-0.0030*	-0.0006	-0.0026**	-0.0026	-0.0006
	(-2.04)	(-1.69)	(-0.36)	(-2.02)	(-1.47)	(-0.41)
Log(Value of stocks held$_{i,q-1}$)	0.0026**	0.0027	-0.0000	0.0023**	0.0025	-0.0001
	(2.38)	(1.42)	(-0.01)	(2.46)	(1.33)	(-0.08)
Log(Number of stocks held$_{i,q-1}$)	-0.0001	-0.0003	0.0010	0.0001	-0.0003	0.0014
	(-0.09)	(-0.22)	(0.79)	(0.11)	(-0.22)	(1.28)
Leverage$_{i,q-1}$	-0.0012	-0.0005	-0.0010	-0.0010	-0.0004	-0.0010
	(-1.46)	(-0.34)	(-0.93)	(-1.48)	(-0.29)	(-1.11)
Portfolio control variables?	Yes	Yes	Yes	Yes	Yes	Yes
Quarter fixed effects?	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2,618	1,604	1,014	2,618	1,604	1,014
R-squared	0.138	0.180	0.125	0.089	0.120	0.089
Subsample	Full sample	Equity	Non-equity	Full sample	Equity	Non-equity

NOTES

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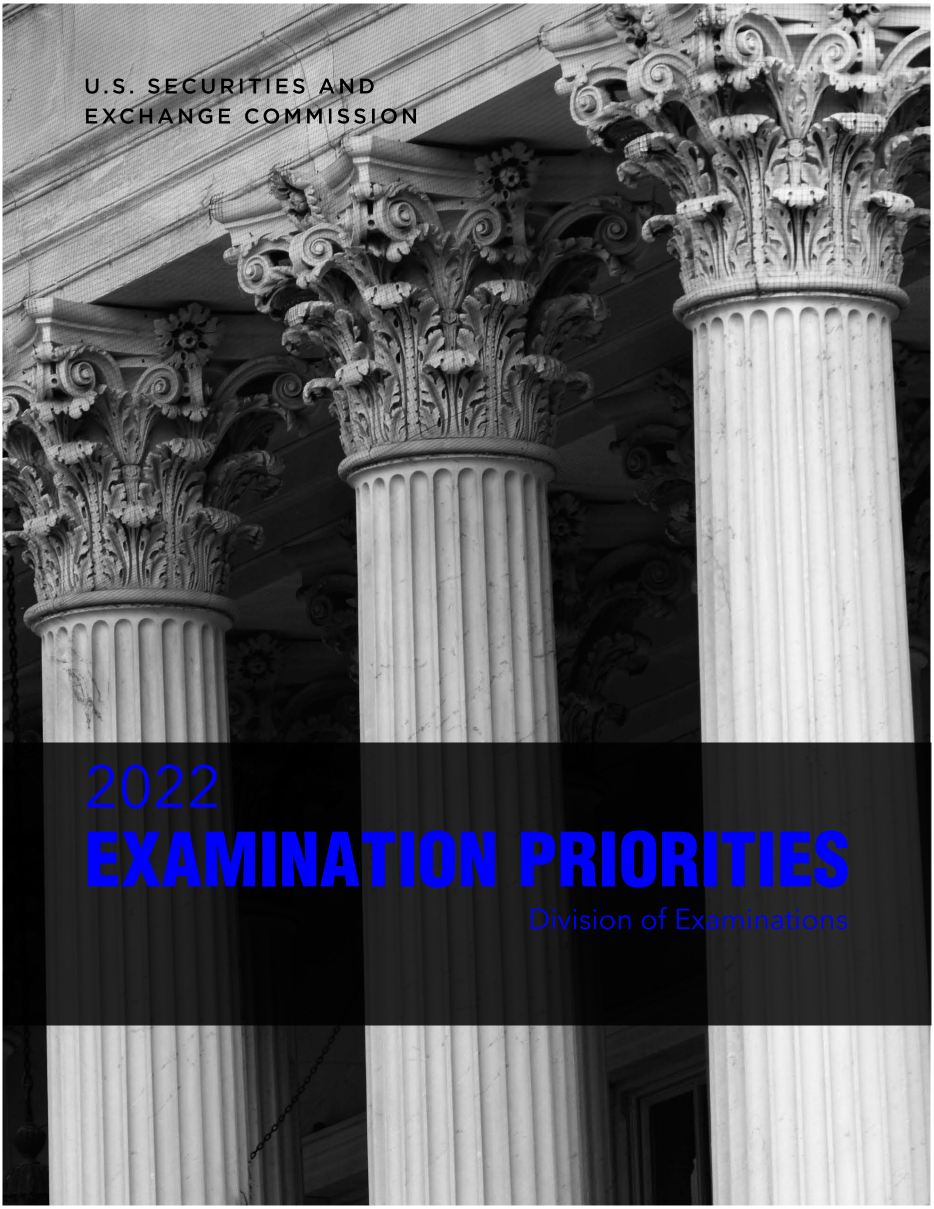
U.S. Securities and Exchange Commission, Division of Examinations 2022 Handbook Materials

- 2022 Examination Priorities (March 30, 2022), https://www.sec.gov/files/2022-exam-priorities.pdf
- Risk Alert: Recent Observations from Municipal Advisor Examinations (August 22, 2022) https://www.sec.gov/municipal-advisor-risk-alert-2022.pdf
- Risk Alert: Observations from Examinations in the Registered Investment Company Initiative (October 26, 2021), https://www.sec.gov/files/exams-registered-investment-company-risk-alert.pdf
- Risk Alert: Observations from Examinations of Advisers that Provide Electronic Investment Advice (November 9, 2021, https://www.sec.gov/files/exams-eia-risk-alert.pdf
- Risk Alert: Division of Examinations Observations: Investment Advisers' Fee Calculations (November 10, 2021), https://www.sec.gov/files/exams-risk-alert-fee-calculations.pdf
- Risk Alert: Observations from Examinations of Private Fund Advisers (January 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf
- Risk Alert: Investment Adviser MNPI Compliance Issues (April 26, 2022), https://www.sec.gov/files/code-ethics-risk-alert.pdf



U.S. SECURITIES AND
EXCHANGE COMMISSION

2022
EXAMINATION PRIORITIES

Division of Examinations

DISCLAIMER: This statement represents the views of the staff of the Division of Examinations. It is not a rule, regulation, or statement of the U.S. Securities and Exchange Commission (SEC). The Commission has neither approved nor disapproved its content. This statement, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by the Division of Examinations and is not legal advice.

CONTENTS

DIVISION OF EXAMINATIONS' LEADERSHIP MESSAGE

The Division of Examinations is pleased to share our examination priorities for fiscal year (FY) 2022. Last year, we acknowledged two important exam milestones, the elevation of the Office of Compliance Inspections and Examinations to the Division of Examinations and the 25th anniversary of a stand-alone examination program. This year, we mark another important milestone – a decade of publishing the Division's examination priorities.

Richard R. Best
Acting Director

Joy G. Thompson
Acting Deputy Director

The annual publication of our examination priorities furthers the SEC's mission and aligns with the Division's four pillars to promote and improve compliance, prevent fraud, monitor risk, and inform policy. The examination priorities have taken on greater prominence over the years and have become an important tool for the examination program. The publication of the examination priorities provides investors and registrants transparency into those areas we believe bring heightened risks to investors, registrants, and the markets.

If you were to review the Division's first priorities from February 2013, you might notice its relative brevity. But upon closer inspection, you would see that many of today's priorities address topics and themes similar to those that the examination program was prioritizing in 2013, and likely many years in between. These perennial priorities represent fundamental obligations under the federal securities laws and are frequently at the core of SEC-registrant operations. For example, the 2013 priorities included a focus on high risk areas such as conflicts of interest, disclosures of fees and expenses, safety of investor and client assets, sales practices, and oversight of systemically important and similarly situated organizations that are essential to the fair and orderly operation of our markets. And although the word "cyber" was not used until 2014, risks related to data compromises were highlighted as well as what has become a perennial focus on addressing the impact and governance surrounding the use of new and emerging technologies across registrant types.

Not all priorities are perennial, however. Each year, in developing our examination priorities, we engage in a deliberative process across the SEC to identify the areas we believe exhibit the highest risks to investors and the markets or are trending in that direction. Some areas take on more or less prominence in our examinations as the markets, technology, regulation, services provided to investors, and investor preferences evolve. However, it is important to note that as our priorities evolve, it does not mean we are no longer conducting examinations in areas not specifically noted in our priorities. Published priorities are not exhaustive, nor do they represent the only areas we will consider in assessing and identifying examination candidates.

Underpinning the last decade of published priorities is the desire to be transparent about the heightened risks that we see, to highlight many of the areas examinations will focus on in the year ahead, and ultimately to protect investors, prevent fraud, and promote and improve compliance. We hope that firms' leadership, including those in compliance, legal, risk, and information security, across the financial services industry will review the priorities and consider their firms' operations and internal controls in these higher-risk areas to avoid potential compliance weaknesses or failures.

Fiscal Year 2021

The Division completed 3,040 examinations in FY21, a 3% increase from FY20 and about on par with pre-Covid-19 pandemic examination totals in FY19. In addition to examinations, the staff conducted hundreds of registrant outreach meetings to monitor several very significant market events, including the volatility in the equity and options markets in early 2021 that touched on several of our program areas. And although numbers are just part of the story, underpinning the great exam numbers for FY21 is the continued perseverance of the staff of the Division and their unwavering commitment to the SEC's and the Division's mission to protect investors. We are incredibly proud of the staff's continued efforts this past year to perform meaningful examinations remotely while contending with the on-going impacts of the Covid-19 pandemic.

During FY21, the Division issued more than 2,100 deficiency letters. Through these letters, we have our most direct impact improving and promoting compliance and investor protection and addressing market risk. Most firms, as a result of the deficiency letters we issue, take steps to remediate the staff's findings. Frequently, remediation includes implementing changes to policies and procedures so they are more effective, updating regulatory filings so they are more clear and responsive, or improving the quality of disclosures made to investors to be more transparent. Deficiency letters have also prompted some firms to return fees and other charges back to investors and make corrections in how they were calculating those fees. To date, our FY21 examinations prompted firms to return more than $45M to investors. The Division also made more than 190 referrals of its examination findings to the Division of Enforcement. As we move further into FY22, we anticipate there will be more money returned to investors, and there will be additional referrals to Enforcement resulting from our FY21 examinations.

The Investment Adviser/Investment Company (IA/IC) Examination Program, the Division's largest program, completed more than 2,200 examinations of investment advisers in FY21, an increase from both FY20 and FY19. It also completed over 125 examinations of investment company complexes. In addition to the number of exams, an important metric is the percentage of SEC-registered investment advisers we examine each year. As the primary and often only regulator responsible for the oversight of this cohort of registrants, we closely track our coverage ratio and have targeted it to be 15% for the past several years. This year, the Division examined approximately 16% of RIAs, compared to 15% in FY20 and FY19. Although there was a slight increase in the coverage percentage in FY21, we will likely soon have to lower our annual coverage target as the growth in the number of RIAs continues to grow at a rate that far outpaces staffing increases. In FY21, we saw some of the fastest year-over-year growth ever, with a net addition of approximately 900 RIAs. And over the last five years, the number of RIAs has increased 20%, from approximately 12,250 to over 14,800.

The growth in the numbers of RIAs does not fully capture the increasing complexity of the asset management industry, and the resulting increased complexity of the compliance issues and risks covered by our examinations. For instance, the number of RIAs with AUM over $10 billion has increased by 30% in the past five years alone, and total AUM is now over $113 trillion, itself a nearly 70% increase from five years ago. In addition, approximately 60% of RIAs are affiliated with other financial industry firms, and more than 35% manage a private fund.

The Division's Broker-Dealer and Exchange Examination Program continued to conduct examinations focused on broker-dealers' compliance with Regulation Best Interest, wrapping up its initial exams to look for good faith compliance and kicking off the second phase of examinations with additional review of effectiveness of policies and procedures and transaction testing. In addition to the oversight of broker-dealers, BDX conducts examinations of municipal advisors, national securities exchanges, and transfer agents. The program completed nearly 450 examinations of these registrants in FY21.

The FINRA and Securities Industry Oversight (FSIO) Examination Program completed more than 115 examinations of FINRA in FY21, including examinations of key FINRA oversight areas, and held frequent monitoring meetings with FINRA on various aspects of its operations to assess and identify risk areas in these operations.

The Clearance and Settlement Examination Program conducted 15 examinations of clearing firms, including critically important work around the Systemically Important Financial Market Utilities (or SIFMUs). And our Technology Controls Program (TCP) completed 81 examinations, including examinations of entities subject to Regulation Systems Compliance and Integrity (SCI), RIAs and broker-dealers.

The Division also maintained its focus on transparency and support of compliance through outreach events and publications. Division staff participated in more than 150 conferences and outreach events, including a national outreach event for municipal advisors in October and regional outreach events for IA and IC compliance officers. We continued to maintain a steady pace of issuing Risk Alerts throughout the year as well. In FY21, the Division published nine Risk Alerts across a variety of topics. These Risk Alerts are designed to raise awareness of compliance and industry risks and are meant to encourage firms to think about their own policies and procedures in particular areas. The FY21 Risk Alerts include:

- Observations from Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices
- Investor Adviser Compliance Programs
- Observations from Examinations of Broker-Dealers and Investment Advisers: Large Trader Obligations
- Executive Order on Securities Investments that Finance Communist Chinese Military Companies
- The Division of Examinations' Continued Focus on Digital Asset Securities
- Compliance Issues Related to Suspicious Activity Monitoring and Reporting at Broker-Dealers
- The Division of Examinations' Review of ESG Investing
- Observations from Examinations of Investment Advisers Managing Client Accounts that Participate in Wrap Fee Programs
- Observations Regarding Fixed Income Principal and Cross Trades by Investment Advisers from an Examination Initiative

We intend to continue publishing Risk Alerts, providing observations from examinations and alerting the industry to potentially new compliance and market risks. We take our role to promote compliance to mean that part of our job is to raise awareness of compliance risks and share practices that aided an effective compliance strategy.

A Word About "Compliance"

With our name change last year to the Division of Examinations, some have speculated that the removal of "compliance" from the Division's name was intended to deemphasize our long-standing focus on, and commitment to, promoting compliance and to empowering compliance officers. Rest assured, that is not the case.

The importance of improving and promoting compliance remains at the forefront of the Division's work. We engage with Chief Compliance Officers and compliance staff routinely on each examination. In addition, we have continued to look for opportunities to engage with compliance professionals and the compliance community through various outreach initiatives. For example, as noted above, we conduct several national and regional compliance outreach programs each year for a variety of registrant types, and publish our priorities, Risk Alerts and other reports to provide transparency on many areas directly tied to compliance.

While many registrants demonstrate the value and importance they place on compliance, far too often we examine registrants where that is not the case. In last year's leadership message we highlighted compliance engagement across business lines, knowledgeable Chief Compliance Officers, and firm principals' commitment to compliance. It bears repeating– compliance officers must be empowered and receive support in the form of resources and a tone from the top that recognizes their contributions. Senior officers and executives empower compliance and compliance officers through their words and actions.

Another characteristic of an effective compliance program is resiliency, which has never been more apparent as we all continue to address pandemic-related change. Compliance programs and the written policies and procedures that embody them should be developed and designed to continue to be effective and withstand changes in, for example, market conditions, investor demand, key personnel, and registrant services or lines of business. A well-designed and resilient compliance program and compliance staff should be able to adjust, pivot, and address a range of conditions and scenarios.

In performing examinations, we have observed several commonalities of resilient compliance programs.

Inclusivity

The primary responsibility to develop and maintain a compliance program may be with the Chief Compliance Officer and others in a compliance department, but for most firms the foundation of a resilient compliance program requires participation and input across all business and operational lines. Staff from across a firm working in collaboration with compliance can bring additional expertise and diverse perspectives to the development of a compliance program and the design of effective controls. Additional benefits, including a sense of shared ownership and greater attention to implementation, can also result from an inclusive approach to compliance.

Change Management

A well thought out and well-designed compliance program will be flexible enough to adjust to known variables in operations and business, but will also have established processes in place to monitor effectiveness and to pivot or be updated when appropriate. As we have all experienced over the last couple of years, significant unanticipated events can occur as well as more incremental change that can compound over time or across operational lines, causing once effective policies and procedures or controls to become weak or ineffective. Compliance programs and related policies and procedures are not "set it and forget it" endeavors, and having a process in place to address new compliance risks and challenges is critical to resiliency.

Reviews and Testing

Periodic review and testing of policies and procedures is necessary to ensure the on-going adequacy and effectiveness of a compliance program. As the Commission has noted in the context of investment adviser compliance programs, reviews should consider compliance matters that arose previously, changes in business activities, and regulatory changes. Testing is also critical, as it provides a means to affirm that policies and procedures are operating as designed and to ensure the detection of outlier events or unusual patterns. An effective testing program, such as one that includes testing on a routine periodic basis at set intervals, when certain transactions occur, and over extended periods to look for patterns or emerging trends, deployed in conjunction with periodic reviews, significantly contributes to the on-going resiliency of a compliance program.

We fully anticipate that our focus on compliance, support of compliance, and compliance empowerment will continue and we look forward to continued engagement with the compliance community in the year to come.

Final Notes

Perhaps the most significant storyline of FY21 for the Division was the continued impact of the Covid-19 pandemic on us and the financial services industry generally. As we look back on the Division's results from the previous year and plan for the new initiatives and focus areas for the year to come, the theme of resiliency again comes to mind. Specifically, the resiliency of the Division's systems and controls, the resiliency of our operating posture and capacity, but most importantly, the resiliency of the 1000 plus person staff that make up the examination program. Their tenacity, commitment to mission and public service, and collaborative spirit is really the crowning achievement for the year. We are certain many firms share a similar sentiment for their own employees and the resiliency they have demonstrated.

Finally, the past year has brought change to the Division. We established the Office of Security-Based Swaps to carry out the Division's oversight responsibilities for security-based swaps entities registered with the Commission, including security-based swaps dealers, and to coordinate and collaborate with our colleagues in the Division of Trading and Markets and other offices and divisions as part of the newly launched Security-Based Swaps Joint Venture. We examined registrants for compliance for several new regulations, including amendments to Regulation NMS Rule 606 and the Investment Company Liquidity Risk Management Program Rule. And last, there was change in the senior leadership ranks of the Division with the departure of Director Pete Driscoll, Acting Director and Chief Counsel Dan Kahl, Deputy Director and co-head of the IA/IC examination program Kristin Snyder, and head of the Clearance and Settlement program Dan Gregus. We thank them for their service, and are fortunate that there are many great leaders in the Division to fill these gaps, including Joy Thompson, Natasha Greiner, and Lourdes Caballes who are currently leading as Deputy Director, co-head of the IA/IC examination program, and head of the Office of Clearance and Settlement, respectively.

The Division's contact information can be found at https://www.sec.gov/contact-information/sec-directory. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify SEC staff at https://www.sec.gov/tcr. We welcome engagement between our staff and members of the public, and we appreciate hearing from the industry about new and emerging risk areas, products, and services.

Division of Examinations

2022
EXAMINATION PRIORITIES

The Division of Examinations (Division or EXAMS) prioritizes examination of certain practices, products, and services that it believes present potentially heightened risks to investors or the integrity of the U.S. capital markets. Examinations of these priority areas are grounded in our four pillars: promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy. Collectively, examinations and our other efforts, including publication of Risk Alerts and industry and investor outreach, are designed to support the SEC's mission to protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets.

The Division will prioritize examinations of several significant focus areas that pose unique or emerging risks to investors or the markets, as well as examinations of core and perennial risk areas. Their importance to investors and the markets, coupled with the seriousness and frequency of observations in prior years' examinations, demonstrate the need for the Division to remain vigilant in these areas. And while all of the areas identified below are critical, this list of priorities is not comprehensive and these will not be the only issues the Division addresses in examinations, Risk Alerts, and industry and investor outreach. The Division continues to be flexible so that examinations may also cover new and exigent risks to investors and the marketplace as they arise.

I. SIGNIFICANT FOCUS AREAS

A. Private Funds

More than 5,000 SEC-registered investment advisers (RIAs), totaling over 35% of all RIAs, manage approximately $18 trillion in private fund assets deployed in a variety of investment strategies in various fund types, including hedge funds, private equity funds, and real estate funds. These private funds frequently have significant investments from state and local pensions with working family beneficiaries, charities, and endowments. The size and complexity of these RIAs vary widely from, for example, an adviser with a small closely-held private fund to an adviser managing hundreds of billions of dollars across multiple types of funds and strategies. In the past five years, there has been a 70% increase in the assets managed by advisers to private funds.

DID YOU KNOW?
In the past five years, there has been a 70% increase in the assets managed by advisers to private funds.

Given the significance of examination findings over the past several years, and the size, complexity, and significant growth of this market, the Division will continue to prioritize our focus on RIAs to private funds. Examinations will review issues under the Investment Advisers Act of 1940 (Advisers Act), including an adviser's fiduciary duty, and will assess risks, including a focus on compliance programs, fees and expenses, custody, fund audits, valuation, conflicts of interest, disclosures of investment risks, and controls around material nonpublic information (MNPI).

Specifically, EXAMS will continue to review: (1) the calculation and allocation of fees and expenses, including the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds; (2) the potential preferential treatment of certain investors by RIAs to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals; (3) compliance with the Advisers Act Custody Rule, including the "audit exception" to the surprise examination requirement and related reporting and updating of Form ADV regarding the audit and auditors that serve as important gate-keepers for private fund investors; (4) the adequacy of disclosure and compliance with any regulatory requirements for cross trades, principal transactions, or distressed sales; and (5) conflicts around liquidity, such as RIA-led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund.

The Division will also review private fund advisers' portfolio strategies, risk management, and investment recommendations and allocations, focusing on conflicts and disclosures around these areas. This will include, for example, review of private funds' investments in Special Purpose Acquisition Companies (SPACs), particularly where the private fund adviser is also the SPAC sponsor. In addition, EXAMS will review the practices, controls, and investor reporting around risk management and trading for private funds with indicia of systemic importance, such as outsized counterparty exposure or gross notional exposure when compared to similarly situated firms.

B. Environmental, Social, And Governance (ESG) Investing

RIAs and registered funds are increasingly offering and evaluating investments that employ ESG strategies or incorporate certain ESG criteria, in part to meet investor demand for such strategies and investments. There is a risk that disclosures regarding portfolio management practices could involve materially false and misleading statements or omissions, which can result in misinformed investors. This risk may be compounded by: (1) the lack of standardization in ESG investing terminology (*e.g.*, strategies that are referred to as sustainable, socially responsible, impact investing, and environmental, social, and governance conscious, which incorporate ESG criteria); (2) the variety of approaches to ESG investing (*e.g.*, a portfolio may be labeled as ESG because of consideration of ESG factors alongside traditional financial, industry-related, and macroeconomic indicators, among others; other portfolios may use ESG factors as the driving or main consideration in selecting investments; or some portfolios engage in impact investing seeking to achieve measurable ESG impact goals); and (3) the failure to effectively address legal and compliance issues with new lines of business and products.

The Division will continue to focus on ESG-related advisory services and investment products (*e.g.*, mutual funds, exchange-traded funds (ETFs), and private fund offerings). Such reviews will typically focus on whether RIAs and registered funds are: (1) accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures, and practices designed to prevent violations of the federal securities laws in connection with their ESG-related disclosures, including review of their portfolio management processes and practices; (2) voting client securities in accordance with proxy voting policies and procedures and whether the votes align with their ESG-related disclosures and mandates; or (3) overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection (*e.g.*, greenwashing), such as in their performance advertising and marketing.

C. Standards of Conduct: Regulation Best Interest, Fiduciary Duty, and Form CRS

The Division will continue to address standards of conduct issues for broker-dealers and RIAs, with reviews focused on how they are satisfying their obligations under Regulation BI and the Advisers Act fiduciary standard to act in the best interests of retail investors and not to place their own interests ahead of retail investors' interests. Examinations will include assessments of practices regarding consideration of alternatives (*e.g.*, with regard to potential risks, rewards, and costs), management of conflicts of interest (*e.g.*, incentive practices that favor certain products or strategies over others), trading (*e.g.*, RIA best execution obligations), disclosures (*e.g.*, disclosures provided in Form ADV and Form CRS and made pursuant to Regulation BI), account selection (*e.g.*, brokerage, advisory, or wrap fee accounts), and account conversions and rollovers. For both broker-dealers and RIAs, examinations will focus on the effectiveness of compliance programs, testing, and training that are designed to support retail investors and working families receiving recommendations and advice in their best interests.

DID YOU KNOW?
The Division will continue to address standards of conduct issues for broker-dealers and RIAs, with reviews focused on how they are satisfying their obligations under Regulation BI and the Advisers Act fiduciary standard to act in the best interests of retail investors and not to place their own interests ahead of retail investors' interests.

Broker-dealer examinations will review firms' recommendations and sales practices related to SPACs, structured products, leveraged and inverse exchange traded products (ETPs), REITs, private placements, annuities, municipal and other fixed income securities, and microcap securities. Examinations will review practices, policies, and procedures concerning the evaluation of cost and reasonably available alternatives as they relate to recommendations of these products being in the investor's best interest. Examinations will also evaluate the compensation structures for financial professionals, including the conflicts created by such structures, and may focus examinations on the sales of securities by financial professionals that are highly compensated.

RIA examinations will focus on whether advisers are acting consistently with their fiduciary duty to clients, looking at both duties of care and loyalty, including best execution obligations, financial conflicts of interest and related impartiality of advice, and any attendant client disclosures. Focus areas include: (1) revenue sharing arrangements; (2) recommending or holding more expensive classes of investment products when lower cost classes are available (*e.g.*, RIAs that recommend no transaction fee mutual fund share classes that have 12b-1 fees in wrap fee accounts where the RIA may be responsible for paying transaction fees); (3) recommending wrap fee accounts without assessing whether such accounts are in the best interests of clients, including the impact of the move to zero commissions on certain types of securities transactions by a number of broker-dealers; and (4) recommending proprietary products resulting in additional or higher fees. Such reviews also will include an assessment of the adequacy of RIAs': (1) compliance policies and procedures designed to address conflicts and ensure advice in the best interest of clients, including the cost of investing; and (2) disclosures to enable investors to provide informed consent.

Dually registered RIAs and broker-dealers remain an area of interest for the Division, as do affiliated firms with financial professionals who service both brokerage customers and advisory clients. The focus areas of such examinations will be similar to those addressed above, but with particular emphasis on potential conflicts of interest present at these firms, including with regard to account recommendations and allocation of investments across different accounts. For example, examinations will include a focus on: (1) the sale or recommendation of high fee products; (2) the sale or recommendation of proprietary products of the firms or their affiliates; (3) incentives for financial professionals to place their own or their firms' interests ahead of customers/clients (*e.g.*, transactions that reduce costs to the adviser and increase expenses borne by the client); and (4) compensation structures that inappropriately influence investment recommendations. The Division will review whether these firms have implemented written policies and procedures to effectively mitigate and address conflicts and to minimize the risk of, and monitor for, misaligned incentives that may result in recommendations and advice to retail investors, such as seniors and working families that is not in their best interest.

D. Information Security and Operational Resiliency

Applying information security controls is critical to ensuring business continuity. Vigilant protection of data is also critical to the operation of the financial markets and the confidence of its participants. Failing to prevent unauthorized access, use, disclosure, disruption, modification, inspection, recording or destruction of sensitive records may have consequences that extend beyond the firm compromised to other market participants and retail investors. Accordingly, the Division will review broker-dealers’ and RIAs’ practices to prevent interruptions to mission-critical services and to protect investor information, records, and assets.

Specifically, EXAMS will continue to review whether firms have taken appropriate measures to: (1) safeguard customer accounts and prevent account intrusions, including verifying an investor’s identity to prevent unauthorized account access; (2) oversee vendors and service providers; (3) address malicious email activities, such as phishing or account intrusions; (4) respond to incidents, including those related to ransomware attacks; (5) identify and detect red flags related to identity theft; and (6) manage operational risk as a result of a dispersed workforce in a work-from-home environment. In the context of these examinations, the Division will focus on, among other things, broker-dealers’ and RIAs’ compliance with Regulations S-P and S-ID, where applicable.

The Division will again be reviewing registrants’ business continuity and disaster recovery plans, with particular focus on the impact of climate risk and substantial disruptions to normal business operations. As the Division described last year, these efforts build on previous examinations and outreach in this area. In some cases, particularly in regard to systemically important registrants, examinations will account for certain climate related risks. The scope of these examinations will include a focus on the maturation and improvements to business continuity and disaster recovery plans over the years as well as these registrants' resiliency as organizations to anticipate, prepare for, respond to, and adapt to both sudden disruptions and incremental changes stemming from climate-related situations.

DID YOU KNOW?
The Division will again be reviewing registrants’ business continuity and disaster recovery plans, with particular focus on the impact of climate risk and substantial disruptions to normal business operations.

E. Emerging Technologies and Crypto-Assets

The Division has observed a significant increase in the number of RIAs choosing to provide automated digital investment advice to their clients (often referred to as "robo-advisers"), continued growth in the use of mobile apps by broker-dealers, and a proliferation of the offer, sale, and trading of crypto-assets. The Division will conduct examinations of broker-dealers and RIAs that are using developing financial technologies to review whether the unique risks these activities present were considered by the firms when designing their regulatory compliance programs.

DID YOU KNOW?
The Division will conduct examinations of broker-dealers and RIAs that are using developing financial technologies to review whether the unique risks these activities present were considered by the firms when designing their regulatory compliance programs.

RIA and broker-dealer examinations will focus on firms that are, or claim to be, offering new products and services or employing new practices (*e.g.*, fractional shares, "Finfluencers," or digital engagement practices) to assess whether: (1) operations and controls in place are consistent with disclosures made and the standard of conduct owed to investors and other regulatory obligations; (2) advice and recommendations, including by algorithms, are consistent with investors' investment strategies and the standard of conduct owed to such investors; and (3) controls take into account the unique risks associated with such practices.

Examinations of market participants engaged with crypto-assets will continue to review the custody arrangements for such assets and will assess the offer, sale, recommendation, advice, and trading of crypto-assets. In particular, EXAMS will review whether market participants involved with crypto-assets: (1) have met their respective standards of conduct when recommending to or advising investors with a focus on duty of care and the initial and ongoing understanding of the products (*e.g.*, blockchain and crypto-asset feature analysis); and (2) routinely review, update, and enhance their compliance practices (*e.g.*, crypto-asset wallet reviews, custody practices, anti-money laundering reviews, and valuation procedures), risk disclosures, and operational resiliency practices (*i.e.*, data integrity and business continuity plans). In addition, the Division will conduct examinations of mutual funds and ETFs offering exposure to crypto-assets to assess, among other things, compliance, liquidity, and operational controls around portfolio management and market risk.

II. INVESTMENT ADVISER AND INVESTMENT COMPANY EXAMINATION PROGRAM

A. Registered Investment Advisers

During a typical examination, the Division reviews the compliance programs of RIAs in one or more of the following core areas: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, conflicts of interest, and related disclosures. The Division will assess whether policies and procedures are reasonably designed to prevent violations of the Advisers Act and its rules, including breaches of the RIA's fiduciary duty in violation of the antifraud provisions. Additionally, EXAMS will review compliance programs to examine whether they address that: (1) investment advice is in each client's best interest; (2) oversight of service providers is adequate; and (3) sufficient resources exist to perform compliance duties. In addition, to the extent that firms are using alternative data or data gleaned from non-traditional sources as part of their business and investment decision-making processes, reviews will include examining whether RIAs, including RIAs to private funds and registered funds, are implementing appropriate compliance and controls around the creation, receipt, and use of potentially MNPI.

DID YOU KNOW?
During a typical examination, the Division reviews the compliance programs of RIAs in one or more of the following core areas: marketing practices, custody and safety of client assets, valuation, portfolio management, brokerage and execution, conflicts of interest, and related disclosures.

As part of its assessment of the effectiveness of a compliance program, the Division will review whether the firm has implemented oversight practices to mitigate any heightened risks. For example, whether RIAs: (1) employing individuals with prior disciplinary histories implemented heightened oversight practices for these individuals; (2) migrating from the broker-dealer business model reviewed whether recommendations to transition investor accounts to advised accounts were in the clients' best interests; and (3) operating from multiple branch offices have appropriately adapted their compliance programs to oversee the activities in their branches.

The Division will also continue to focus on RIA disclosures and other issues related to fees and expenses. In particular, EXAMS will concentrate on issues associated with: (1) advisory fee calculation errors, including, but not limited to, failure to adjust management fees in accordance with investor agreements; (2) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts or pro-rated fees for onboarding clients.

As in previous years, the Division prioritizes RIAs and registered funds that have never been examined, including recently registered firms, and those that have not been examined for a number of years. Typically, these examinations focus on firms' compliance programs.

B. Registered Investment Companies, Including Mutual Funds and ETFs

The Division will continue to prioritize examinations of registered investment companies, including mutual funds and ETFs, given their importance to retail investors. The Division typically reviews certain perennial focus areas during its assessments of registered funds' compliance programs and governance practices. Perennial areas include, among other topics, disclosures to investors, accuracy of reporting to the SEC, compliance with the new rules and exemptive orders (including ETF rules and exemptive orders for non-transparent, actively managed ETFs, and custom baskets). As part of its review of registered funds' LRMPs, the Division will consider whether the programs are reasonably designed to assess and manage the funds' liquidity risk and review the implementation of required liquidity classifications, including firms' oversight of third party service providers.

DID YOU KNOW?
Perennial areas include, among other topics, disclosures to investors, accuracy of reporting to the SEC, compliance with the new rules and exemptive orders (including ETF rules and exemptive orders for non-transparent, actively managed ETFs, and custom baskets).

Certain types of registered funds, portfolio investments, and fund practices will be prioritized. Examples of the types of funds include: (1) money market funds, which remain an important part of the registered fund industry to retail and institutional investors for cash management and will be reviewed for compliance with applicable requirements, including stress-testing, website disclosures, and board oversight; and (2) business development companies, which will undergo reviews of their valuation practices, marketing activities, and conflicts of interest with underlying portfolio companies. The Division's focus on portfolio investments will include examinations of mutual funds investing in private funds to assess risk disclosure and valuation issues. EXAMS will also prioritize examinations of certain fund practices, including a focus on advisory fee waivers to assess the sustainability of services for firms that provide such waivers, and trading activities of portfolio managers that may be designed to inflate fund performance.

III. BROKER-DEALER AND EXCHANGE EXAMINATION PROGRAM

A. Microcap, Municipal, Fixed Income, and Over-The-Counter Securities

The Division remains committed to deterring microcap fraud, or fraud in connection with securities of companies with a market capitalization under $250 million. The Division will continue to prioritize examinations of broker-dealers for compliance with their obligations in the offer, sale, and distribution of microcap securities. Focus areas for examinations will include: (1) transfer agent handling of microcap distributions and share transfers; (2) broker-dealer sales practices and their consistency with Regulation BI; and (3) broker-dealer compliance with certain regulatory requirements, including the locate requirement of Regulation SHO, penny stock disclosure rules (*i.e.*, Rules 15g-2 through 15g-6 of the Securities Exchange Act of 1934 (Exchange Act)), and the obligation to monitor for and report suspicious activity and other anti-money laundering (AML) obligations.

States and local governments issue debt securities, referred to as municipal securities or municipal bonds, to finance a wide variety of public projects. Timely and accurate municipal issuer disclosure is vitally important to investors and the markets for these securities. The Division will examine the activities of broker-dealers, underwriters, and municipal advisors to assess whether these firms are meeting their respective obligations, as and to the extent applicable, in relation to municipal issuer disclosure.

In addition, the Division will examine broker-dealer trading activity in fixed income securities with a focus on sales practices; best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements, including disclosures relating to mark-ups and mark-downs.

The Division's focus on products and services will also include the sale of over-the-counter securities and whether broker-dealers recommending these securities are meeting their obligations under Regulation BI. Examinations will also assess compliance with revised Exchange Act Rule 15c2-11, which generally requires broker-dealers to refrain from publishing quotations in a quotation medium for an issuer's security when current issuer information is not publicly available (among other requirements).

DID YOU KNOW?
The Division's focus on products and services will also include the sale of over-the-counter securities and whether broker-dealers recommending these securities are meeting their obligations under Regulation BI.

B. Broker-Dealer Operations

Broker-dealers that hold customer cash and securities have a responsibility to ensure that those assets are safeguarded in accordance with the Customer Protection Rule and the Net Capital Rule. Examinations of broker-dealers will continue to focus on compliance with these rules, including the adequacy of internal processes, procedures, and controls, and compliance with requirements for borrowing fully paid and excess margin securities from customers. Examiners may also assess broker-dealer funding and liquidity risk management practices to assess whether firms have sufficient liquidity to manage stress events.

The Division will continue to examine broker-dealer trading practices. Examinations will focus on broker-dealer compliance with best execution obligations in a zero commission environment and compliance with Exchange Act Rule 606 order routing disclosure rules. The Division will continue to review potential conflicts of interest in order routing, such as conflicts arising from payment for order flow, including wholesaler payments or exchange rebates, and the possible effect any conflicts of interest may have on order routing decisions and best execution obligations. Examinations will also focus on large trader reporting obligations and broker-dealer compliance with Regulation SHO, including the rules regarding aggregation units and locate requirements.

The Division will also examine the operations of certain alternative trading systems for compliance with Regulation ATS, and in particular focus on consistency with their disclosures provided in Form ATS-N.

As in previous years, EXAMS will prioritize the review of firms that are engaged in activities that appear to require broker-dealer registration and those that may be involved in the illegal distribution of unregistered securities to ensure investors are receiving the benefits of the federal securities laws.

C. National Securities Exchanges

National securities exchanges provide marketplaces for facilitating securities transactions and, under the federal securities laws, serve as self-regulatory organizations responsible for enforcing compliance by their members with the federal securities laws and rules and the exchanges' own rules. The Division will examine the national securities exchanges to assess whether they are meeting their obligations under the federal securities laws and will focus on exchange regulatory programs to detect and discipline violations, and participation in National Market System (NMS) Plans. Examinations may also assess and compare any exchange advisory services offered to issuers regarding ESG initiatives.

D. Security-Based Swap Dealers (SBSDs)

The compliance date for registration of SBSDs and several other SBSD requirements was October 6, 2021. Initial examinations of these new registrants will focus on the policies and procedures related to compliance with the security-based swap rules generally (*e.g.*, trade acknowledgement and verification, recordkeeping and reporting, and risk management requirements).

DID YOU KNOW?
The compliance date for registration of SBSDs and several other SBSD requirements was October 6, 2021.

E. Municipal Advisors

The Division will examine whether municipal advisors have met their fiduciary duty and conflict disclosure obligations to municipal entity clients. The Division will also examine whether municipal advisors have satisfied their registration, professional qualification, continuing education, and supervision requirements.

F. Transfer Agents

The Division will continue to examine transfer agents' core functions: the timely turnaround of items and transfers, recordkeeping and record retention, safeguarding of funds and securities, and filing obligations with the Commission. Examination candidates will include, among others, never-before-examined transfer agents and transfer agents that service microcap or municipal bond issuers, use novel technologies (*e.g.*, blockchain or online crowdfunding portal applications), or engage in significant paying agent activity.

IV. CLEARANCE AND SETTLEMENT EXAMINATION PROGRAM

The Division will conduct, as required by Title VIII of the Dodd-Frank Act, at least one risk-based examination of each clearing agency designated as systemically important and for which the SEC serves as the supervisory agency. These examinations will focus on core risks, processes, and controls and will cover the specific areas required by statute, including the nature of clearing agencies' operations and assessment of financial and operational risk. Additionally, the Division will conduct risk-based examinations of other registered clearing agencies which have not been designated as systemically important. The Division will also examine both groups of clearing agencies for compliance with the SEC's Standards for Covered Clearing Agencies, which are rules that require covered clearing agencies to, among other things, have policies and procedures that address maintaining sufficient financial resources, protecting against credit risks, managing member defaults, and managing operational and other risks.

In addition, EXAMS will conduct risk-based examinations of SEC-registered clearing agencies to: (1) determine whether their respective risk management frameworks comply with the Exchange Act, and serve the needs of their members and the markets they serve; (2) assess the adequacy and timeliness of their remediation of prior deficiencies, including, for example, the role of senior leadership in the remediation process; and (3) examine other risk areas identified in collaboration with the SEC's Division of Trading and Markets and other regulators. Areas of focus may include margin, counterparty credit risk, disclosure framework, governance, recovery and wind-down, default management, liquidity risk management, and project management, among other things.

V. REGULATION SYSTEMS COMPLIANCE AND INTEGRITY

The Commission adopted Regulation SCI to strengthen the technology infrastructure of the U.S. securities markets. Regulation SCI entities include national securities exchanges, registered and certain exempt clearing agencies, FINRA, MSRB, plan processors, and alternative trading systems that meet certain volume thresholds. Among other things, these critical market infrastructure entities must establish, maintain, and enforce written policies and procedures reasonably designed to ensure that their systems' capacity, integrity, resiliency, availability, and security is adequate to maintain their operational capability and promote the maintenance of fair and orderly markets.

EXAMS will continue to evaluate whether SCI entities have established, maintained, and enforced written policies and procedures as required. Areas of focus will include: (1) whether the incident response policies and procedures of SCI entities are reasonably designed, with a particular focus on ransomware; (2) the use of third-party network infrastructure services to support critical functions; (3) policies and procedures pertaining to the return to the workplace or further hybridization of the workplace after the extended telework posture caused by the COVID-19 pandemic; and (4) whether SCI entities have established reasonably designed policies and procedures to identify and mitigate software supply chain risks, including secure code development practices of SCI entities.

VI. FINRA

FINRA oversees approximately 3,400 brokerage firms, 153,000 branch offices, and 618,000 registered representatives through examinations, enforcement, and surveillance. In addition, FINRA, among other things, provides a forum for securities arbitration and mediation, conducts market regulation, including by contract for a majority of national securities exchanges, reviews broker-dealer advertisements, administers the testing and licensing of registered persons, and operates industry utilities such as Trade Reporting Facilities.

EXAMS conducts risk-based oversight examinations of FINRA. It selects areas within FINRA to examine through a risk assessment process designed to identify those aspects of FINRA's operations important to the protection of investors and market integrity, including FINRA's implementation of new investor protection initiatives. The analysis is informed by collecting and analyzing extensive information and data, regular meetings with key functional areas within FINRA, and outreach to various stakeholders, including broker-dealers and investor groups. Based on the outcome of this risk-assessment process, EXAMS conducts inspections of FINRA's major regulatory programs. EXAMS also conducts oversight examinations of FINRA's examinations of certain broker-dealers and municipal advisors. From its observations during all of these inspections and examinations, EXAMS makes detailed recommendations to improve FINRA's programs, its risk assessment processes, and its future examinations.

VII. MSRB

MSRB regulates the activities of broker-dealers that buy, sell, and underwrite municipal securities, as well as the activities of municipal advisors. MSRB establishes rules for municipal broker-dealers (including registered municipal securities dealers) and municipal advisors, supports market transparency by making municipal securities trade data and disclosure documents available, and conducts education and outreach regarding the municipal securities market. EXAMS, along with FINRA and the federal banking regulators, conducts examinations of registered firms to assess compliance with MSRB rules. EXAMS also applies a risk assessment process, similar to the one it uses to oversee FINRA, to identify areas to examine at MSRB. Examinations of MSRB evaluate the effectiveness of MSRB's policies, procedures, and controls.

VIII. THE LONDON INTER-BANK OFFERED RATE (LIBOR) TRANSITION

The discontinuation of LIBOR could have a significant impact on the financial markets and may present a material risk for certain market participants, including the RIAs, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies overseen by the Division. Preparation for the transition away from LIBOR is essential for minimizing any potential adverse effects associated with LIBOR discontinuation. EXAMS will continue to engage with registrants through examinations and outreach efforts to assess their exposure to LIBOR and their transition to an alternative reference rate, preparations for the cessation of many LIBOR rates beginning immediately after December 31, 2021, and the transition to an alternative reference rate, in connection with registrants' own financial operations, the exposures of their clients and customers, and their obligations when recommending LIBOR-linked instruments.

IX. ANTI-MONEY LAUNDERING

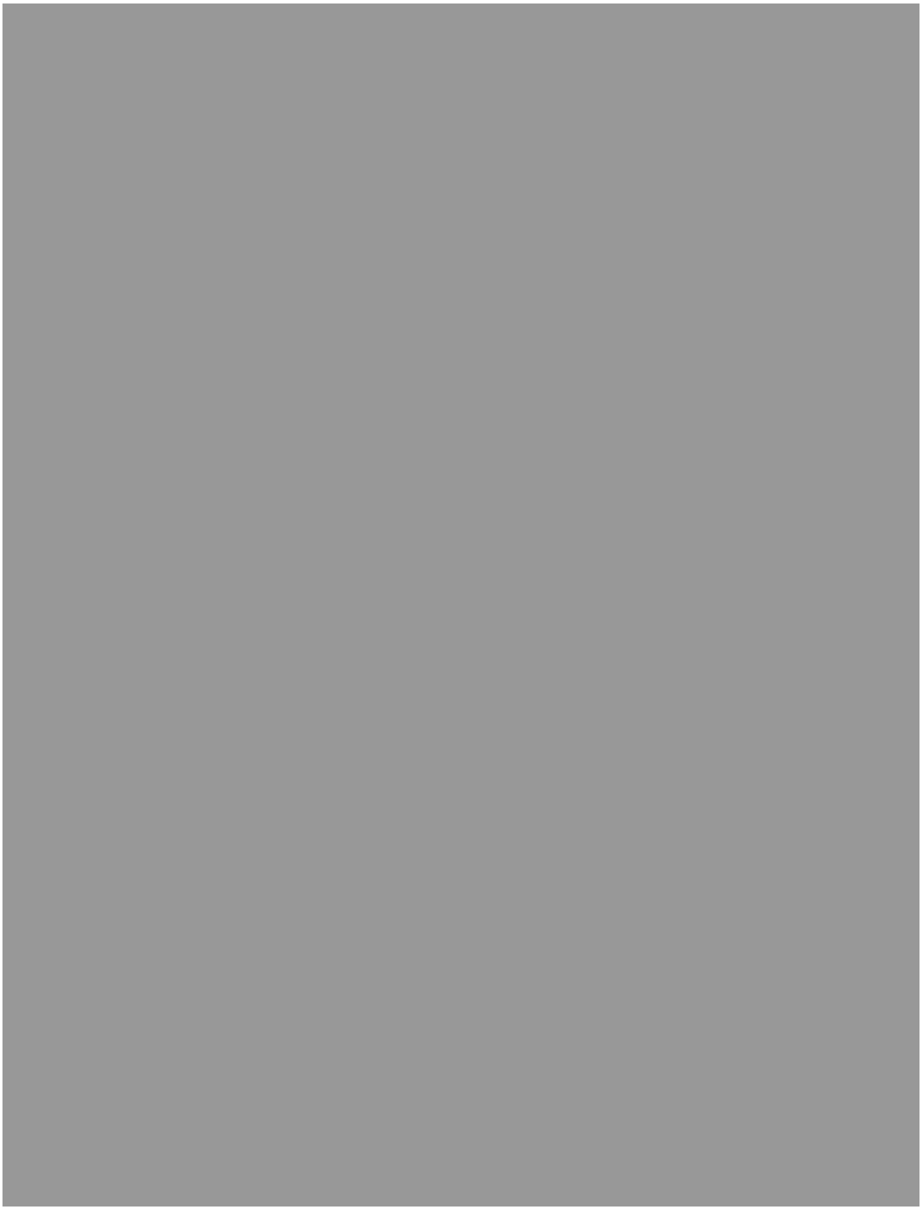
The Bank Secrecy Act requires financial institutions, including broker-dealers and registered investment companies, to establish AML programs that are tailored to address the risks associated with the firm's location, size, and activities, including customers they serve, the type of products and services offered, and the means by which those products and services are offered. These programs must, among other things, include policies and procedures reasonably designed to identify and verify the identity of customers and beneficial owners of legal entity customers, perform customer due diligence (as required by the Customer Due Diligence rule), monitor for suspicious activity, and, where appropriate, file Suspicious Activity Reports (SARs) with the Financial Crimes Enforcement Network. SARs are used to detect and combat terrorist financing, public corruption, market manipulation, and a variety of other fraudulent behaviors.

Given the importance of these requirements, the Division will continue to prioritize examinations of broker-dealers and registered investment companies for compliance with their AML obligations in order to assess, among other things, whether firms have established appropriate customer identification programs and whether they are satisfying their SAR filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs. The goal of these examinations is to evaluate whether broker-dealers and registered investment companies have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities.

DID YOU KNOW?
The goal of AML examinations of broker-dealers and investment companies is to evaluate whether they have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities.

X. CONCLUSION

These priorities reflect the Division's assessment of certain risks, issues, and policy matters arising from market and regulatory developments, information gathered from examinations, and other sources, including tips, complaints, and referrals, and coordination with other Divisions and Offices at the SEC as well as other regulators. While the Division will allocate significant resources to the examination issues described herein, it will also conduct examinations focused on and devote resources to new or emerging risks, products and services, market events, and investor concerns. The Division welcomes comments and suggestions regarding how it can better fulfill its mission to promote compliance, prevent fraud, identify and monitor risk, and inform SEC policy. Our contact information is available at https://www.sec.gov/exams. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify SEC staff at https://www.sec.gov/tcr.



U.S. Securities and Exchange Commission

DIVISION OF EXAMINATIONS

Washington, DC

RISK ALERT
DIVISION OF EXAMINATIONS

August 22, 2022

RECENT OBSERVATIONS FROM MUNICIPAL ADVISOR EXAMINATIONS [*]

With more than 450 municipal advisors ("MAs") currently registered with the SEC, the Division of Examinations continues to make the examination of MAs a priority.[1] The rules of the SEC and those of the Municipal Securities Rulemaking Board ("MSRB") address registration, disclosure of conflicts of interest, fiduciary duties, professional qualifications, and continuing education, among other aspects of MA operations.[2] In 2017, EXAMS published a Risk Alert that provided the staff's observations from a series of examinations of newly registered MAs, with a focus on deficiencies observed in the areas of registration, recordkeeping, and supervision.[3]

This Risk Alert reminds municipal advisors of their obligations and raises awareness among municipal advisors and other market participants of the most often cited deficiencies and weaknesses observed in recent MA examinations, which include many of the areas covered in the Risk Alert issued in 2017, as well as deficiencies and weaknesses related to municipal advisors' disclosure to clients. We encourage municipal advisors to review each of these areas and assess their compliance with each. In addition to the areas discussed below, the Division intends in the future for examinations to include a more prominent focus on the core standards of conduct and duties applicable to municipal advisors.

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[*] The views expressed herein are those of the staff of the Division of Examinations ("EXAMS" or the "Division"). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert, like all other staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

[1] The Division's Examination Priorities for 2019, 2020, 2021, and 2022 include a focus on municipal advisors.

[2] Section 15B(b)(2) of the Securities Exchange Act of 1934 (the "Exchange Act") authorizes the MSRB to propose and adopt rules with respect to, among other things, municipal advisors providing advice to or on behalf of municipal entities or obligated persons. This Risk Alert does not address compliance by MAs or their affiliated municipal securities dealers with any FINRA rules that may apply.

[3] Division, "Observations from Municipal Advisor Examinations" (Nov. 7, 2017).

Staff Observations from Examinations of Municipal Advisors

A. Registration and Filings

Regulatory Framework. Section 15B(a)(1)(B) of the Exchange Act requires all MAs to register with the Commission before engaging in municipal advisory activities. Exchange Act Rule 15Ba1-2 requires an MA applying for registration to file Form MA. In addition, subject to certain exemptions, the rule requires an MA to file a Form MA-I for each natural person associated with the municipal advisor and engaged in municipal advisory activities on its behalf. Exchange Act Rule 15Ba1-5 requires an MA to update its Form MA annually, within a specific time frame, and to amend it promptly whenever a material event has occurred that changes the information previously provided. The rule also requires a municipal advisor to amend Form MA-I promptly whenever information on the form becomes inaccurate for any reason. After registering with the Commission, an MA must register with the MSRB on MSRB Form A-12 and pay to the MSRB initial and annual registration fees, pursuant to MSRB Rule A-12. Municipal advisors are also required to affirm the Form A-12 annually during the "Annual Affirmation Period" pursuant to MSRB Rule A-12(k) and update it within 30 days of any of the information on the form becoming inaccurate.

Observations. There was significant overlap between the types of registration and filing deficiencies and weaknesses observed in the 2017 Risk Alert and those that continue to be the most commonly observed deficiencies and weaknesses in recent examinations from which this Risk Alert draws:

- *Filings with Inaccurate, Incomplete, or Inconsistent Information.* The staff observed municipal advisors that filed their SEC Forms MA and MA-I with inaccurate or incomplete information, including with respect to information about an MA's affiliates, solicitation activities, other businesses, and the types of activities the MA engaged in with respect to municipal securities. For Form MA-I, there were municipal advisors that did not include accurate or complete information about their associated persons' other business and required disclosures such as customer complaints and tax liens. In addition, the staff observed MAs that provided information on SEC Form MA that was inconsistent with information provided on MSRB Form A-12.
- *Failure to Amend and Untimely Amendments.* The staff observed municipal advisors that did not file amendments to SEC Forms MA and MA-I and MSRB Form A-12 when information became inaccurate or when material events occurred, or did not file amendments in a timely manner. For example, there were MAs that did not amend their Form MA to reflect changes concerning ownership and disciplinary disclosures. Similarly, the staff observed MAs that did not amend Form MA-I to reflect changes in an associated person's employment or other business, or to add new disclosures involving civil judicial actions or judgment or liens. The staff also observed municipal advisors that did not amend their Form A-12 to reflect changes in items such as contact information and business activities.

- *Annual Filing Requirements.* The staff observed municipal advisors that (1) did not file annual updates to their SEC Form MA, in some instances for multiple years and/or (2) did not review, update, and affirm the information in MSRB Form A-12 on an annual basis.
- *MSRB Fees.* The staff observed municipal advisors that did not pay the required MSRB initial and annual registration fees.

B. Recordkeeping

Regulatory Framework. Exchange Act Rule 15Ba1-8 requires MAs to make and keep certain books and records for specified periods of time. MSRB Rules G-8 and G-9 further specify certain books and records that MAs must make and the periods of time that required books and records must be preserved, respectively.

Observations. The staff continues to observe deficiencies and weaknesses related to books and records requirements similar to those highlighted in the 2017 Risk Alert. For example, the staff observed municipal advisors that did not make or keep true, accurate, and current copies of some of the books and records required by the rules, or did not preserve such records, including in the following categories:

- Originals or copies of written communications relating to municipal advisory activities, particularly electronic communications, such as emails relating to municipal advisory activities that were sent from a personal email address, text messages on mobile devices, and instant messages.
- Financial or accounting documents, including cash reconciliations and general ledgers.
- Records concerning compliance with the MSRB's MA supervision and compliance rule (MSRB Rule G-44), including records of annual certifications and designations of chief compliance officers.
- Written consents to service of process from natural persons associated with the MA who engage in municipal advisory activities solely on behalf of such MA.
- Copies of documents created by the MA that were material to making a recommendation to a municipal entity or obligated person.
- Written agreements entered into by the MA with municipal entities and their employees, obligated persons, or otherwise relating to the MA's business.

C. Supervision

Regulatory Framework. MSRB Rule G-44 requires MAs to establish, implement, and maintain a system to supervise the MA activities of the municipal advisor and its associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations, including MSRB rules. An MA's supervisory system must provide for the establishment, implementation, maintenance, and enforcement of written supervisory procedures ("WSPs") that are reasonably designed to ensure that the conduct of the municipal advisory activities of the MA and its associated persons are in compliance with applicable rules. In addition, the WSPs must take into consideration factors such as the MA's size and organizational structure; nature and scope of municipal advisory activities; likelihood that associated persons may be engaged in relevant outside business activities; and any indicators of irregularities or misconduct.

Subject to certain exceptions, a municipal advisor's chief executive officer (or equivalent) must certify, annually, in writing that the MA has in place processes to establish, maintain, review, test, and modify written compliance policies and WSPs reasonably designed to achieve compliance with applicable rules. In addition, the rule requires an MA to designate one or more municipal advisory principals to be responsible for the supervision required by the rule and to designate an individual to serve as its chief compliance officer.

Observations. The staff continued to observe deficiencies relating to supervision, including many of the same types observed in the 2017 Risk Alert. Specifically, some of the most common deficiencies the staff observed related to the following topics:

- *Failure to Establish, Amend, or Design WSPs.* The staff observed municipal advisors that did not have any WSPs. Other MAs did not promptly amend their WSPs to reflect changes to applicable rules, such as the adoption of MSRB Rule G-42—which, among other things, establishes duties of care and loyalty and governs conflicts of interest and is discussed in the following section—and the MA advertising rule (MSRB Rule G-40, which became effective in 2019). In addition, WSPs appeared not to be reasonably designed, or were not implemented and enforced, to ensure compliance with applicable rules, including rules relating to gifts, gratuities, and expenses; the preservation of electronic communications; and the filing and updating of required forms. The staff also observed municipal advisors whose WSPs did not take into consideration their organizational structure, nature of their municipal advisory activities, or the relevant outside business activities of their associated persons.

- *Annual Reviews and Certifications.* The staff observed MAs that did not conduct required at-least-annual reviews of their WSPs and MAs whose chief executive officers did not annually certify, in writing, that the MAs had in place processes to establish, maintain, review, test, and modify WSPs.

D. Disclosure to Clients (MSRB Rule G-42)

Regulatory Framework. Among other things, MSRB Rule G-42 requires that before or upon engaging in municipal advisory activities, an MA must provide to its municipal entity or obligated person client full and fair disclosure, in writing, of all material conflicts of interest. The disclosure must be sufficiently detailed to inform the client of the nature, implications, and potential consequences of each conflict and include an explanation of how the MA addresses or intends to manage or mitigate each conflict. An MA that concludes it has no known material conflicts of interest based on the exercise of reasonable diligence must provide a written statement to the client to that effect. If a conflict cannot be managed or mitigated in a manner that permits the municipal advisor to act in the client's best interest, the municipal advisor must not engage in municipal advisory activity for that client.[4]

In addition, an MA must evidence each of its municipal advisory relationships by documents created and delivered to the municipal entity or obligated person client before, upon, or promptly after the establishment of the relationship. The rule specifies the minimum elements that must be included in the documentation, including but not limited to the scope of the municipal advisory activities to be performed and any limitations on the scope of the engagement. An MA must promptly amend or supplement relationship documents to reflect any material changes or additions and promptly deliver any amendment or supplement to the client.

<u>Observations.</u> The most often cited deficiencies and weaknesses under MSRB Rule G-42 included:

- *No Disclosure of Conflicts.* The staff observed municipal advisors that did not disclose in writing to their clients all material conflicts of interest including, for example, conflicts regarding:
    - The nature of relationships between the MA and other MAs that shared a common client; between the MA and other relevant parties, such as underwriters or other parties providing services to or on behalf of a municipal entity client; or between the MA and the municipal entity client itself.
    - Fee-splitting arrangements involving the municipal advisor.
    - Compensation for municipal advisory activities that was contingent on the closing of the transaction or the size of the transaction.
- *No Statement of Lack of Known Conflicts.* The staff observed municipal advisors that did not provide their clients with written statements that the MA has no known material conflicts of interest (where applicable).
- *Inadequate Documentation of Relationship.* The staff observed municipal advisors that did not document their advisory relationships, did not include in their documentation all of the required elements, or did not promptly amend or supplement such documents to reflect material changes.
- *Untimely Documentation or Disclosure.* The staff observed MAs that did not provide the required conflicts disclosure or documentation of municipal advisory relationship prior to or upon engaging in municipal advisory activities, or promptly after establishment of the relationship, as required by the rule.

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4 *See* Supplementary Material .02 to Rule G-42—Duty of Loyalty.

Conclusion

In sharing the information in this Risk Alert, EXAMS encourages municipal advisors to review their practices, policies, and procedures in these areas and to consider improvements in their compliance programs, as may be appropriate.

This Risk Alert is intended to highlight for firms risks and issues that EXAMS staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

October 26, 2021

Observations from Examinations in the Registered Investment Company Initiatives*

I. Introduction

The Division of Examinations (the "Division") conducted a series of examinations that focused on mutual funds and exchange-traded funds (collectively, "funds") to assess industry practices and regulatory compliance in certain areas that may have an impact on retail investors ("RIC Initiatives" or "Initiatives"). The RIC Initiatives were announced in a Risk Alert in November 2018 and included in the Division's fiscal year 2019 priorities.[1] The RIC Initiatives focused on funds and/or their investment advisers ("advisers") that fell into one or more of the following six categories: (1) index funds that track custom-built indexes; (2) smaller ETFs and/or ETFs with little secondary market trading volume; (3) mutual funds with higher allocations to certain securitized investments; (4) mutual funds with aberrational underperformance relative to their peer groups; (5) mutual funds managed by advisers that are relatively new to managing such funds; and (6) advisers that provide advice to both mutual funds and private funds, both of which have similar strategies and/or are managed by the same portfolio managers.

This Risk Alert provides observations made by Division staff during examinations conducted under the RIC Initiatives, including examinations of more than 50 fund complexes – covering more than 200 funds and/or series of funds – and nearly 100 advisers. In conducting these examinations, the Division issued deficiency letters to some firms, while other firms did not receive deficiency letters. However, the Division believes the observations in this Risk Alert can assist all funds in assessing compliance risks. The more frequent deficiencies and weaknesses are summarized below. This Risk Alert is intended to highlight risk areas and assist funds and their advisers in developing and enhancing their compliance programs and practices.

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* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

1 *See* Division, Risk Alert: Risk-Based Examination Initiatives Focused on Registered Investment Companies (Nov. 8, 2018) and Division, 2019 Examination Priorities (December 18, 2018).

II. Focus of Initiatives

The scope of the examinations and focus areas selected for review were tailored to address the business practices, risks, and conflicts applicable to each of the six categories. However, across all examinations the staff generally assessed:

- *Effectiveness of the compliance policies and procedures of the funds and their advisers* to address certain risks – particularly in the areas of disclosures, portfolio management compliance, and conflicts of interest – and the efficacy of the oversight of funds' compliance programs by funds' boards.[2]

- *Disclosures by the funds to investors* in their prospectuses and other filings and shareholder communications, and by advisers to the funds' boards, regarding risks and conflicts in the highlighted areas.[3]

- *Fund governance practices*, particularly as they relate to the deliberative processes utilized by funds and funds' boards when exercising oversight of funds' compliance programs and assessing the practices and controls related to risks in the highlighted areas.[4]

III. Staff Observations from the Examinations

A. Compliance Program

Below are examples of deficiencies or weaknesses observed by the staff related to funds' and their advisers' compliance programs for portfolio management and other business practices, and board oversight of funds' compliance programs.

- *The staff observed funds and their advisers that did not establish, maintain, update, follow and/or appropriately tailor their compliance programs to address various business practices, including portfolio management, valuation, trading, conflicts of interest, fees and expenses, and advertising*. Examples include inadequate policies and procedures in the following areas:

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2 *See* Investment Company Act of 1940 ("IC Act") Rule 38a-1 and Investment Advisers Act of 1940 ("Advisers Act") Rule 206(4)-7. *See also* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release No. IC-26299 (Dec. 17, 2003). Funds and advisers should adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws and the Advisers Act, respectively. Fund compliance programs should also include policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator, and transfer agent of the fund (collectively, "service providers").

3 *See*, generally, IC Act Section 34(b), Securities Act of 1933 ("Securities Act") Section 17(a), Securities Exchange Act of 1934 Section 10(b), and Advisers Act Section 206(4) and Rule 206(4)-8 thereunder. Under the federal securities laws, it is unlawful to make untrue statements of material fact, or omit material information necessary to make other statements not misleading in registration statements, reports, and other documents filed with the Commission or provided to investors.

4 Each fund is required to have a board of directors, which is elected by shareholders to represent their interests. *See*, generally, IC Act Section 24(a) (requires a fund to file a registration under the Securities Act), Securities Act Section 6(a) (requires that a majority of the fund's directors sign the fund's registration statement), and IC Act Section 16(a) (requires that a director of a fund be elected by shareholders). A fund board's primary responsibility is to protect the interest of the fund and its shareholders, which may be adversely affected by any substantial ongoing conflicts of interest of the fund's investment adviser.

Compliance Oversight of Investments and Portfolios

- Monitoring for portfolio management compliance, including monitoring compliance requirements regarding trade aggregation, trade allocation and best execution, and senior securities and asset segregation.[5]

- Monitoring for adherence to each fund's specific investment restrictions (*e.g.*, investment concentration restrictions, limitations on investments in alternative investments, and/or restrictions on lower-rated securities).

- Monitoring for the specific risks associated with each fund's investments such as asset classes that present certain operational or other risks.

- Monitoring portfolios for compliance with the "Fund Names Rule," as applicable.[6]

- Addressing the administration of each fund's liquidity risk management program ("LRMP") and providing appropriate oversight of third-party vendors providing liquidity classifications of holdings for purposes of the funds' LRMP.[7]

- Providing appropriate oversight of the viability of smaller and/or thinly traded ETFs and oversight of their liquidation, as applicable, including communications with their shareholders.

Compliance Oversight of Valuation

- Maintaining an adequate compliance program for valuation of portfolio securities, including processes, controls, or both, that provide for due diligence and oversight of pricing vendors that provide evaluated prices for portfolio holdings for purposes of

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5 The Commission recently adopted new Rule 18f-4 for derivatives use by funds, which has a compliance date of August 19, 2022 (*see* Final Rule: Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-34084 (Nov. 2, 2020)). Prior to the compliance date for this new Rule, funds may choose to comply with Rule 18f-4 voluntarily, provided they no longer consider existing Commission and staff guidance and no-action letters that will be withdrawn on the compliance date.

6 *See also* IC Act Section 35(d) and Rule 35d-1 (requiring a fund to invest at least 80% of its net assets, plus any borrowings for investment purposes, in the particular type of investments, or in investments in the particular industry or industries, suggested by the fund's name).

7 *See* IC Act Rule 22e-4. *See also* Final Rule: Investment Company Liquidity Risk Management Programs, Release No. IC-32315 (Oct. 13, 2016). Open-end funds, including ETFs but not money market funds, are required to establish a written liquidity risk management program under Rule 22e-4 that will be overseen by the fund's board. Funds are required to classify the liquidity of each portfolio investment into one of four liquidity categories based on the number of days the fund reasonably expects the investment would be convertible to cash (or, in the case of the less-liquid and illiquid categories, sold or disposed of) without the conversion (or, in the case of the less-liquid and illiquid categories, sale or disposition) significantly changing the market value of the investment.

calculating the funds' daily net asset values.[8]

- Maintaining appropriate policies, procedures and/or controls for valuation of portfolio securities, including provisions that address potential conflicts and issues, such as where portfolio managers are permitted to provide input – as voting members of the valuation committee – on prices of securities in funds they managed.

Compliance Oversight of Trading Practices

- Addressing appropriate trade allocation among client accounts so that all clients are treated fairly, including instances where trades for fund clients are aggregated with trades for other client accounts, including sub-advised funds, wrap accounts, and other non-wrap client accounts.

- Preventing prohibited principal transactions with affiliates, prohibited joint transactions with affiliates, or both.[9]

- Identifying cross trades and preventing related violations of the legal requirements for cross trading and principal trading under the Advisers Act and the IC Act.[10]

- Addressing sharing of soft dollar commissions among clients to assess whether any client is disadvantaged.

Compliance Oversight of Conflicts of Interest

- Addressing advisers' conflicts of interest with funds and their service providers, such as certain "dual capacity" instances where the adviser to an index fund also acts as the index provider.

- Reviewing index providers and the services they provide for, among other things: (1) conflicts of interest with advisers, such as when they share personnel, are affiliated, and/or have business arrangements (*e.g.*, marketing support payments by index providers to advisers and/or revenue sharing payments by advisers to index providers); and (2) the sharing, or the potential misuse, of material non-public information.

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[8] Examples of due diligence and oversight processes concerning pricing vendors include, but are not limited to, processes for reviewing variance reports on stale or outlier prices and formal price challenges. *See* Division of Investment Management, Valuation Guidance Frequently Asked Questions ("FAQs") (Feb. 11, 2016) and Final Rule: Money Market Fund Reform; Amendments to Form PF ("money market reforms release"), Rel. No. IC-31166 (July 23, 2014) regarding oversight of mutual fund pricing service providers (FAQs provide responses to questions related to valuation guidance for all mutual funds provided in the money market reforms release). *See also* IC Act Rule 2a-5 and Final Rule: Good Faith Determinations of Fair Value, Rel. No. IC-34128 (Dec. 3, 2020) (adopting Rule 2a-5). New Rule 2a-5, which has a compliance date of Sept. 8, 2022, updates the regulatory framework on valuation practices and a board of director's role in valuating securities of a registered investment company or business development company. Under this new regulatory framework, funds may choose to comply with Rule 2a-5 voluntarily prior to the compliance date, provided they no longer consider Commission and staff guidance and no-action letters that will be withdrawn on the compliance date.

[9] *See* IC Act Sections 17(a) and 17(d), respectively.

[10] *See* Advisers Act Section 206(3) and IC Act Section 17(a). The staff also observed cross trades where the funds did not comply with the requirements under IC Act Rule 17a-7 (if certain conditions are met, Rule 17a-7 permits trades between a fund and certain affiliated persons, where the affiliation arises solely because the two have a common adviser, directors, and/or officers).

Compliance Oversight of Fees and Expenses

- Monitoring allocation of expenses between funds and their advisers, subject to any fee waivers by the adviser.

- Reviewing fee calculations for any inconsistencies between a fund's contractual expense limitation and its disclosures regarding expenses included in operating expenses, subject to the expense cap.

Compliance Oversight of Fund Advertisements and Sales Literature

- Reviewing and filing fund advertisements and sales literature, including review of fee and expense disclosures for whether they are fair, balanced and not misleading within the context in which they are made,[11] and, as applicable, the presentation of back-tested index returns (*e.g.*, the characteristics of back-tested index returns when compared to a fund's actual returns).

- Reviewing affiliated index providers' websites – accessible through hyperlinks in the statements of additional information ("SAIs") of self-indexing funds – to assess whether the websites may be deemed fund sales literature that should be filed with the Commission or FINRA.[12]

- *The staff observed issues with funds' policies and procedures for their boards' oversight of the funds' compliance programs*. For example, the staff observed funds that did not:

  - Have appropriate policies, procedures and processes for monitoring and reporting to their boards with accurate information, such as information regarding: (1) fees paid by the funds to financial intermediaries and other service providers for providing shareholder services; (2) the type of services provided by service providers; (3) pricing exceptions under the funds' valuation policies and procedures; (4) adviser's recommendation whether a fund's liquidation may be in the best interests of the fund and its shareholders;[13] and (5) portfolio compliance with senior securities and asset coverage requirements.[14]

  - Provide appropriate processes as part of the respective fund board's annual review and approval of the fund's investment advisory agreement under Section 15(c) of the IC Act

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[11] *See* FINRA Rule 2210(d).

[12] *See* IC Act Section 24(b) and Rule 24b-3 (making it unlawful for any registered open-end investment company to transmit any advertisement, pamphlet, circular, form letter or other sales literature addressed to or intended for distribution to prospective investors unless the material has been filed with the Commission; filing of such material with FINRA is deemed to be filing with the Commission). *See also* SEC Interpretation: Use of Electronic Media, Investment Company Act Rel. No. IC-24426 (April 28, 2000) and Commission Guidance on the Use of Company Websites, Investment Company Act Rel. No. IC-28351 (August 1, 2008).

[13] Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers, which includes both a duty of care and a duty of loyalty. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (Jun. 5, 2019).

[14] *Supra* note 6.

regarding the board's considerations as to whether the adviser has any financial condition that is reasonably likely to impair its ability to meet its contractual commitments to clients.[15]

- Complete required annual reviews of the funds' compliance programs that address the adequacy of policies and procedures and effectiveness of their implementation.[16]

- Ensure that the annual report from the respective fund's chief compliance officer addressed the operation of the policies and procedures of the fund's adviser,[17] including whether the adviser had policies and procedures in specific risk areas.

- Adopt or maintain appropriate policies and procedures for the funds' boards to exercise appropriate oversight in instances where the funds' delegated responsibilities to their advisers that were not reflected in the advisers' compliance programs.[18]

B. Disclosure to Investors

Below are examples of deficiencies or weaknesses observed by the staff related to the funds' disclosures to investors in fund filings, advertisements, sales literature and/or other shareholder communications.

- *The staff observed funds had inaccurate, incomplete and/or omitted disclosures in their filings*. Examples include:

    - Omitted disclosures regarding: (1) certain principal investment strategies and/or risks of investing in the funds;[19] (2) potential conflicts associated with allocating investment opportunities among overlapping investment strategies;[20] and (3) change in the broad-

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15 *See* IC Act Section 15(c). For example, the board's considerations may include review of the adviser's responses to the 15(c) questionnaire provided to the adviser by counsel to the fund and/or counsel to the fund's independent directors.

16 *See* IC Act Rule 38a-1(a)(3).

17 *See* IC Act Rule 38a-1(a)(4)(iii)(A). The staff also observed a number of instances of inaccurate Form ADV disclosures by advisers, including: (1) disclosure of investment allocation practices and trade monitoring practices inconsistent with actual practices; (2) inadequate disclosure of differences between a private fund and a mutual fund with similar, if not identical, investment strategies and overlapping investment managers; (3) omission of sub-advised funds from the investment company advisory business; (4) omission of certain advisory client accounts over which the adviser or a related person had custody; (5) failure to disclose change in ownership following spin-off of broker-dealer affiliate; and/or (6) inaccurate disclosure concerning receipt of soft dollar benefits.

18 The staff also observed advisers that did not have annual reviews of their compliance program that were consistent with Advisers Act Rule 206(4)-7(b).

19 *See* Item 9(b)(1) of Form N-1A, which requires a fund to disclose its principal investment strategies (including the type or types of securities in which the fund invests or will invest principally). Instruction 2 to Item 9(b)(1) of Form N-1A states that a fund shall, in determining whether a strategy is a principal investment strategy, consider, among other things, the amount of the fund's assets expected to be committed to the strategy, the amount of the fund's assets expected to be placed at risk by the strategy, and the likelihood of the fund's losing some or all of those assets from implementing the strategy. *See also* Item 9(c) of Form N-1A, which requires a fund to disclose the principal risks of investing in the fund, including the risks to which the fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the fund's net asset value, yield, or total return.

20 The staff also observed instances where advisers that managed mutual funds and private funds with similar strategies or were managed by the same portfolio managers did not disclose conflicts, including failure to disclose conflicts associated with their allocation of investment opportunities. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (Jun. 5, 2019).

based indexes used for comparison of funds' performance.[21]

- Inconsistent and/or inaccurate disclosure concerning the funds' net assets and net expense ratios, contractual expense limitations, and/or operating expenses subject to the contractual expense limitation.

- Did not disclose in the funds' SAIs required information concerning standing committees of a fund's board and accurate information regarding the number of accounts and total assets managed by the portfolio managers within each of the required categories.[22]

- *The staff observed funds that had inaccurate, incomplete, and/or omitted disclosures on a variety of advertising and sales literature-related topics*, such as: (1) investment strategies and portfolio holdings; (2) the differences in investment objective between predecessor and successor funds; (3) inception dates; (4) funds' expenses, contractual expense limitations, and/or expense ratios; (5) average total returns and/or gross expenses and net expenses;[23] (6) performance information not disclosed with the required legends;[24] (7) awards received for fund performance;[25] (8) weighting of index constituents in the benchmark index; (9) methodologies for calculating the performance of the benchmark index; (10) differences in holdings, risk, and volatility between the broad-based and bespoke indexes used for performance comparisons; and/or (11) composition of index used for performance comparisons.

C. Staff Observations Regarding Compliance and Disclosure Practices

The staff observed various practices with respect to funds' and their advisers' compliance programs, the boards' oversight of funds' compliance programs, and disclosure practices that funds and their advisers may find helpful in their compliance oversight practices. Below is a sampled list of practices that may assist funds and their advisers in designing and implementing their compliance programs.

- *Certain funds and their advisers adopted and implemented compliance programs that provided for the following:*

  - Review of compliance policies and procedures for consistency with practices (*e.g.*, funds reviewed their advisers' compliance manuals for specific policies and procedures addressing various risk areas for which the funds had delegated responsibility to their

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[21] *See* Instruction 2(c) of Item 4 of Form N-1A.

[22] *See* Item 17(b)(2) and Item 20 of Form N-1A, respectively (Item 20 requires accounts and assets managed information by the following three categories: registered funds, other pooled investment vehicles, and other accounts).

[23] *See* Securities Act Rule 482(d)(5) (requires that total returns and any non-standardized performance be disclosed with equal prominence). *See* FINRA Rule 2210(d)(5) and FINRA Notice to Members 06-48, "SEC Approves Amendments to NASD Rules 2210 and 2211 to Require Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material" (gross and any net operating expense ratios should be disclosed in a fair and balanced manner).

[24] Securities Act Rule 482(b)(3).

[25] The staff observed instances where funds did not disclose material facts regarding awards received for fund performance, *e.g.*, the selection criteria for the award, the amount of any fee paid by the adviser to receive or promote the award, the number of other funds that applied and received the award, or whether the adviser was required to be a member of an organization to receive the award.

advisers).

- Conducting periodic testing and reviews for compliance with disclosures (*e.g.*, review whether funds are complying with their stated investment objectives, investment strategies, restrictions, and other disclosures) and assess the effectiveness of compliance policies and procedures in addressing conflicts of interests (*e.g.*, review trade and expense allocation policies and procedures in light of potential conflicts that may exist among the various types of accounts managed by the adviser).

- Ensuring compliance programs adequately address the oversight of key vendors, such as pricing vendors (*e.g.*, written pricing vendor oversight processes include reviewing variance reports on stale or outlier prices and price challenges).

- Adopting and implementing policies and procedures to address: (1) compliance with applicable regulations (*e.g.*, to identify cross trades, where applicable, and prevent related violations); (2) compliance with the terms and conditions of applicable exemptive orders and any disclosures required to be made under the order; and (3) undisclosed conflicts of interest, including potential conflicts between funds and/or advisers and their affiliated service providers.

- *Certain funds' boards provided oversight of funds' compliance programs by assessing whether:*

  - The information provided to the board was accurate, including whether funds' and their advisers were accurately disclosing to the boards: (1) funds' fees, expenses and performance, and (2) funds' investment strategies, any changes to the strategies, and the risks associated with the respective strategies.

  - The funds were adhering to their processes for board reporting, including an annual review of the adequacy of the funds' compliance program and effectiveness of their implementation.

- *Certain funds adopted and implemented policies and procedures concerning disclosure, such as those that required:*

  - Review and amendment of disclosures in funds' prospectuses, SAIs, shareholder reports or other investor communications consistent with the funds' investments and investment policies and restrictions.

  - Amendment of disclosures for consistency with actions taken by the funds' boards, as applicable.

  - Update of funds' website disclosures concurrently with new or amended disclosures in funds' prospectuses, SAIs, shareholder reports or other client communications.

  - Review and testing of fees and expenses disclosed in funds' prospectuses, SAIs, shareholder reports or other client communications for accuracy and completeness of presentation.

- Review and testing of funds' performance advertising for accuracy and appropriateness of presentation and applicable disclosures.

III. Conclusion

In response to these observations, many of the funds and their advisers revised their compliance policies and procedures, amended disclosures, or changed certain practices. In sharing the information in this Risk Alert, the Division encourages funds and their advisers to review their practices, policies, and procedures in these areas and to consider improvements in their compliance programs and disclosure practices, as appropriate.

This Risk Alert is intended to highlight for firms risks and issues that the Division's staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

RISK ALERT
DIVISION OF EXAMINATIONS

November 9, 2021

Observations from Examinations of Advisers that Provide Electronic Investment Advice*

I. Introduction

Advisers have been providing automated digital investment advisory services to retirement plan participants and retail investors for more than two decades; however, the Division of Examinations ("Division") has recently observed a significant increase in the number of investment advisers choosing to provide automated digital investment advisory services to their clients. These advisers either exclusively provide online services or supplement their traditional investment advisory services by using proprietary software, third party software, or a combination thereof. Millions of investors, individually and through their employer-sponsored retirement plans, now entrust their savings to advisers that provide their investment advisory services online, via mobile applications, or both (also known as robo-advisers).

The use of automated digital investment advisory services ("robo-advisory services") can have important investor protection implications. On the one hand, automation can offer significant benefits, including providing convenient, accessible, and lower cost services for investors and enhancing operational efficiency for advisers. When robo-advisers fail to comply with their regulatory obligations, however, investors may experience poor outcomes. If, for example, a robo-adviser's client survey process does not appropriately capture a client's risk tolerance, it could result in advice to invest in securities that are not aligned with the client's best interest. Similarly, if a robo-adviser is programmed to act on conflicts of interest that raise the costs or decrease the quality of the services provided, the client may be harmed as a result of the adviser's putting its own interests ahead of its clients.

The Division conducted a series of examinations to assess the practices of advisers providing robo-advisory services.[1] Under its Electronic Investment Advice Initiative (the "Initiative" or "eIA

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1 The Division previously focused on examining advisers that provide advisory services through the Internet, including prior to the adoption of the exemption from the prohibition on Commission registration for Internet advisers pursuant to Advisers Act Rule 203A-2(e) (the "Internet adviser exemption") (*See* Exemption for Certain Investment Advisers Operating Through the Internet, Advisers Act Rel. No. 2091 (Dec. 12, 2002) ("IA-2091")). There is no standard industry nomenclature to describe advisers that provide electronic advisory services. The term "Internet adviser" herein refers to robo-advisers that registered with the Commission in reliance on this exemption. In addition, the Division's observations from multiple robo-adviser examinations were considered when drafting the guidance published by the SEC's Division of Investment Management ("Investment Management") on robo-advisers and informed the development of the Initiative's scope (*See* Investment Management, Guidance Update: Robo-Advisers (Feb. 23, 2017)

Initiative"), the staff sought to obtain a better understanding of how robo-advisers were operating their firms, providing advisory services to retail and institutional clients, and satisfying their regulatory obligations under the Investment Advisers Act of 1940 ("Advisers Act"). In particular, the staff focused on how robo-advisers were upholding their fiduciary duty to: (1) provide clear and adequate disclosure regarding the nature of the advisers' services and performance history; and (2) act in their clients' best interests.

The purpose of this Risk Alert is to raise awareness of certain compliance issues the Division observed while conducting examinations of advisers providing, or claiming to provide, robo-advisory services, including advisers that operate, recommend, or sponsor discretionary investment advisory programs.[2]

In order to gain a broad understanding of the industry, the Division selected advisers to examine under the eIA Initiative that had different business models, client types, investment practices, assets under management, and bases for SEC-registration. The examined advisers: (1) provided robo-advisory services to employer-sponsored retirement plans ("retirement plans") and/or retail investors, including retirement plan participants; (2) sold, licensed, or otherwise granted interactive, digital platform access to third parties, such as advisers, broker-dealers, and banks; and/or (3) provided advisory or sub-advisory services to an interactive, digital investment platform.

II. Examination Focus and Relevant Regulations

A. Provision of Electronic Investment Advice

Examinations focused on the advisers' robo-advisory practices in several areas. In addition to a broader review of these advisers' adherence to their fiduciary duty,[3] the staff specifically examined the advisers':

- *Compliance programs* to assess whether compliance policies and procedures, particularly those related to the provision of robo-advisory services, were adopted, implemented, reasonably designed, and tested at least annually.[4]

("Guidance") for additional information). The eIA Initiative included Internet advisers as well as other advisers that provided electronic investment advice either exclusively or in addition to traditional investment advisory services (together, "advisers").

[2] Discretionary investment advisory programs may raise implications under the Investment Company Act of 1940 ("Company Act"). *See* Final Rule: Status of Investment Advisory Programs under the Investment Company Act of 1940 ("Adopting Release"), Company Act Release No. 22579 (Mar. 24, 1997) (although investment advisory programs are typically sponsored by investment advisers, Rule 3a-4 is available to any investment advisory program, regardless of whether the sponsor, for example, is excepted from the definition of investment adviser, such as a bank, or is required or permitted to be registered under the Advisers Act). For this Risk Alert, the use of "operate" or "operating" includes advisers that operate a discretionary investment advisory program, recommend such a program, or both.

[3] *See*, *e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 (Jun. 5, 2019) ("Fiduciary Release") ("[T]he duty of care requires an investment adviser to provide investment advice in the best interest of its client, based on the client's objectives… The duty of loyalty requires that an adviser not subordinate its clients' interests to its own. In other words, an… adviser must not place its own interest ahead of its client's interests."). The Commission has recently brought an action against a robo-adviser that did not uphold its duties of loyalty and care. *See* In re SoFi Wealth, LLC, Advisers Act Rel. No. 5826 (Aug. 19, 2021) (settled) (alleging that the adviser harmed clients by investing in certain affiliated securities and lacked written policies and procedures designed to prevent such harm).

[4] Advisers Act Rule 206(4)-7 ("the Compliance Rule") requires SEC-registered advisers to adopt, implement, and annually review written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and rules thereunder by advisers and their supervised persons. *See also* Compliance Programs of Investment Companies and Investment

- *Formulation of investment advice* to evaluate whether advisers gathered sufficient information from clients to form a reasonable belief that clients were receiving investment advice that was in their best interest based on each client's financial situation and investment objectives.[5] Where applicable, the staff also reviewed conflicts of interest disclosures and "customization" representations for adequacy and accuracy.[6]

- *Marketing and performance advertising practices* for compliance with the "Advertising Rule."[7] Also, if relevant, the staff reviewed whether the advertised securities selection and portfolio management techniques were used when managing client accounts.

- *Data protection practices* to understand the firms' policies and procedures regarding client data protection, including cybersecurity practices.[8]

- *Registration information* to determine whether the advisers were eligible for SEC registration as investment advisers.

B. Use of Discretionary Investment Advisory Programs

Advisers that provide electronic investment advice may also sponsor or operate investment advisory programs, including for example, wrap fee programs and asset allocation programs that allocate client assets among mutual funds or exchange-traded funds. These programs are designed to provide the same or substantially similar professional portfolio management services to a large number of individual clients ("retail clients") and are commonly used to manage retail clients'

Advisers, Advisers Act Rel. No. 2204 (Dec. 17, 2003) ("IA-2204") ("Where appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns."). In the context of this Initiative, staff reviewed advisers' practices, policies, and procedures addressing, among other things, advisers' fiduciary duty to: (1) act in their clients' best interest; (2) not place their interests ahead of their clients' interests; and (3) make adequate and accurate disclosures.

5 *See* Advisers Act Section 206 (anti-fraud provision that imposes a fiduciary duty on advisers). *See also* supra Fiduciary Release at note 3 ("[I]n order to avoid liability under this antifraud provision, an investment adviser should have sufficient information about the prospective client and its objectives to form a reasonable basis for advice before providing any advice about these matters.").

6 *See* supra Guidance at note 1 (information must be presented in a manner that clients are likely to read, if in writing, and understand).

7 Advisers Act Rule 206(4)-1 ("Advertising Rule") prohibits any adviser that is registered or required to be registered under the Advisers Act from, among other things, using any advertisement that contains any untrue statement of material fact or that is otherwise false or misleading. The Commission recently adopted amendments to the Advertisements Rule, creating a merged rule (the "Marketing Rule") that will replace the existing Advertising Rule and Rule 206(4)-3 (addresses cash solicitations). The Marketing Rule became effective on May 4, 2021, and has a compliance date of November 4, 2022. The staff anticipates that some advisers may seek to comply with the new marketing rule in advance of the compliance date. In conjunction with these amendments, the Commission adopted amendments to Form ADV, to provide the Commission with additional information about advisers' marketing practices, and Rule 204-2 (requires advisers to make and keep certain books and records). *See* Investment Adviser Marketing, Advisers Act Rel. No. 5653 (Dec. 22, 2020) ("IA-5653").

8 *See* Privacy of Consumer Financial Information (Regulation S-P), Advisers Act Rel. No. 1883 (Jun. 22, 2000) (adopting rules implementing the privacy provisions of Subtitle A of Title V of the Gramm-Leach-Bliley Act with respect to financial institutions regulated by the SEC) ("Regulation S-P Release") and Identity Theft Red Flags Rules, Advisers Act Rel. No. 3582 (Apr. 10, 2013) ("Regulation S-ID Release") (adopting rules and guidelines to require certain regulated entities to establish programs to address risks of identity theft). *See also* Division (published as OCIE) Report on Cybersecurity and Resiliency Observations (Jan. 27, 2020).

individual accounts and retirement plans (*e.g.*, 401(k) plans) on a discretionary or nondiscretionary basis.

Certain discretionary investment advisory programs may meet the definition of an "investment company" under the Company Act.[9] To address this concern, the Commission adopted Company Act Rule 3a-4 as a nonexclusive safe harbor.[10] An investment adviser that sponsors or operates a discretionary investment advisory program should consider the program's status under the Company Act. Furthermore, if the program intends to rely on the Rule 3a-4 safe harbor, then the program's sponsor or operating adviser should consider whether the program is in compliance with the Rule's conditions.[11]

Where advisers recommended discretionary investment advisory programs, the staff reviewed whether such programs could be considered investment companies pursuant to the Company Act. More specifically, the staff inquired as to whether the advisers were aware of how these programs were organized and whether they were being operated in accordance with the nonexclusive safe harbor provided by Rule 3a-4.

III. Staff Observations

Nearly all of the examined advisers received a deficiency letter, with observations most often noted in the areas of: (1) compliance programs, including policies, procedures, and testing; (2) portfolio management, including, but not limited to, an adviser's fiduciary obligation to provide advice that is in each client's best interest; and (3) marketing/performance advertising, including misleading statements and missing or inadequate disclosure. The staff also observed, among other things,

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[9] The Commission has indicated that discretionary investment advisory programs that provide each client with individualized treatment and the ability to maintain indicia of ownership of the securities in their accounts are not investment companies. *See* Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice, Advisers Act Rel. No. 5833 (Aug. 27, 2021). *See also* supra Guidance at note 1 ("[R]obo-advisers should consider whether the organization and operation of their programs raise any issues under the other federal securities laws... in particular Rule 3a-4 under the… Company Act"). Company Act Section 3(a)(1) defines the term investment company generally to include any "issuer" that is engaged primarily in the business of investing, reinvesting, or trading in securities. The definition of "issuer" includes any organized group of persons, whether or not incorporated, that issues or proposes to issue any security. For a detailed discussion of why a discretionary investment advisory program may meet the definition of investment company and may be deemed to be issuing securities, *see* Status of Investment Advisory Programs under the Investment Company Act of 1940, Company Act Rel. No. 21260 (Jul. 27, 1995) (revised proposal of Rule 3a-4).

[10] Rule 3a-4 only applies to discretionary investment advisory programs. *See* supra Adopting Release at note 2. ("A nondiscretionary program (*i.e.*, one in which the investor has the authority to accept or reject each recommendation to purchase or sell a security made by the portfolio manager, and exercises judgment with respect to such recommendations), generally will not meet the definition of investment company under the Investment Company Act or issue securities that are required to be registered under Section 5 of the Securities Act, regardless of whether the program is operated in accordance with the provisions of [R]ule 3a-4.").

[11] *See* supra Adopting Release at note 2 ("Whether a program that operates outside of [R]ule 3a-4 is an investment company is a factual determination and depends on whether the program is an issuer of securities under the… Company Act and the Securities Act [of 1933]… [Rule 3a-4] is not intended… to create any presumption about a program that is not organized and operated in the manner contemplated by the [Rule]… Investment advisers under the Advisers Act owe their clients the duty to provide only suitable investment advice, whether or not the advice is provided to clients through an investment advisory program."). Rule 3a-4 is designed to address only the status of the program under the Company Act, not the obligations of any investment adviser under the Advisers Act. Accordingly, the steps required to meet the conditions to Rule 3a-4 may not satisfy an adviser's obligations under the Advisers Act, including its fiduciary obligations to clients participating in an investment advisory program. *See* supra Fiduciary Release at note 3.

advisers that were relying on, but not acting in accordance with, the Internet adviser exemption and Company Act Rule 3a-4. Additional details regarding these observations are described below.

A. Electronic Investment Advice

- *Compliance programs*. Most advisers had inadequate compliance programs, typically as a result of either a lack of written policies and procedures or having ones that were insufficient for their operations, unimplemented, or untested.[12] Specifically, the staff observed advisers that did not:

  - Include elements in their policies and procedures specific to their use of an online platform and/or other digital tools for the provision of investment advice, such as assessing whether the advisers': (1) algorithms were performing as intended; (2) asset allocation and/or rebalancing services were occurring as disclosed; and/or (3) data aggregation services did not impair the safety of clients' assets as a result of the adviser having direct or indirect access to clients' credentials (*e.g.*, pins and passwords).[13] Additionally, advisers using business-to-business platforms (*e.g.*, "white-label platforms") lacked policies and procedures that addressed the platform providers' attention to these matters.

  - Undertake a sufficient review of their policies and procedures at least annually to determine their adequacy, the effectiveness of their implementation, or both. For example, in addition to not addressing the above practices, many advisers did not detect inadequacies or non-compliance with their marketing and performance advertising practices, and several failed to recognize that certain practices constituted custody, causing the adviser to violate the "Custody Rule."[14]

  - Comply with the "Code of Ethics Rule."[15] For example, some advisers did not: (1) receive the required holdings and/or transaction reports from all access persons, typically because not all access persons had been identified; (2) obtain or maintain the required written acknowledgements from all supervised persons confirming receipt of the advisers' codes; and/or (3) include in their codes all required provisions.

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[12] *See* supra IA-2204 at note 4 ("[A]n adviser should identify… factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.") *See also* supra Guidance at note 1 ("In developing its compliance program, a robo-adviser should be mindful of the unique aspects of its business model.").

[13] Some robo-advisers offer data aggregation services, through which a client can view all or a portion of their personal financial information on the adviser's platform, such as outside bank and brokerage account information (e.g., assets, debt, transaction activity).

[14] Advisers Act Rule 206(4)-2 requires advisers that are registered or required to be registered under the Advisers Act, and that have custody of their clients' funds or securities, to take several steps that are designed to safeguard those clients' assets against theft, loss, misappropriation, or financial reverses of the adviser. Advisers have custody if they hold, directly or indirectly, client funds or securities, or have the authority to obtain possession of them. Examples of an adviser that has indirect access or the authority to obtain possession of clients' funds or securities include a firm that has access to a client's log-in credentials, has personnel who serve as a trustee to a firm client, or accepts client checks for investment that are made payable to the adviser.

[15] Advisers Act Rule 204A-1 requires any adviser that is registered or required to be registered under the Advisers Act to establish, maintain and enforce a code of ethics that, at a minimum, includes certain provisions. Among these are provisions requiring the adviser's access persons to: (1) report, and the adviser to review, their personal securities holdings and transactions; and (2) obtain pre-approval of certain investments from the adviser.

- *Portfolio management – oversight.*[16] Many advisers were not testing the investment advice generated by their platforms to clients' stated or platform-determined investment objectives or otherwise satisfying their duty of care. The staff observed advisers that:

    - Either lacked written policies and procedures that would allow the firms to develop a reasonable belief that the investment advice being provided to clients was in each client's best interest based on the client's objective, or adopted policies and procedures that were inadequate or not followed. A review of practices revealed that, while advisers commonly used questionnaires to collect client data, some firms relied on just a few data points to formulate investment advice. This raised the concern that the questions did not elicit sufficient information to allow the adviser to conclude that its initial and ongoing advice were suitable and appropriate for that client based on the client's financial situation and investment objectives.[17] In addition, many advisers did not periodically evaluate whether accounts were still being managed in accordance with the clients' needs, such as by inquiring about any changes in their financial situation or investment objectives or having clients update or retake their questionnaires.[18]

    - Lacked written policies and procedures related to the operation and supervision of their automated platforms, increasing the risk of algorithms producing unintended and inconsistent results (*e.g.*, due to coding errors or coding insufficient to address unforeseen or unusual market conditions, such as those caused by geo-political events, substantial oil price movements, or interest rate changes). The staff observed, among other things, rebalancing errors and other trade errors at firms that lacked adequate oversight of their automated platforms.

    - Lacked written policies and procedures to prevent violations of legal requirements related to their duty to seek best execution. For example, some advisers did not conduct, or document the details of, a best execution review, while others did not appear to be aware of their best execution obligations at all.

- *Portfolio management – disclosures and conflicts.*[19] The staff observed inaccurate or incomplete disclosures in many advisers' Form ADV filings, including those related to conflicts

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[16] *See* supra Fiduciary Release at note 3 (stating that an adviser has a fiduciary duty to: (1) provide advice that is in the best interest of its client, which requires the adviser to make a reasonable inquiry into the client's investment objectives and have a reasonable belief that the advice is in the client's best interest; (2) seek best execution; and (3) provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship). *See also* supra IA-2204 at note 4 ("The [Compliance Rule] requires advisers to consider their fiduciary and regulatory obligations under the Advisers Act and to formalize policies and procedures to address them.").

[17] *See* supra Guidance at note 1 (suggesting written policies and procedures a robo-adviser should consider adopting and implementing).

[18] While the duty of care applies to all advisers, this observation generally was noted in the context of advisers operating investment advisory programs. *See* Section III.B. of this Risk Alert for additional information regarding sponsor and operator reliance on Rule 3a-4.

[19] *See* supra Fiduciary Release at note 3 ("[t]o meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship... In addition, an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser-consciously or unconsciously-to render advice which was not disinterested... In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent... Whether the disclosure is full and fair will depend upon, among other things, the nature of the client, the scope of the services, and the

of interest, advisory fees, investment practices, and ownership structure. In addition, more than half of the advisers included hedge clauses and/or other exculpatory language in their advisory agreements, "terms of use and conditions," or other documents that may not align with their fiduciary duty.[20] Examples of omitted, inaccurate, or incomplete disclosures include instances where the advisers:

- Had purported third-parties recommend the advisers or provide execution services for advisory clients, but did not disclose that these parties were, in fact, affiliated with, and received compensation from, the advisers for the referrals, trades executed, or both.

- Omitted or had insufficient disclosure regarding how the adviser collects and uses information gathered from a client to generate a recommended portfolio, or how and when rebalancing occurs.[21]

- Omitted disclosures regarding processes for addressing profits and losses from trade errors.

- Provided inconsistent disclosures in various documents regarding advisory fee calculations.

- *Performance advertising and marketing*. More than one-half of the advisers had advertisement-related deficiencies.[22] For example, the staff observed advisers that:

    - Made misleading or prohibited statements on their websites, such as: (1) using vague or unsubstantiated claims that could cause an untrue or misleading implication or inference to be drawn regarding the advisory services provided, investment options available, performance expectations, and costs incurred in investing (*e.g.*, a comparative analysis of adviser-offered versus other products and services); (2) misrepresenting SIPC protections by implying that client accounts would be protected from market declines;[23] (3) using press logos (*e.g.,* ABC, CNN, Forbes) without links or disclosure that would explain their relevance; and (4) referring to, or providing links to, positive third party commentary, without disclosing the relevance, any conflict of interest (*e.g.,* adviser compensation), or both.[24]

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material fact or conflict"). *See also* supra IA-2204 at note 4 ("Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.").

20 *Id* (stating the Commission's view an adviser's federal fiduciary duty may not be waived, though its application may be shaped by the agreed-upon scope of its advisory relationship, and, "[a] contract provision purporting to waive the adviser's federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act...").

21 *See* supra Guidance at note 1 (providing examples of information a robo-adviser should consider disclosing).

22 The Commission has brought actions against advisers that provided electronic investment advice and made false or misleading statements in their advertisements. *See*, *e.g.*, In re Hedgeable, Inc., Advisers Act Rel. No. 5087 (Dec. 21, 2018) (settled) (alleging that the adviser disseminated false and misleading marketing materials and performance data) and In re Wealthfront, LLC, Advisers Act Rel. No. 5086 (Dec. 21, 2018) ("Wealthfront") (settled) (alleging that the adviser falsely stated that it monitored client accounts to avoid making wash sale transactions).

23 SIPC does not protect against investment losses. SIPC protects the custody function of a broker-dealer in the event the broker-dealer should fail. The limit of its protection is $500,000, which includes a $250,000 limit for cash.

24 The Commission has brought actions against advisers that published advertisements that omitted material information, including robo-advisers. *See* supra Wealthfront at note 22 (adviser allegedly selectively republished certain social media posts that made

- Used materially misleading performance advertisements on their websites, including hypothetical performance results of an investment model applied retroactively without including disclosures that would make the presentation not misleading.[25]

- Provided inadequate or insufficient disclosure about "human" services (*e.g.*, whether interactions with live individuals are available, mandatory, or restricted; whether they cost extra; or whether the client is assigned a financial professional).[26]

- *Cybersecurity and protection of client information.* The staff observed that while all of the advisers had business continuity plans, and the vast majority had implemented written policies and procedures regarding identifying and recovering from cybersecurity events, fewer advisers had policies and procedures that addressed protecting the firm's systems and responding to such events. The staff also observed advisers that were not in compliance with Regulation S-ID, Regulation S-P, or both because they: (1) had "covered accounts," but lacked written policies and procedures designed to detect, prevent, and mitigate identity theft; (2) lacked or did not implement written policies and procedures addressing compliance with certain elements of Regulation S-P; and/or (3) did not deliver initial and/or annual privacy notices to all clients when required to do so.[27]

- *Registration matters.* Nearly half of the advisers claiming reliance on the Internet adviser exemption were ineligible to rely on the exemption, and many were not otherwise eligible for SEC-registration. This has been a common finding for many years.[28] The staff observed advisers that: (1) did not have an interactive website; or (2) provided advisory personnel who could expand upon the investment advice provided by the adviser's interactive website or otherwise provide investment advice to clients, such as financial planning.[29] The staff also

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positive statements about its services, including ones made by individuals that it knew or should have known had an economic interest in promoting the adviser, without disclosing this conflict of interest).

25 Newly adopted amendments to Rule 206(4)-1 generally limit an adviser's use of hypothetical performance in advertisements provided to investors who have access to the resources to independently analyze such information and have the financial expertise to understand the risks and limitations of such performance presentations. *See* supra IA-5653 at note 7.

26 Advisers that provide electronic investment advice should disclose their use of algorithms and explain the degree of human involvement in the oversight and management of individual client accounts. *See* supra Guidance at note 1.

27 *See* supra Regulation S-P Release and Regulation S-ID Release at note 8. *See also* Division (published as OCIE), Risk Alert: Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P - Privacy Notices and Safeguard Policies (Apr. 16, 2019) (highlighting the requirements of Regulation S-P and common areas of non-compliance observed by the staff).

28 The Commission has cancelled the registration of advisers claiming reliance on the Internet adviser exemption for not satisfying the requisite conditions and also brought actions against them. *See*, *e.g.*, Ajenifuja Investments, LLC; Order Cancelling Registration Pursuant to Section 203(h) of the Investment Advisers Act of 1940, Advisers Act Rel. No. 5110 (Feb. 12, 2019) (finding that adviser was registered as an Internet adviser for over three years and in that time period did not have an interactive website and did not demonstrate any other basis for registration eligibility). *See also* In re RetireHub, Inc., Advisers Act Rel. No. 3337 (Dec. 15, 2011) (settled) (alleging that the adviser was never an Internet adviser because, over the course of its registration, it did not provide investment advice exclusively through an interactive website, advised more clients than permitted through personal contact, or both).

29 *See* supra IA-2091 at note 1 and Advisers Act Rule 203A-2(e)(1)(i) (stating that the Internet adviser exemption is available only to an adviser that provides investment advice to clients *exclusively* through an "interactive website," except as permitted by the *de minimis* exception). The *de minimis* exception permits an adviser relying on the rule to advise clients through means other than its interactive website, so long as the adviser had fewer than 15 of these non-Internet-based clients during the preceding 12 months. Thus, an adviser relying on this exemption for SEC registration generally cannot offer non-interactive website based services to its clients.

observed that some advisers' affiliates were operating as unregistered investment advisers because they were operationally integrated with the respective advisers. Such affiliates could not rely on the Internet adviser's registration as a basis for their own registration, as such reliance is prohibited under Advisers Act Rule 203A-2(e)(iii).[30]

B. Discretionary Investment Advisory Programs

The staff reviewed the use of discretionary investment advisory programs ("programs") by more than two dozen advisers under the eIA Initiative. During these examinations, the staff assessed whether the programs provided each retail client with individualized treatment and enabled clients to maintain certain indicia of ownership of the securities in their accounts as required for reliance on Company Act Rule 3a-4. Where compliance with Rule 3a-4 was not specified or observed, the staff reviewed whether alternative measures that addressed their status under the Company Act were being employed. The staff also examined whether advisers had adequate disclosures about the programs that addressed implications under the Company Act and had adopted and implemented effective written policies and procedures to address the provisions of Rule 3a-4 or any alternative measures employed to address Company Act status questions.

- *Reliance on the nonexclusive safe harbor provisions of Rule 3a-4*. Advisers recommending programs commonly provided the same or similar investment advice on a discretionary basis to a large number of their advisory clients, frequently using asset allocation portfolios that they, an affiliate, or a third-party created. Often, these advisers:
    - Were unaware that the programs they sponsored or operated may be unregistered investment companies. Many had clients with similar investment objectives that received the exact same investment advice, were placed in the same model portfolio, and invested identically as other clients. Some advisers recognized these issues and claimed reliance on Rule 3a-4, but others neither specifically claimed reliance on Rule 3a-4 nor claimed to be employing any alternative measures.[31]
    - Claimed that programs they sponsored or operated were relying on Rule 3a-4, but the programs or adviser did not comply with all of the provisions of the safe harbor. Many advisers had compliance policies and procedures that were inadequate in addressing adherence with Rule 3a-4, were not implemented, or both. Advisers that sponsor or operate discretionary investment advisory programs that are relying on the safe harbor afforded under Rule 3a-4 should adopt compliance policies and procedures that are reasonably designed to validate that such programs are, in fact, consistent with the Rule's provisions.[32]

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[30] *See* Investment Management No-Action Letter to Richard Ellis, Inc. (Mar. 18, 1981) and Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Advisers Act Rel. No. 3222 (Jun. 22, 2011) (discussing principles of adviser integration and applicability of Advisers Act Section 208(d)). *See also* supra IA-2091 at note 1 (Internet advisers cannot rely on the Internet adviser exemption as their basis for registration with the Commission if another adviser in a control relationship with them relies on the Internet adviser's Internet adviser registration as the basis for its own registration under Advisers Act Rule 203A-2(b), the "related adviser" exemption).

[31] *See* supra Adopting Release at note 2 (Rule 3a-4 does not create any presumption about a program that does not meet the rule's provisions).

[32] *See* supra Adopting Release at note 2 ("Each person relying on [R]ule 3a-4 is responsible for demonstrating its compliance with the [R]ules' provisions... The Commission... strongly recommends that a sponsor of an advisory program seeking to rely on

- *Establishing client accounts*. To rely on Rule 3a-4, sponsors or another person designated by a sponsor (*e.g.*, the adviser recommending the program) must obtain information from each client regarding the client's financial situation and investment objectives and inquire as to whether the client wishes to impose any reasonable restrictions on the management of the client's account. This information must be obtained at the opening of the account and updated periodically thereafter. Advisers observed not complying with these provisions:

    - Used questionnaires to gather information pertinent to providing individualized advice that included a very limited number of data points, potentially increasing the risk of not providing clients with individualized advice or acting in their clients' best interests.[33]

    - Did not allow clients to impose reasonable restrictions, or placed obstacles impeding their ability to do so. Many advisers engaged in practices that were inconsistent with this Rule 3a-4 requirement, which allows clients to designate particular securities or types of securities that should not be purchased or that should be sold if held. Some advisers expressly prohibited the imposition of any restrictions, while others appeared to impede clients from imposing reasonable restrictions. Examples include advisers that:

        - Required the selection of a different model portfolio if any restrictions were requested, established unduly restrictive requirements (*e.g.*, investment thresholds that very few clients likely would attain, or only allowed specific securities), or warned of negative consequences that may result from applying restrictions (without further explanation).

        - Did not disclose to clients, or did not disclose adequately, that they could impose reasonable restrictions on the management of their accounts or provided inaccurate or insufficient information regarding the client's ability to impose such restrictions.

- *Ongoing communications*. An adviser relying on the safe harbor must contact each client at least annually to: (1) update the client's financial situation or investment objectives; and (2) determine if the client wishes to impose any reasonable restrictions on the management of the client's account or reasonably modify existing restrictions. In addition, at least quarterly, an adviser must provide its clients with written notification to contact the adviser with any changes to such information. The adviser (or sponsor) also is required to make a person sufficiently knowledgeable about the account and its management reasonably available to the client for consultation. The staff observed issues with advisers meeting these requirements, including instances where advisers:

    - Did not request with the required frequency information regarding clients' financial situations and investment objectives. Many advisers did not satisfy the Rule's quarterly notification provision, as they contacted clients only once or twice per year. Nevertheless,

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[R]ule 3a-4 establish and implement written policies and procedures, and a system for applying such procedures, that are reasonably designed to ensure that the program operates in the manner contemplated by the rule.").

33 Questionnaires varied greatly in the quantity and quality of information requested. Such advisers generally offered a very small set of responses from which a client could choose. Commonly requested investment profile data points include items such as age, income, retirement status, and investment goals. *See also* Section III.A. *Portfolio management – oversight* observations.

most of the communications were in writing and indicated how clients should convey changes to the adviser.

  - Did not communicate with clients about their ability to impose new, or modify existing, reasonable restrictions. Many advisers did not provide written notice to their clients at least quarterly, or contact their clients at least annually, regarding the client's ability to add or change reasonable restrictions on their accounts.[34]

  - Provided clients with limited or no access to advisory personnel knowledgeable about the account and its management. Advisers sometimes limited client communication to technical support (*e.g.*, navigating the adviser's website) and general customer service support (*e.g.*, directing investors to educational materials). At firms where advisers made advisory personnel available to clients to address this Rule provision, there generally were access limitations or restrictions. For example, only clients who met certain account size thresholds were eligible for these services.

- *Account statements*. Rule 3a-4 requires the sponsor of a discretionary investment advisory program, or a person designated by the sponsor, to provide each client with a statement, at least quarterly, that contains certain information. The staff observed general compliance with this provision.

- *Client rights*. Rule 3a-4 provides for the retention by clients of certain indicia of ownership, to the same extent as if the clients held the securities and funds outside of the discretionary investment advisory program. However, the staff observed advisers that:

  - Restricted their clients' ability to withdraw cash or securities from their accounts. For example, some advisers limited the types of permitted withdrawals (*e.g.*, cash-only).

  - Did not allow clients to vote proxies or to delegate that right to a third-party for any or all securities, or required clients to request this right.

  - Appeared not to ensure that clients were being sent legally required documents (*e.g.*, trade confirmations and prospectuses).

  - Did not allow clients to have the legal right to proceed, directly as a security holder, against the issuer of any security in the client's account, as prescribed in Rule 3a-4.

III. Staff Observations on Ways to Improve Compliance

Due to the assorted advisers included in the eIA Initiative, the staff observed a wide range of compliance practices. As a result, while not all of the practices noted below may be universally applicable, they may assist advisers in developing and maintaining adequate and effective policies and procedures under the Compliance Rule.

- *Adopting, implementing, and following written policies and procedures that are tailored to the adviser's practices.* Advisers cited for compliance program-related deficiencies often had

[34] Compliant advisers contacted clients and also indicated how clients should convey their requests to the adviser.

multiple deficiencies across more than one category (*e.g.*, disclosure, marketing, or portfolio management). Conversely, advisers with compliance programs that appeared to be adequate and effective were not cited for deficiencies related to: (1) portfolio management (*e.g.*, best interest advice, best execution, and practices being inconsistent with disclosures); (2) custody; and (3) books and records. Such advisers also rarely had deficiencies related to marketing, performance advertising, or billing practices.

- *Testing algorithms periodically to ensure that they are operating as expected.* At advisers where algorithm-related testing was performed at least quarterly, the staff observed the following practices:
  - Testing frequently was performed by the advisers' algorithm designers/software developers, but rarely in isolation. Most included one or more other groups in their testing process, such as portfolio management, compliance, internal audit, and information technology ("IT") staff.
  - Where compliance was included in the process, compliance staff performed independent testing and also relied on work performed by others.
  - Exception reports or other reporting mechanisms commonly were used and frequently involved a combination of high-level and account-specific results. Reports often were reviewed by algorithm designers/software developers and compliance staff, but many firms also had portfolio management staff and/or IT staff review them.
- *Safeguarding algorithms*. Most advisers employed safeguards to prevent unauthorized algorithm changes, such as exclusively limiting code access to certain persons and providing compliance staff with advance notice of substantive algorithm changes or overrides (usually during the development process). Advisers using white-label platforms generally could not modify the platform's underlying code but reported that platform providers would notify them of changes.

IV. Conclusion

The examinations conducted within the scope of this review resulted in a range of actions. In response to the staff's observations, some advisers elected to amend disclosures and marketing materials, modify or eliminate performance advertisements, revise compliance policies and procedures, improve data protection practices, and/or change other practices.

The Division encourages advisers providing electronic investment advice to review their portfolio management practices and related disclosures; performance advertising and marketing materials; and written policies and procedures, including the implementation and testing of those policies and procedures, to ensure that they are consistent with the Advisers Act and the rules thereunder, as well as other federal securities laws, as applicable. Advisers relying on the Internet adviser exemption also are encouraged to review their registration eligibility.

The Division encourages advisers that recommend discretionary investment advisory programs to assess whether clients are being provided with individualized advice and whether sufficient policies, procedures, and practices are being employed to prevent such programs from being deemed unregistered investment companies and securities.

This Risk Alert is intended to highlight for firms risks and issues that the Division's staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

RISK ALERT
DIVISION OF EXAMINATIONS

November 10, 2021

Division of Examinations Observations: Investment Advisers' Fee Calculations[*]

I. Introduction

It is important for clients to receive timely and accurate information regarding fees and expenses when hiring an investment adviser because every dollar an investor pays in fees and expenses is a dollar not invested for the investor's benefit. Thus, the staff from the Division of Examinations (the "Division") often reviews whether advisers, among other things: have adopted and are following policies and procedures that are reasonably designed to result in the fair and accurate charging of fees; and have disclosed their fees with sufficient clarity for their clients to understand the costs associated with their services.[1]

The Division recently concluded a national initiative that focused on advisory fees, predominantly those charged to retail clients ("Advisory Fees Initiative" or "Initiative"). This Initiative assessed the various ways in which investment advisers charge fees for their services, as well as evaluated the adequacy of fee disclosures and the accuracy of fee calculations.[2] The staff conducted approximately 130 examinations of SEC-registered investment advisers under this Initiative ("examined advisers") and identified deficiencies related to the advisory fees charged during most of these examinations.

The advisory fee-related deficiencies observed often resulted in financial harm to clients, including: (1) advisory fee calculation errors, such as over-billing of advisory fees, inaccurate calculations of tiered or breakpoint fees, and inaccurate calculations due to incorrect householding of accounts;[3] and (2) not crediting certain fees due to clients, such as prepaid fees

[*] The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

[1] The Division has identified disclosures regarding the costs of investing as an examination priority since 2018 (*see* Division, Examination Priorities for 2018, 2019, 2020, and 2021).

[2] Other types of compensation, such as fees received in connection with client investments, were included within the scope of the Initiative to the extent that these fees related to the advisory fee calculations (*e.g.*, advisory fees were to be reduced by any transaction-based compensation received by the advisers' supervised persons). The staff also focused on additional compensation-based conflicts of interest identified during the examinations, if applicable.

[3] *See*, *e.g.*, In re Retirement Capital Strategies Inc., Advisers Act Rel. No. 5065 (Nov. 19. 2018) (settled) (alleging that the adviser inconsistently applied tiered "breakpoints" that reduced advisory fees as the total amount of client assets under

for terminated accounts or pro-rated fees for onboarding clients. In addition, the staff observed fee-related compliance and disclosure issues. The Investment Advisers Act of 1940 ("Advisers Act") establishes a fiduciary duty for investment advisers.[4] Advisers that fail to adhere to the terms of their agreement and disclosures, or otherwise engage in inappropriate fee billing and expense practices, may violate their fiduciary duties and the Advisers Act, including its antifraud provisions.[5]

The Division previously published a Risk Alert highlighting compliance issues observed by the staff related to advisory fees ("Advisory Fees Risk Alert").[6] In this follow up Risk Alert, the Division is supplementing the Advisory Fees Risk Alert by providing greater detail on certain compliance issues observed during the recent Advisory Fees Initiative examinations, including additional details regarding the staff's observations in the two areas outlined above.

II. Focus of Advisory Fees Initiative

All of the examined advisers provided investment advice to retail clients; however, they had a wide range of assets under management, business operations, staffing levels, and affiliations. The scope of the Advisory Fees Initiative included a review of the examined advisers' compliance policies, procedures, and practices related to advisory or other fees charged and the related disclosures provided to clients. More specifically, examiners typically reviewed the following areas:

- *The accuracy of the fees charged by the examined advisers.* The staff reviewed the accuracy of the advisory fees charged and whether the advisers overcharged clients.

- *The accuracy and adequacy of the examined advisers' disclosures*. The staff reviewed the disclosures provided to clients related to the advisory fees billed, including whether certain types of assets should be excluded for fee billing purposes.[7]
- *The effectiveness of the examined advisers' compliance programs and accuracy of their books and records*. When reviewing advisers' compliance programs, the staff reviewed the

management increased and failed to aggregate or "household" related account balances of the same client and clients within the same household for the purposes of achieving the advisory fee breakpoint discounts).

[4] An adviser's federal fiduciary obligations are enforceable through Advisers Act Section 206. *See*, generally, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 (June 5, 2019) ("Fiduciary Interp.").

[5] *See* Fiduciary Interp. *supra* note 4 ("The investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship"). *See also*, In re Barclays Capital Inc., Advisers Act Rel. No. 4705 (May 10, 2017) (settled) (alleging that the adviser violated Advisers Act Section 206(2) by incorrectly calculating the advisory fees based on, among other things, a billing methodology that differed from the advisory agreements); In re Morgan Stanley Smith Barney, LLC, Advisers Act Rel. No. 4607 (Jan. 13, 2017) (settled) (alleging that the adviser violated Advisers Act Section 206(2) by charging clients advisory fees that did not reflect negotiated discounts).

[6] Division, Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 12, 2018).

[7] *See* Fiduciary Interp. *supra* note 4 ("In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent"). *See also* Advisers Act Section 207 (stating that it is unlawful for advisers to make untrue statements or omit any material facts in applications or reports filed with the Commission).

adequacy of policies and procedures or other operational documents related to advisory fee billing practices and the calculation of assets under management used for fee billing purposes.[8] In addition, the staff reviewed policies and procedures related to the valuation of unique or hard-to-value assets.[9] Lastly, the staff assessed whether the examined advisers made and kept books and records that were true and accurate.[10]

An adviser that engages in inappropriate fee billing and other fee-related deficient practices may have regulatory implications beyond these areas of focus. Therefore, the staff recommends reviewing this Risk Alert in conjunction with the Advisory Fees Risk Alert and other SEC and staff-issued guidance for a discussion of the legal requirements and helpful resources regarding Commission actions and interpretative guidance relevant to this topic.[11]

III. Staff Observations[12]

While investment advisers continue to have assorted advisory fee arrangements and use a wide variety of calculation methodologies, the staff observed that the typical examined adviser: (1) had a standard fee schedule with tiered fee levels based upon assets under management; (2) quarterly assessed its advisory fees; (3) deducted advisory fees directly from clients' accounts; (4) calculated fees based on the account value at the beginning or ending date of the billing period; (5) used software or third-party service providers to calculate fees; (6) documented advisory fees with clients through written advisory agreements or contracts; and (7) combined family account values when such actions resulted in lower fees (*i.e.*, householding of accounts). Understanding these general characteristics may be helpful when reviewing the deficiencies noted below.

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8 *See* Advisers Act Rule 206(4)-7 (requiring any adviser that is registered or required to be registered under the Advisers Act to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and the rules thereunder, review those policies and procedures at least annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering their policies and procedures).

9 *See* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. 2242 (Dec. 17, 2003) (noting that an adviser's compliance policies and procedures should, among other things, address its "processes to value client holdings and assess fees based on those valuations").

10 Advisers Act Rule 204-2 requires every adviser registered or required to be registered with the Commission to make and keep true, accurate, and current certain books and records relating to its advisory business.

11 *See*, *e.g.*, Form ADV Part 2, Item 5 and General Instruction 3 (requiring an adviser to disclose its compensation arrangements and reminds advisers of their fiduciary duty and related disclosure obligations, including providing "sufficiently specific facts" to allow clients to understand the adviser's conflicts and business practices and give informed consent or reject them); and Division of Investment Management, Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation (last modified Oct. 18, 2019) (discussing certain compensation arrangements and related disclosure obligations arising from both the adviser's fiduciary duty and Form ADV).

12 While the staff's observations focus on advisers' calculations of retail client fees, many of the principles and disclosure obligations also apply to other types of client accounts (*e.g.*, institutional and fund clients) and forms of compensation (*e.g.*, direct or indirect receipt of services, fees, or payments from third-parties servicing client accounts).

A. Notable Deficient Practices

Advisory Fee Calculations

- *Several examined advisers charged advisory fees inaccurately*. These inaccurate calculations were due to a variety of errors, including:

  - *Inaccurate percentages were used to calculate advisory fees*. For example, the staff identified examined advisers that, among other things: (1) charged fees that were different from contractually agreed-upon rates; (2) used the incorrect fee schedule (*e.g.*, used the schedule intended for clients domiciled in a country other than the United States); (3) failed to convert all clients to their new or updated fee schedule; and (4) had errors in fee percentages manually entered into their portfolio management systems.

  - *Advisory fees were double-billed.* Such errors were typically due to oversights, such as not updating a system following a change in billing practices.

  - *Breakpoint or tiered billing rates were not correctly calculated.* Often these issues related to tiered fee schedules not being applied correctly or applied at all.

  - *Householding of client accounts were not correctly calculated*. In such instances, the examined advisers did not aggregate client or family accounts and/or apply the declining fee schedule, as applicable.

  - *Incorrect client account valuations were used.* For example, examined advisers included in their account valuations: (1) assets that disclosures stated would be excluded from the fee calculations, such as legacy positions; (2) stale account balance information as a result of the loss of data during transitions of portfolio management systems; (3) incorrect valuation dates for client billings; and (4) inaccurate account values due to timing differences in cash and dividend transactions in electronic custodial feeds compared to the available balance at the custodian (*e.g.*, certain pending deposits may be excluded from available balance).

- *Several examined advisers either did not refund prepaid fees on terminated accounts or did not assess fees for new accounts on a pro-rata basis.* The staff identified the following issues, among others, related to refunding prepaid fees:

  - *Inconsistently refunding unearned fees*. The examined advisers were obligated – by disclosures, advisory contracts, or both – to refund unearned advisory fees, but the examined advisers were inconsistent in providing refunds to clients (*i.e.*, provided refunds to some clients, but not others) or were unnecessarily delayed in providing such refunds, sometimes for several years post termination.

  - *Requiring clients to provide written requests to refund unearned advisory fees*. In these instances, the examined advisers had policies to refund prepaid advisory fees only upon written notice from clients.[13] Thus, the examined advisers kept the unearned advisory fees for clients that: (1) terminated the advisory relationship through their custodians, rather than notifying the adviser directly; or (2) did not specifically request a refund of prepaid fees when terminating the relationship.

False, Misleading or Omitted Disclosures

- *Several of the examined advisers were identified as having a range of disclosure issues.* The issues identified were related to incomplete or misleading Form ADV Part 2 brochures and/or other disclosures, including disclosure that: (1) did not reflect current fees charged or whether fees were negotiable; (2) did not accurately describe how fees would be calculated or billed; and (3) was inconsistent across advisory documents, such as stating the maximum fee in an advisory agreement that exceeded the fees disclosed in the adviser's brochure. The staff also identified examined advisers that did not have any written agreements or documentation establishing the client fee amount.

  Examples of issues with fee-related disclosures the staff observed, include:

  - *Cash flows and their effect on fees*. The staff observed disclosures that were inconsistent with the examined advisers' practices or were insufficient in describing how cash flows (*e.g.*, deposits and withdrawals) may impact client advisory fees, such as how a client will be billed for large deposits made mid-billing cycle.

  - *Timing of advisory fee billing.* The staff observed examined advisers that provided inaccurate disclosures regarding the timing of their fee billing. In some cases, advisers disclosed that advisory fees would be billed in advance, but elected to have some or many clients billed in arrears (and vice versa). In addition, although some examined advisers' fee disclosures stated that clients would be billed based on the average-weighted daily capital balances during the quarter, many of the clients' advisory agreements stated that fees were calculated in arrears based on the value at quarter-end. Lastly, some examined advisers did not disclose any information about the timing of advisory fee billing.

  - *Valuations for fee calculations*. Some examined advisers provided inaccurate disclosures about the values used to calculate advisory fees, such as using the month end account values rather than the disclosed average daily account values.

  - *Minimum fees, extra fees, and discounts.* Some examined advisers did not fully disclose a variety of other fee-related topics. Examples include examined advisers that did not disclose: (1) platform administration fees assessed (and that the fees could be avoided if clients elected to have their advisory accounts managed without using the platforms); (2) actual or minimum asset-based fee rates charged to clients; (3) the negotiability of fees or falsely disclosed that fees were not negotiable when they, in fact, could be negotiated; (4) the process for implementing householding and eligibility criteria; and (5) fees related to participating in wrap fee programs and non-wrap accounts.

[13] *See*, *e.g.*, Monitored Assets Corp., Advisers Act Rel. No. 1195 (Aug. 28, 1989) (settled) (alleging that adviser violated the anti-fraud provisions of the Advisers Act by refunding prepaid advisory fees only to certain clients).

Missing or Inadequate Policies and Procedures

- *Many of the examined advisers did not maintain written policies and procedures addressing advisory fee billing, monitoring of fee calculations and billing, or both.* Although some of these advisers had informal or unwritten practices in these areas, the staff considered such issues to be relevant to the operations of the adviser, and thus should be captured in written policies and procedures. Below are some examples of the staff's observations in this area:

  - *Policies and procedures that specifically address fee calculations.* The staff identified examined advisers with policies and procedures that were generic in nature and did not address specifics related to the processes for computing, billing, and testing advisory fees. In some cases, the examined advisers had no policies for testing or monitoring fee calculations.

  - *Policies and procedures to address material advisory fee components.* The staff observed examined advisers' policies and procedures missing a variety of critical advisory fee components that were relevant to the firms' businesses, including: (1) valuation of illiquid or difficult-to-value assets included in the assets for the calculation of advisory fees; (2) fee offsets, such as those offered for 12b-1 fees; (3) fee reimbursements for terminated accounts, where the client prepaid fees; (4) prorating fees for additions or subtractions of assets in accounts; and (5) family account aggregation (householding) or the application of breakpoints for fee calculations.

Inaccurate Financial Statements

- *The staff observed issues or inaccuracies with financial statements at several examined advisers with respect to advisory fees.* These issues included examined advisers in potential financial distress (*e.g.*, substantial balances on loans or lines of credit)[14] and examined advisers not properly: (1) recording pre-paid advisory fees as liabilities; or (2) maintaining their financial statements. Some examples include:

  - *Not recording all advisory fee income, administrative fee revenue, and compensation expenses in general ledgers and on financial statements*. These examined advisers did not record such gross revenue and expenses in their books and records because they were exchanged for other goods and services (*e.g.*, IT support) or did not record advisory fees paid directly to investment adviser representatives.

  - *Using a cash and modified cash basis of accounting, but preparing financial statements on an accrual basis of accounting*. These examined advisers incorrectly classified client advisory fees as "accounts receivable."

[14] *See* Form ADV, Part 2A, Item 18 (requiring an adviser to disclose any financial condition that is reasonably likely to impair the adviser's ability to meet contractual commitments to clients if the adviser has discretionary authority or custody of client funds or securities or if the adviser requires or solicits prepayment of more than $1,200 in fees per client, six months or more in advance).

B. Staff Observations Regarding Industry Practices

During the examinations, the staff observed advisers implementing a range of policies and practices to address their legal and regulatory obligations related to the compliance issues identified above. Recognizing that there is no such thing as a "one-size fits all" approach, the staff is providing these observed examples of policies and practices to assist advisers with compliance in these areas.

- *Adopt and implement written policies and procedures addressing advisory fee billing processes and validating fee calculations.* The staff generally observed fewer errors when the examined advisers had specific written policies and procedures addressing the supervision, calculation, review, and billing of advisory fees.

- *Centralize the fee billing process and validate that the fees charged to clients are consistent with compliance procedures, advisory contracts, and disclosures*. The staff observed that the examined advisers with centralized billing – rather than billing that was dispersed throughout the adviser with separate, supervised persons preparing and invoicing client billing statements – had fewer clients being billed incorrectly or client accounts being calculated inconsistent with the advisers' written policies and procedures.

- *Ensure resources and tools established for reviewing fee calculations are utilized*. The staff observed that checklists and other resources for reconciling client fee calculations with client advisory agreements may be useful tools when used consistently by all advisory personnel.

- *Properly record all advisory expenses and fees assessed to and received from clients, including those paid directly to advisory personnel.*

IV. Conclusion

Advisory fee calculation and billing has been, and continues to be, an area that warrants routine review during investment adviser examinations. The staff's observations and examination findings often lead to advisers returning money owed to clients due to fee billing and calculation errors, or to the improvement of advisers' compliance programs, policies, and procedures that foster prevention of future advisory fee issues. In sharing the information in this Risk Alert, the Division encourages advisers to review routinely, refine, and improve, as appropriate, their fee billing policies, procedures, and practices and address new risks as they are identified. In addition, advisers should review their disclosures regarding such practices to ensure that clients are provided with full and fair disclosure of all fees and expenses and related material conflicts of interest.

This Risk Alert is intended to highlight for firms risks and issues that Examinations staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

RISK ALERT
DIVISION OF EXAMINATIONS

January 27, 2022

Observations from Examinations of Private Fund Advisers

I. Introduction

On June 23, 2020, the Division of Examinations ("EXAMS") published a Risk Alert (the "2020 Private Fund Adviser Risk Alert") providing an overview of compliance issues observed by EXAMS staff[*] in examinations of registered investment advisers that manage private funds ("private fund advisers").[1] In light of the significant role of private fund advisers in the financial markets, we are publishing this risk alert detailing additional observations: (A) failure to act consistently with disclosures; (B) use of misleading disclosures regarding performance and marketing; (C) due diligence failures relating to investments or service providers; and (D) use of potentially misleading "hedge clauses."[2]

More than 5,000 SEC-registered investment advisers, approximately 35% of all SEC-registered advisers, manage approximately $18 trillion in private fund assets.[3] In the past five years alone, we have observed substantial growth in reported private fund assets, which have increased by 70% in that period. These assets are deployed through a variety of investment strategies employed by hedge funds, private equity funds, and real estate-related funds, among others. The size and complexity of advisers vary widely from, for example, an adviser with a private fund limited to investors made up of friends and family, to an adviser with a worldwide footprint managing multiple private funds with hundreds of billions of dollars in assets. This Risk Alert is intended to assist private fund advisers in reviewing and enhancing their compliance programs, and also to provide investors with information concerning private fund adviser deficiencies.

II. Legal Background

An investment adviser's fiduciary duty under the Investment Advisers Act of 1940 ("Advisers

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[*] This Risk Alert represents the views of the staff of EXAMS. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by EXAMS staff and is not legal advice.

[1] EXAMS Risk Alert, Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020) (the "2020 Private Fund Adviser Risk Alert").

[2] The observations in this Risk Alert and the 2020 Private Fund Adviser Risk Alert were drawn from over 5 years of examinations of private fund advisers. This Risk Alert, the 2020 Private Fund Adviser Risk Alert, and The Five Most Frequent Compliance Topics (Feb. 17, 2017) (for all advisers) reflect observations of the EXAMS staff regarding private fund advisers and are intended to assist private fund adviser compliance staff.

[3] Form ADV data current as of November 30, 2021.

Act") comprises a duty of care and a duty of loyalty.[4] This means the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own. In other words, the investment adviser cannot place its own interests ahead of the interests of its client. This combination of care and loyalty obligations requires the investment adviser to act in the "best interest" of its client at all times. Although investment advisers owe their clients a fiduciary duty under the Advisers Act, that fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client.[5]

In addition, Advisers Act Rule 206(4)-8 prohibits investment advisers to pooled investment vehicles from: (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

Advisers Act Rule 206(4)-7 (the "Compliance Rule") requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules that the Commission has adopted under the Advisers Act by the adviser or any of its supervised persons. In developing its policies and procedures, an adviser should identify matters that create risk exposure for the adviser and its clients in light of the firm's particular operations and then design compliance policies and procedures that address those risks. The Compliance Rule also requires advisers to review, no less frequently than annually, the adequacy of the policies and procedures established and the effectiveness of their implementation.

III. Private Fund Adviser Deficiencies[6]

A. Conduct Inconsistent with Disclosures

EXAMS staff has observed the following failures to act consistently with material disclosures to clients or investors:

- *Failure to obtain informed consent from Limited Partner Advisory Committees, Advisory Boards or Advisory Committees (collectively "LPACs") required under fund disclosures.* EXAMS staff observed private fund advisers that did not follow practices described in their limited partnership agreements ("LPAs"), operating agreements, private placement memoranda, due-diligence questionnaires, side letters or other disclosures ("fund disclosures") regarding the use of LPACs. For example, staff observed private fund advisers that failed to bring conflicts to their LPACs for review and consent, in

[4] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019) ("Fiduciary Interpretation").

[5] *See* Fiduciary Interpretation.

[6] This Risk Alert does not address all deficiencies among private fund advisers. In addition to the 2020 Private Fund Adviser Risk Alert, EXAMS also published, for example, a risk alert on February 7, 2017, The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers, which identifies deficiencies across all types of investment advisers.

contravention of fund disclosures. EXAMS staff also observed private fund advisers that did not obtain consent for certain conflicted transactions from the LPAC until after the transaction had occurred or obtained approval after providing the LPAC with incomplete information in contravention of fund disclosures.

- *Failure to follow practices described in fund disclosures regarding the calculation of Post-Commitment Period fund-level management fees.* EXAMS staff observed private fund advisers that did not follow practices described in fund disclosures regarding the calculation of the fund-level management fee during a private fund's Post-Commitment Period.[7] EXAMS staff observed that such failures resulted in investors paying more in management fees than they were required to pay under the terms of the fund disclosures. For example, private fund advisers did not reduce the cost basis of an investment when calculating their management fee after selling, writing off, writing down or otherwise disposing of a portion of an investment. Other private fund advisers used broad, undefined terms in the LPA, such as "impaired," "permanently impaired," "written down," or "permanently written down," but did not implement policies and procedures reasonably designed to apply these terms consistently when calculating management fees, potentially resulting in inaccurate management fees being charged.

- *Failure to comply with LPA liquidation and fund extension terms.* EXAMS staff observed advisers that extended the terms of private equity funds without obtaining the required approvals or without complying with the liquidation provisions described in the funds' LPAs, which, among other things, resulted in potentially inappropriate management fees being charged to investors.

- *Failure to invest in accordance with fund disclosures regarding investment strategy.* EXAMS staff observed private fund advisers that did not comply with investment limitations in fund disclosures. For example, the staff observed private fund advisers that implemented an investment strategy that diverged materially from fund disclosures. EXAMS staff also observed advisers that caused funds to exceed leverage limitations detailed in fund disclosures.

- *Failures relating to recycling practices.* "Recycling" refers to contractual provisions that allow a fund to add realized investment proceeds back to the capital commitments of investors. EXAMS staff observed private fund advisers that did not accurately describe the "recycling" practices utilized by their funds or omitted material information from such disclosures. In some instances, this failure may have caused private fund advisers to collect excess management fees.

- *Failure to follow fund disclosures regarding adviser personnel.* EXAMS staff observed advisers that did not adhere to the LPA "key person" process after the departure of

[7] Advisers to private equity funds typically assess a management fee based on a percentage of limited partner capital commitments during the period of time the fund deploys capital ("Commitment Period"). The basis of the amount used to calculate this fee, however, is generally reduced to "invested capital," less dispositions, write downs and write offs after the Commitment Period ("Post-Commitment Period"). These arrangements vary in accordance with contractual provisions.

several adviser principals or did not provide accurate information to investors reflecting the status of key previously-employed portfolio managers.

B. Disclosures Regarding Performance and Marketing

EXAMS staff has observed private fund advisers providing to investors or prospective investors misleading track records or other marketing statements that appear to violate Rule 206(4)-8.[8] In addition, Advisers Act Rule 204-2(a)(16) requires advisers to maintain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of any performance or rate of return of any or all managed accounts or securities recommendations. EXAMS staff has also observed failures by private fund advisers to maintain these required records.

- *Misleading material information about a track record.* EXAMS staff observed private fund advisers that provided inaccurate or misleading disclosures about their track record, including how benchmarks were used or how the portfolio for the track record was constructed. For example, the staff observed advisers that only marketed a favorable or cherry-picked track record of one fund or a subset of funds or did not disclose material information about the material impact of leverage on fund performance. In addition, the staff observed private fund advisers that utilized stale performance information in presentations to potential investors or track records that did not accurately reflect fees and expenses.

- *Inaccurate performance calculations.* EXAMS staff observed private fund advisers that presented inaccurate performance calculations to investors. For example, the staff observed private fund advisers that used inaccurate underlying data (*e.g.,* data from incorrect time periods, mischaracterization of return of capital distributions as dividends from portfolio companies, and/or projected rather than actual performance used in performance calculations) when creating track records, thereby leading to inaccurate and potentially misleading disclosures regarding performance.

- *Portability - failure to support adequately, or omissions of material information about, predecessor performance.* EXAMS staff observed private fund advisers that did not maintain books and records supporting predecessor performance at other advisers as required under Advisers Act Rule 204-2(a)(16). In addition, the staff observed private fund advisers that appeared to have omitted material facts about predecessor performance. For example, the staff observed private fund advisers that marketed incomplete prior track records or advertised performance that persons at the adviser were not primarily responsible for achieving at the prior adviser.

- *Misleading statements regarding awards or other claims.* EXAMS staff observed private fund advisers that made misleading statements regarding awards they received or characteristics of their firm. For example, the staff observed private fund advisers that

[8] The Commission adopted significant revisions to Advisers Act Rule 206(4)-1 that address the marketing of private funds. The rule, which advisers must comply with by November 4, 2022, provides additional specificity regarding misleading marketing materials. In addition to Rule 206(4)-1 and Rule 206(4)-8, the anti-fraud provisions of the federal securities laws, *e.g.,* Section 206 of the Advisers Act, Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934, may apply to this activity.

marketed awards received, but failed to make full and fair disclosures about the awards, such as the criteria for obtaining them, the amount of any fee paid by the adviser to receive them, and any amounts paid to the grantor of the awards for the adviser's right to promote its receipt of the awards. The staff also observed advisers that incorrectly claimed their investments were "supported" or "overseen" by the SEC or the United States government.

C. Due Diligence

As a fiduciary, an investment adviser must have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives. A reasonable belief that investment advice is in the best interest of a client also requires that an adviser conduct a reasonable investigation into the investment that is sufficient to ensure that the adviser is not basing its advice on materially inaccurate or incomplete information.[9]

EXAMS staff observed potential failures to conduct a reasonable investigation into an investment, to follow the due diligence process described to clients or investors, and to adopt and implement reasonably designed due diligence policies and procedures pursuant to the Compliance Rule:

- *Lack of a reasonable investigation into underlying investments or funds.* EXAMS staff observed advisers that did not perform reasonable investigations of investments in accordance with their policies and procedures, including the compliance and internal controls of the underlying investments or private funds in which they invested. In addition, the staff observed advisers that failed to perform adequate due diligence on important service providers, such as alternative data providers and placement agents.

- *Inadequate policies and procedures regarding investment due diligence.* EXAMS staff observed private fund advisers that did not appear to maintain reasonably designed policies and procedures regarding due diligence of investments. For example, the staff observed private fund advisers that outlined a due diligence process in fund disclosures, but did not maintain policies and procedures related to due diligence that were tailored to their advisory businesses.

D. Hedge Clauses

Whether a clause in an agreement, or a statement in disclosure documents provided to clients and investors, that purports to limit an adviser's liability (a "hedge clause") is misleading and would violate Sections 206(1) and 206(2) of the Advisers Act depends on all of the surrounding facts and circumstances.[10] EXAMS staff observed private fund advisers that included potentially misleading hedge clauses in documents that purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud. Such clauses could be inconsistent with Sections 206 and 215(a) of the Advisers Act.

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[9] *See* Fiduciary Interpretation.

[10] *See* Fiduciary Interpretation.

IV. Conclusion

Examinations of private fund advisers have resulted in a range of actions, including deficiency letters and, where appropriate, referrals to the Division of Enforcement. In response to these observations, many of the advisers modified their practices to address the issues identified by EXAMS staff. The Division encourages private fund advisers to review their practices, and written policies and procedures, including implementation of those policies and procedures, to address the issues identified in this Risk Alert.

This Risk Alert is intended to highlight for firms risks and issues that EXAMS staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

RISK ALERT
DIVISION OF EXAMINATIONS

April 26, 2022

Investment Adviser MNPI Compliance Issues

I. Introduction

The Division of Examinations ("EXAMS")* is issuing this risk alert to provide investment advisers, investors, and other market participants with information concerning notable deficiencies that the staff has cited related to Section 204A ("Section 204A") of the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 204A-1 (the "Code of Ethics Rule") thereunder. Deficiencies related to Section 204A and the Code of Ethics Rule have been among the most commonly observed by EXAMS.[1]

Section 204A requires all investment advisers, registered and unregistered, to establish, maintain, and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of material non-public information ("MNPI") by the adviser or any person associated with the adviser.[2] The Code of Ethics Rule requires investment advisers that are registered or required to be registered under the Advisers Act to adopt a "code of ethics" (or "code") that sets forth, among other things, the standard(s) of business conduct expected from the adviser's "supervised persons" (*e.g.*, employees, officers, partners, directors and other persons who provide advice on behalf of the adviser and are subject to the adviser's supervision and control). The Code of Ethics Rule requires certain supervised persons, called "access persons,"[3] to report their personal securities transactions and holdings to the adviser's chief compliance officer ("CCO") or other designated persons.

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* This Risk Alert represents the views of the staff of EXAMS. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by EXAMS staff and is not legal advice.

1 *See* EXAMS Risk Alert, The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (Feb. 7, 2017).

2 *See* Section 204A of the Investment Advisers Act of 1940; *see also Investment Adviser Codes of Ethics*, Investment Advisers Act Release No. 2256 (July 2, 2004) ("Code of Ethics Adopting Release").

3 "Access persons" are any supervised persons who have access to non-public information regarding client transactions or reportable fund holdings, make securities recommendations to clients or have access to such recommendations that are non-public, and, for most advisers, all officers, directors and partners. *See* Advisers Act Rule 204A-1(e)(1).

The Code of Ethics Rule requires advisers to adopt a code of ethics that includes:

- Standard(s) of business conduct that the adviser requires of all its supervised persons that reflect the adviser's fiduciary obligations and those of its supervised persons;[4]

- Provisions requiring supervised persons' compliance with applicable federal securities laws;[5]

- Provisions requiring access persons to report, and the adviser to review, their personal securities transactions and holdings periodically;[6]

- Provisions requiring supervised persons to report any violations of the code of ethics promptly to the chief compliance officer or another designated person;[7] and

- Provisions requiring the adviser to provide each supervised person with a copy of the code of ethics and any amendments, and requiring the supervised persons to provide the adviser with a written acknowledgment of their receipt of the code and any amendments.[8]

II. Compliance Issues Related to Section 204A

Below are examples of deficiencies and weaknesses associated with Section 204A observed by EXAMS staff:

- *Policies and procedures related to Alternative Data.* Exams staff observed advisers that used data from non-traditional sources ("alternative data"), but did not appear to adopt or implement reasonably designed written policies and procedures to address the potential risk of receipt and use of MNPI through alternative data sources.[9] For example:

    - Advisers did not appear to adequately memorialize diligence processes or follow them consistently and instead engaged in ad hoc and inconsistent diligence of alternative data service providers.

    - Advisers did not appear to have policies and procedures regarding the assessment of the terms, conditions, or legal obligations related to the collection or provision

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4 Advisers Act Rule 204A-1(a)(1).

5 Advisers Act Rule 204A-1(a)(2).

6 Advisers Act Rule 204A-1(a)(3).

7 Advisers Act Rule 204A-1(a)(4).

8 Advisers Act Rule 204A-1(a)(5).

9 "Alternative data" refers to many different types of information increasingly used in financial analysis, beyond traditional financial statements, company filings, and press releases. Alternative data does not necessarily contain MNPI. Examples of "alternative data" include information gleaned from satellite and drone imagery of crop fields and retailers' parking lots, analyses of aggregate credit card transactions, social media and internet search data, geolocation data from consumers' mobile phones, and email data obtained from apps and tools that consumers may utilize.

of the data, including when advisers became aware of red flags about the sources of such alternative data.

  - Advisers did not appear to consistently implement their policies and procedures related to alternative data service providers. For example, advisers did not apply their due diligence process to all sources of alternative data. In addition, staff observed advisers that had an onboarding process for alternative data service providers, but did not have a system for determining when due diligence needed to be re-performed based on passage of time or changes in data collection practices. Staff also observed advisers that could not demonstrate, such as by producing documentation, that their policies and procedures had been consistently implemented.

- *Policies and procedures related to so-called "value-add investors."*[10] EXAMS staff observed advisers that did not have or did not appear to implement adequate policies and procedures regarding investors (or in the case of institutional investors, key persons) who are more likely to possess MNPI, including officers or directors at a public company, principals or portfolio managers at asset management firms, and investment bankers.

  - EXAMS staff observed advisers that did not have policies and procedures regarding MNPI risks posed by their "value-add investors."

  - EXAMS staff also observed advisers that maintained MNPI policies and procedures regarding value-add investors, but the advisers did not correctly identify all of the value-add investors or correctly identify and track their relationships with potential sources of MNPI.

- *Policies and procedures related to "expert networks."*[11] EXAMS staff observed advisers that did not appear to have or did not appear to implement adequate policies and procedures regarding their discussions with expert network consultants who may be related to publicly traded companies or have access to MNPI, including:

  - Tracking and logging calls with expert network consultants;

  - Reviewing detailed notes from expert network calls; and

  - Reviewing relevant trading activity of supervised persons in the securities of publicly traded companies that are in similar industries as those discussed during calls.

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[10] "Value-add investor" refers to clients or fund investors that are corporate executives or financial professional investors who may have MNPI.

[11] "Expert network" refers to a group of professionals who are paid for their specialized information and research services.

III. Compliance Issues Related to the Code of Ethics Rule

Below are examples of deficiencies associated with the Code of Ethics Rule identified by EXAMS staff.

- *Identification of access persons*. EXAMS staff observed advisers that did not identify and supervise certain employees as access persons in accordance with the Code of Ethics Rule. EXAMS staff also observed adviser codes that did not define "access person" or accurately reflect which employees are considered access persons.

- *Access persons did not obtain required pre-approval for certain investments.* EXAMS staff observed adviser access persons that purchased beneficial ownership in initial public offerings and limited offerings without requisite pre-approval. For example:

    - EXAMS staff observed advisers that did not include a provision in their codes requiring access persons to obtain pre-approval before directly or indirectly acquiring any interests in an initial public offering or limited offering.

- *Personal Securities Transactions and Holdings*. EXAMS staff observed deficiencies related to the required reporting of access persons' personal securities transactions and holdings. For example:

    - *Review of holdings and transaction reports.* EXAMS staff observed advisers that could not produce evidence of supervisory review of holdings and transaction reports. In addition, EXAMS staff observed advisers that did not have policies and procedures in place to assign the CCO's reporting to another member of the adviser – effectively permitting the CCO to self-review his/her own holding and transaction reports.

    - *Submission of holdings and transaction reports.* EXAMS staff observed situations in which the holdings and/or transaction reports were not submitted by access persons, the adviser's code of ethics did not include provisions requiring access persons to submit reports, or the reports were not submitted within the timeframes reflected in the Code of Ethics Rule.

    - *Content of holdings and transaction reports*. EXAMS staff observed codes that did not require access persons to include the specified content set out by the Code of Ethics Rule in their transaction and holdings reports, including instances in which access persons did not include their investments in private placements.

- *Written acknowledgement of receipt of the code and any amendments.* EXAMS staff observed instances where supervised persons were not provided with a copy of the code or did not provide written acknowledgement of their receipt of the code or any amendments. In other instances, the code did not contain provisions to reflect the written acknowledgment requirement of Rule 204A-1(a)(5).

In addition, the Commission discussed in the Code of Ethics Adopting Release a number of practices that advisers should consider in crafting their codes.[12] Below are examples of related observations made by EXAMS staff:

- *Trading investments on restricted list.* The Commission stated that advisers should consider incorporating provisions into their codes to include "restricted lists" of issuers about which the advisory firm has inside information, and prohibit any trading in securities of those issuers while they remain on the restricted list. EXAMS staff observed instances where employees traded investments that were on the adviser's restricted list.

- *Allocation of investment opportunities.* The Commission stated that advisers should consider incorporating procedures to ensure that investment opportunities must first be offered to clients before the adviser or its employees may act on them. The staff observed situations where the adviser or its employees purchased securities at a better price, ahead of the adviser's clients in contravention of the adviser's code.

IV. Conclusion

In response to the issues identified in the deficiency letters, many of the advisers modified their codes of ethics and written policies, procedures and practices to address the issues identified by EXAMS staff. The Division encourages advisers to review their practices, policies, and procedures in this area and to ensure they are in compliance with provisions of the Advisers Act and the rules thereunder.

This Risk Alert is intended to highlight for firms risks and issues that EXAMS staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

[12] *See* Code of Ethics Adopting Release (stating that "[a]dvisory firms that have already adopted codes of ethics, however, commonly include many of the following elements, or address the following issues, which we believe that all advisers should consider in crafting their own procedures for employees' personal securities trading.").

NOTES

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Order Denying Motion to Vacate Settled Order and Other Relief, *In the Matter of Daniel C. Masters*, Securities Act Release No. 11064, Exchange Act Release No. 94956, Admin. Proc. File No. 3-20051 (May 20, 2022)

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 11064 / May 20, 2022

SECURITIES EXCHANGE ACT OF 1934
Release No. 94956 / May 20, 2022

Admin. Proc. File No. 3-20051

In the Matter of DANIEL C. MASTERS	ORDER DENYING MOTION TO VACATE SETTLED ORDER AND OTHER RELIEF

Daniel C. Masters, an attorney, moves to vacate a settled order that the Commission entered against him with his consent.[1] The Division of Enforcement and Office of General Counsel oppose the motion. Masters has not established the requisite compelling circumstances to justify vacating his settlement.[2] Accordingly, we deny the motion. Masters also seeks to restore his privilege of appearing or practicing before the Commission as an attorney. Because he has not shown good cause for reinstatement, we deny that request.[3]

I. Background

In 2018, Masters represented Worthington Energy, Inc., before the U.S. Bankruptcy Court for the Southern District of California.[4] At that time, Worthington Energy's common stock was registered with the Commission and traded over the counter. On behalf of Worthington Energy, Masters drafted a current report on Form 8-K that was filed with the Commission in March 2018. The current report announced that Worthington Energy would petition for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. It also disclosed that Worthington Energy would solicit the approval of its creditors for a "prepackaged" plan of reorganization and made representations about the nature of the plan and formation of a successor company. Lastly, it stated that

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[1] *See Daniel C. Masters*, Securities Exchange Act of 1934 Release No. 89976, 2020 WL 5700696 (Sept. 23, 2020).

[2] *See Gregory T. Bolan Jr.*, Exchange Act Release No. 85971, 2019 WL 2324336, at *3 (May 30, 2019).

[3] 17 C.F.R. § 201.102(e)(5)(i).

[4] *See In re Worthington Energy, Inc.*, No. 18-bk-2702 (Bankr. S.D. Cal.).

Worthington Energy would not send the plan to its shareholders for approval and that they were deemed to have rejected the plan because shareholders would "nether receive nor retain anything of value after the proposed reorganization," as full priority would be given to paying the creditors in the bankruptcy proceeding.

Masters drafted the plan of reorganization and an accompanying disclosure statement, circulated these documents to Worthington Energy's creditors and tabulated their votes, and filed the plan and disclosure statement with the bankruptcy court in May 2018. The plan represented that Worthington Energy would acquire a private company to form a successor company and, in exchange for creditors' respective claims, offered the creditors cash and new shares, exempt from registration, in the successor company as well as in nine additional shell companies that would be spun off from Worthington Energy's dormant oil well assets.

In May 2018, Commission staff sent a comment letter to Masters, objecting to the plan of reorganization. The staff noted that the plan and disclosure statement had multiple deficiencies and contained unsupported and unreliable information, and that the plan amounted to "nothing more than an attempt to traffic in public corporate shells in contravention of Sections 1129(d) and 1141(d)(3) of the Bankruptcy Code and is unconfirmable." Worthington Energy then moved to dismiss the bankruptcy petition, which the court granted in July 2018.

In September 2020, we issued an order instituting administrative and cease-and-desist proceedings against Masters, in accordance with an offer of settlement submitted by him.[5] We found that the disclosure statement and plan of reorganization contained materially false and misleading information. The plan falsely stated that a reorganized Worthington Energy had an agreement to acquire a private company and that the private company had substantial assets.[6] Because the assets of the successor company were overstated, Masters knew that the plan's sales projections about the successor company were materially misleading.[7] Masters made these false and materially misleading statements in the plan to entice Worthington Energy's creditors to vote in favor of the plan and the bankruptcy court to confirm it.[8] Our order summarized Masters's involvement in drafting Worthington Energy's Form 8-K, plan of reorganization, and disclosure statement and how the plan constituted an unregistered offer of securities and was in connection with the purchase or sale of securities.[9]

We found that Masters willfully violated Sections 17(a)(1) and 17(a)(3) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Accordingly, we imposed a cease-and-desist order against Masters, prohibited him from serving as an officer or director of a public company, barred him from participating in any

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[5] *See Masters*, 2020 WL 5700696.

[6] *Id.* at *2–3.

[7] *Id.* at *3.

[8] *Id.*

[9] *Id.* at *1–3.

offering of penny stock, denied him the privilege of appearing or practicing before the Commission as an attorney, and ordered him to pay a civil money penalty of $50,000.[10]

Masters consented to the sanctions and the entry of the settled order, but he did not admit or deny the findings. He did admit, however, that the Commission had jurisdiction over him and the subject matter of the proceeding.[11] In his offer of settlement, he also agreed to waive a hearing and further proceedings, in accordance with Rule 240 of the Commission's Rules of Practice.[12]

In January 2022, Masters, through counsel Norman B. Arnoff, moved to vacate the settled order. In opposition, the Division of Enforcement and Office of General Counsel point to the interest in finality of settled orders and argue that there is no compelling reason to vacate the settlement and that Masters has not shown good cause for reinstatement. In reply, Masters's counsel has made multiple submissions and sent emails to multiple Commission offices.[13]

II. Analysis

A. Masters has not established compelling circumstances that justify vacating his settlement, and he has waived further proceedings.

"We have a 'strong interest' in the finality of our settlement orders."[14] "Agreements settling litigation are 'solemn undertakings,' and public policy 'strongly favors' settlements; as

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10 *Id.* at *3–4.

11 *Id.* at *1.

12 *See* 17 C.F.R. § 201.240(c)(4).

13 Papers filed in connection with any administrative proceeding must be filed electronically through our Electronic Filings in Administrative Proceedings (eFAP) system, unless the party submits a certification of inability to file electronically. 17 C.F.R. § 201.151(a), .152(a); eFAP, https://www.sec.gov/efap. Sending emails to Commission offices is not the appropriate means to request relief under the Rules of Practice. Moreover, sending multiple submissions in reply is inconsistent with our rules, which contemplate a motion followed by opposition and reply briefs, 17 C.F.R. § 201.154(b), and which discourage repetitive, overlapping, or duplicative filings that contribute to "unnecessary delay or needless increase" in the resources needed to resolve a proceeding, 17 C.F.R. § 201.153(b)(1)(iii); *see also Am. CryptoFed DAO LLC*, Exchange Act Release No. 93806, 2021 WL 5966848, at *1 n.3 (Dec. 16, 2021). Although we have not done so in this proceeding, we may reject filings that do not comply with our rules. *See* 17 C.F.R. § 201.180(b); *Edward M. Daspin*, Exchange Act Release No. 10813, 2020 WL 4463315, at *7 n.60 (Aug. 3, 2020).

14 *Michael H. Johnson*, Exchange Act Release No. 75894, 2015 WL 5305993, at *4 (Sept. 10, 2015) (quoting *Kenneth W. Haver, CPA*, Exchange Act Release No. 54824, 2006 WL 3421789, at *3 (Nov. 28, 2006)).

such, settlement agreements should 'be upheld whenever equitable and policy considerations so permit.'"[15] "As a result, . . . a respondent must establish 'compelling circumstances' to justify vacating a settled order."[16]

Masters has not shown the requisite compelling circumstances. Masters—who is a lawyer—"does not suggest that his offer to settle was not voluntary, knowing, or informed."[17] Rather, he attacks the legal and factual bases of the settled order. He argues that: (1) the Commission lacked "subject-matter jurisdiction" over his misconduct because it was not in connection with an offer, purchase, or sale of securities; (2) the bankruptcy case was withdrawn following the Commission's comment letter objecting to the plan of reorganization and disclosure statement, and therefore his conduct in the bankruptcy proceeding cannot support sanctions imposed by the Commission; (3) the allegedly false statements in the plan of reorganization and disclosure statement were true or, at the least, he reasonably believed them to be true; and (4) his conduct complied with bankruptcy law.

These arguments are not premised on any newly discovered evidence, an intervening change in law, or any other unforeseeable circumstance.[18] All of these arguments could have been raised before. Masters made the conscious choice to forgo litigation and resolve the

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15 *Bolan*, 2019 WL 2324336, at *3 (quoting *Ford Motor Co. v. Mustangs Unlimited*, 487 F.3d 465, 469–70 (6th Cir. 2007)).

16 *Id.* (quoting *Richard D. Feldmann*, Exchange Act Release No. 77803, 2016 WL 2643450, at *2 (May 10, 2016)); *cf. Miller v. SEC*, 998 F.2d 62, 65 (2d Cir. 1993) ("If sanctioned parties easily are able to reopen consent decrees years later, the SEC would have little incentive to enter into such agreements.").

17 *Haver*, 2006 WL 3421789, at *3.

18 *See Feldmann*, 2016 WL 2643450, at *2 ("Feldmann bases his request to modify the settled order entirely on circumstances that were foreseeable when he entered into the settlement."); *id.* at *3 (denying a request to reduce a settled disgorgement amount because "there has been no post-settlement, judicial determination in light of which the sanctions imposed were no longer authorized by the governing substantive law"); *see also SEC v. Conradt*, 309 F.R.D. 186, 188 (S.D.N.Y. 2015) (ruling that even new developments in the law, which did not overrule any binding precedent, were insufficient to justify vacating consent judgments), *aff'd*, 696 F. App'x 46 (2d Cir. 2017); *Clayton v. Ameriquest Mortg. Co.*, 388 F. Supp. 2d 601, 609 (M.D.N.C. 2005) (rejecting argument to vacate settlement on grounds of newly discovered evidence where the "information was available to the Plaintiffs, and certainly could have been uncovered with the exercise of reasonable diligence on their part"); *Bolan*, 2019 WL 2324336, at *5 ("[N]o statutory prerequisites for imposing the settled order on Bolan have been vacated and no court has held that we lacked authority to impose the settled order's sanctions against Bolan."); *Edward I. Frankel*, Exchange Act Release No. 38378, 1997 WL 103785, at *2 n.5 (Mar. 10, 1997) (noting that where the respondent "elected to settle the matter and did not develop the record further," he "cannot now complain that the record is inaccurate or incomplete").

allegations by consenting to the settled order; his change of heart does not constitute compelling circumstances to justify vacating the settled order.[19]

Moreover, Masters's motion to vacate the settled order fails because he waived his right to further proceedings when he settled.[20] Our rules provide that a settling respondent waives all hearings pursuant to the statutory provisions under which the proceeding is to be or has been instituted; the filing of proposed findings of fact and conclusions of law; proceedings before, and an initial decision by, a hearing officer; all post-hearing procedures; and judicial review by any court.[21] Our rules also provide that settlement offers "shall recite or incorporate" these waiver provisions, and Masters's settlement offer did so.[22] His waiver thus "precludes him from challenging his settlement" now.[23]

In any event, Masters's arguments are without merit. Masters mainly argues that we lacked "subject-matter jurisdiction" over his misconduct because it was not in connection with an offer, purchase, or sale of securities.[24] But both the federal courts and we have consistently construed these nexus requirements broadly and flexibly.[25] As we found in the settled order, the plan of

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19 *See Conradt*, 309 F.R.D. at 188 (emphasizing that defendants chose to settle, "thereby receiving the certainty of the settlement terms in place of the risks of litigation"); *cf. Ackermann v. United States*, 340 U.S. 193, 198 (1950) ("Petitioner made a considered choice not to appeal …. Petitioner cannot be relieved of such a choice because hindsight seems to indicate to him that his decision not to appeal was probably wrong …. There must be an end to litigation someday, and free, calculated, deliberate choices are not to be relieved from.").

20 *See Bolan*, 2019 WL 2324336, at *4; *Feldmann*, 2016 WL 2643450, at *3.

21 17 C.F.R. § 201.240(c)(4).

22 17 C.F.R. § 201.240(b); Opp'n, Peirce Decl. Ex. 1, at 2 (notarized offer of settlement).

23 *Bolan*, 2019 WL 2324336, at *4; *Feldmann*, 2016 WL 2643450, at *3.

24 Sections 17(a)(1) and 17(a)(3) of the Securities Act prohibit fraudulent conduct "in the offer or sale of any securities," 15 U.S.C. § 77q(a), and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit fraudulent conduct "in connection with the purchase or sale of any security," 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. The meaning of the terms "in" and "in connection with" are not substantially different, and the Supreme Court has "used the terms interchangeably." *United States v. Naftalin*, 441 U.S. 768, 773 n.4 (1979).

25 *See, e.g.*, *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 84–85 & n.10 (2006); *SEC v. Zandford*, 535 U.S. 813, 819–20, 825 (2002); *Naftalin*, 441 U.S. at 772–73, 773 n.4, 778; *S.W. Hatfield, CPA*, Exchange Act Release No. 73763, 2014 WL 6850921, at *8 (Dec. 5, 2014); *William H. Murphy & Co.*, Exchange Act. Release No. 90759, 2020 WL 7496228, at *9 (Dec. 21, 2020) ("[E]ven a communication that [does] not on its face refer to a particular offering could nonetheless constitute an offer as long as it was 'designed to awaken an interest'

reorganization that Masters disseminated to creditors "was an unregistered offer of securities pursuant to the exemption from registration for securities issued to creditors in exchange for their claims contained in Section 1145 of the Bankruptcy Code."[26] The plan of reorganization was also in connection with the purchase or sale of securities including because when it was sent to Worthington Energy's creditors for approval Worthington Energy was publicly traded[27] and because Masters drafted a current report on Form 8-K filed with the Commission in March 2018 announcing the plan.[28]

Masters's remaining arguments also fail. Contrary to Masters's contentions, past misconduct may in fact give rise to sanctions under the relevant provisions of the federal securities laws,[29] and the availability of Rule 102(e) sanctions does not turn on whether his misconduct occurred while he was "appearing or practicing" before the Commission.[30] And Masters's assertions that the statements in the plan of reorganization were true or he at least believed them to be true, aside from his own declaration and inferences from documents that

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in the security." (quoting *Gearhart & Otis, Inc.*, Exchange Act Release No. 7329, 1964 WL 66874, at *18 (June 2, 1964), *aff'd on other grounds*, 348 F.2d 798 (D.C. Cir. 1965))).

[26] *Masters*, 2020 WL 5700696, at *3.

[27] *Id.*

[28] Both the federal courts and we have held that a Commission filing is a type of document on which investors would presumably rely in making investment decisions, and thus material misrepresentations or omissions in such documents would meet the nexus requirements. *See Pirate Investor*, 580 F.3d at 250; *SEC v. Wolfson*, 539 F.3d 1249, 1262–63 (10th Cir. 2008); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1362 (9th Cir. 1993); *Rita J. McConville*, Exchange Act Release No. 51950, 2005 WL 1560276, at *10 (June 30, 2005), *pet. denied*, 465 F.3d 780 (7th Cir. 2006).

[29] In relevant part, we have authority: to enter a cease-and-desist order under Section 8A of the Securities Act, 15 U.S.C. § 77h-1(a), and Section 21C of the Exchange Act, 15 U.S.C. § 78u-3(a); to impose officer-and-director bars under Section 8A of the Securities Act, 15 U.S.C. § 77h-1(f), and Section 21C of the Exchange Act, 15 U.S.C. § 78u-3(f); to impose a penny stock bar under Section 15(b)(6) of the Exchange Act, 15 U.S.C. § 78*o*(b)(6); to deny the privilege of appearing or practicing before the Commission under Section 4C of the Exchange Act, 15 U.S.C. § 78d-3(a)(3), and Rule 102(e) of the Commission's Rules of Practice, 17 C.F.R. § 201.102(e)(1)(iii); and to impose a civil money penalty under Section 8A of the Securities Act, 15 U.S.C. § 77h-1(g)(1), and Section 21B of the Exchange Act, 15 U.S.C. § 78u-2(a)(2). In the context of determining whether to impose cease-and-desist orders, we have long held that even a single instance of past misconduct may "raise[] a sufficient risk of future violation." *KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 WL 47245, at *24 (Jan. 19, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002).

[30] *Steven Altman, Esq.*, Exchange Act Release No. 63306, 2010 WL 5092725, at *15–16 (Nov. 10, 2010), *pet. denied*, 666 F.3d 1322 (D.C. Cir. 2011).

were previously known to him, are unsupported. Lastly, whether his conduct complied with bankruptcy law says nothing about the Commission's authority to institute proceedings or impose sanctions under the federal securities laws.

In summary, Masters has provided no valid basis to revisit the settled order.

B. Masters has not established good cause to be reinstated.

Masters also asks us to restore his privilege to appear or practice before the Commission. "An application for reinstatement of a person permanently suspended … may be made at any time," but we may reinstate a person to the privilege of appearing and practicing before us only "for good cause shown" in accordance with Rule 102(e)(5).[31] "[T]he determination of 'good cause' is necessarily highly fact specific."[32] "In making that determination, we are guided by the purpose of the Rule, which is 'to determine whether a person's professional qualifications, including his character and integrity, are such that he is fit to appear and practice before the Commission.'"[33]

Masters has not shown good cause. His misconduct was serious.[34] His letters of reference from other attorneys and certificate of good standing from the State Bar of California are outweighed by the severity of his misconduct, his current failure to fully recognize his wrongdoing, and his refusal to cooperate during the Commission's investigation.[35] Thus, given the severity of his misconduct and in the absence of other favorable circumstances, the time since Masters was suspended in September 2020 until now "is not sufficient to permit a reasonable determination whether [he] presently possesses the qualifications and fitness necessary to justify reinstatement."[36]

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31 17 C.F.R. § 201.102(e)(5).

32 *Steven C. Wolfe, Sr., CPA*, Exchange Act Release No. 39589, 1998 WL 28039, at *2 (Jan. 28, 1998).

33 *Id.* (quoting *Touche Ross & Co. v. SEC*, 609 F.2d 570, 579 (2d Cir. 1979)).

34 *See Peter Siris*, Exchange Act Release No. 71068, 2013 WL 6528874, at *6 (Dec. 12, 2013) ("We have repeatedly held that conduct that violates the antifraud provisions of the securities laws is especially serious and subject to the severest of sanctions under the securities laws." (internal quotation marks omitted)), *pet. denied*, 773 F.3d 89 (D.C. Cir. 2014).

35 Masters invoked his Fifth Amendment privilege against self-incrimination during the investigation as a basis to refuse to provide documents and answer questions at a deposition. *Cf. David Howard Welch*, Exchange Act Release No. 92267, 2021 WL 2941483, at *3 (June 25, 2021) ("Because our proceedings are civil in nature, we may draw adverse inferences from a respondent's invocation of his Fifth Amendment privilege and take this into account in weighing all of the evidence.").

36 *Steven C. Wolfe*, Exchange Act Release No. 34209, 1994 WL 274012, at *3 (June 14, 1994) (finding that "the time elapsed since the imposition of the sanction (approximately two

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Masters has not established compelling circumstances to justify vacating his settled order. Nor has he shown good cause for reinstatement.

Accordingly, IT IS ORDERED that the motion of Daniel C. Masters to vacate the settled order dated September 23, 2020, is DENIED.[37]

IT IS FURTHER ORDERED that the application of Daniel C. Masters for readmission to appear or practice before the Commission is DENIED, without prejudice to the right to reapply at a later date.

By the Commission.

Vanessa A. Countryman
Secretary

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years)" was insufficient to make the requisite determination, given the seriousness of the misconduct); *cf. Wolfe*, 1998 WL 28039, at *1–2 (reinstating the same applicant after more than six years elapsed since the imposition of the sanction, where, among other considerations, he acknowledged the severity of his misconduct, accepted responsibility for his actions, provided evidence regarding his rehabilitation, was cooperating with authorities in a related criminal prosecution, and, in connection with his application, submitted an undertaking to comply with several conditions if reinstated).

[37] Because our decisional process would not be significantly aided by oral argument, the motion for oral argument is DENIED. 17 C.F.R. § 201.451(a).

NOTES

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Order Granting Application to Enforce
SEC Order, *SEC v. Hackman*,
No. 2:21-cv-01234-APG-EJY (D. Nev. 2022)

UNITED STATES DISTRICT COURT

DISTRICT OF NEVADA

UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Plaintiff v. SHAWN F. HACKMAN, Defendant	Case No.: 2:21-cv-01234-APG-EJY **Order Granting Application to Enforce SEC Order** [ECF No. 1]

Shawn F. Hackman was disbarred from the Nevada bar in 2002. Later that same year, the United States Securities and Exchange Commission (the SEC) issued an order suspending Hackman from appearing or practicing before it as an attorney (the 2002 Order). The SEC subsequently determined that Hackman violated the 2002 Order. It filed this action seeking an order compelling Hackman to comply with its 2002 Order and to disgorge, with prejudgment interest, the compensation he received from violating the 2002 Order. Hackman argues that he did not violate the 2002 Order because he did not practice as an attorney and the SEC's proposed disgorgement amount includes income that was not derived as a result of his alleged violation. I find that Hackman violated the 2002 Order by practicing as an attorney before the SEC and that the SEC's proposed disgorgement is a reasonable approximation of the profits he received as a result of the violation. I therefore grant the SEC's application.

I. BACKGROUND

Hackman was admitted to the Nevada bar in 1996 and was disbarred in 2002. ECF Nos. 1-3 at 2; 1-7 at 7. Based on this disbarment, the SEC entered an order on September 10, 2002 suspending Hackman from appearing or practicing before it as an attorney, under Rule 102(e)(2) of the SEC's Rules of Practice, 17 C.F.R. § 201.102(e)(2). ECF No. 1-3 at 2-3. Beginning in at least 2007, Hackman worked at the law firms Harold P. Gewerter, Esq. Ltd. (Gewerter Law) and EAD Law Group (EAD Law), which was owned and operated by Elizabeth Dowling, [1] (collectively, the Law Firms). ECF Nos. 1-5 at 32 (120:15)-33 (122:4); 1-7 at 11 (36:16-37:3). The SEC presented extensive evidence regarding Hackman's conduct at the Law Firms between 2016 and the present, which I will not repeat fully here. Instead, I summarize the representative evidence most relevant to my conclusions: [2]

One EAD Law client, Anthony Iarocci, testified that he relied on Hackman for legal advice on SEC filings, Hackman provided advice on SEC filings, Hackman drafted filings, and Iarocci had no contact with Dowling while he relied on Hackman to prepare SEC filings. *See* ECF No. 1-16 at 16 (56:2-18), 18 (63:16-64:25), 19 (68:13-69:15), 22 (78:24-79:6), 26 (96:24-97:14), 29 (107:1-108:14), 33 (122:16-23), 36 (134:11-23). Hackman advised Iarocci regarding statements and documents disclosed to the SEC. *See* ECF Nos. 1-18 (advising on timing and content of financial statements); 1-19 (advising regarding language used in Form 10 and SEC's prior approval of that language); 1-21 (advising requiring filing requirements); [3] 1-22 (same); [4] 1-23 (same); *see also* ECF No. 1 at 44 (Appendix B, list of SEC forms). Hackman also drafted and edited SEC filings for Iarocci's companies. *See* ECF Nos. 1-24 (Hackman providing comments

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[1] The SEC states and Hackman does not dispute that Dowling owns and operates EAD Law.

[2] The SEC's application detailed examples of Hackman's work which, they argue, is representative of all of his work. Hackman does not dispute that these examples are representative of the entirety of his work.

[3] Dowling testified that she did not recall discussing any of these questions with Hackman. ECF No. 1-9 at 72 (586:17-25)-73 (587:1-16).

[4] Dowling testified that she had no reason to believe Hackman did or did not consult with her prior to responding. ECF No. 1-9 at 73 (588:17-589:8).

on financial statements and Form 10); 1-25 (drafting Form 10's); 1-26 (circulating Form 10 drafts "with our updates[,] inserts[,] and responses.")

A different client, Tracy Smith, testified that Hackman filed a form ID for one of Smith's companies. ECF No. 1-35 at 67 (261:19)-68 (262:8). Hackman sent Smith an S-1 registration statement and a document titled "Final Legal Opinion" which had Dowling's electronic signature on it. ECF Nos. 1-8 at 41 (523:9-19); 1-37; *see also* ECF No. 1-8 at 16 (422:7-22) (Hackman invoking his Fifth Amendment rights when asked whether it is more likely than not that Dowling never reviewed opinion letters issued under her electronic signature). Hackman invoked his Fifth Amendment rights when asked whether he functioned as SEC counsel on this S-1, whether Dowling reviewed this opinion letter, and whether Dowling authorized him to sign her name on this letter. ECF No. 1-8 at 41 (523:9-25)-42 (524:1-3). Dowling testified that she did not recall doing work on this S-1 and that she believed that if Hackman had worked on this S-1 without her review or involvement, then this would violate his disbarment. ECF No. 1-9 at 53 (509:21-510:19). Hackman later provided additional advice regarding the S-1 and prepared revisions to the S-1, an exhibit to the S-1, and an SEC comment response letter. *See* ECF Nos. 1-39; 1-40; 1-41;[5] 1-42;[6] 1-43; 1-44; 1-45; *see also* 1-8 at 31 (482:16-483:3) (Hackman's computer shows author as EAD Law Group). Hackman invoked his Fifth Amendment rights when he was asked whether he functioned as SEC counsel on the S-1s filed by Smith's company, and as counsel on

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[5] There are indications that even when a draft filing or SEC-related legal advice came from Dowling or Gewerter's email address, Hackman often completed the work or provided the advice. Such indications include emails being sent from a Sprint mobile phone (*See* ECF Nos. 1-5 at 56 (Dowling uses Verizon); 1-6 at 11 (Gewerter uses Sprint); 1-7 at 5 (Hackman used Sprint during the relevant period)) and the informal language or typos used in the emails (ECF No. 1-5 at 54 (208:10-209:7)).

[6] Emails being sent from and simultaneously copied to the same email address also indicate that even when a draft filing or SEC-related legal advice came from Dowling or Gewerter's email address, Hackman often completed the work or provided the advice. ECF No. 1-8 at 17 (426:8-12).

the Form D filed by another of Smith's companies. ECF No. 1-8 at 42 (525:1-11) and 43 (528:11-24).

Hackman's work for clients also included:

- Providing drafts of S-1s and recommendations for language used in and revisions to S-1 filings. *See* ECF Nos. 1-63; 1-67; 1-68; 1-86; 1-87.
- Providing final drafts of S-1 attorney opinion letters. *See* ECF Nos. 1-64; 1-65; 1-66; 1-71; 1-72; *see also* ECF Nos. 1-7 at 23 (84:1-19) (identifying Hackman's computer name for purposes of metadata); 1-8 at 11 (400-401) (Hackman invoking the Fifth Amendment when asked whether Dowling would review S-1 opinion letters, whether Hackman attached her name without her review, and whether he regularly submitted opinion letters without Dowling's review), 54-55 (573:18-576:8) (Hackman invoking his Fifth Amendment rights when asked whether he functioned as SEC counsel on specific S-1 and all of specific client's SEC filings, whether he believes Dowling reviewed the S-1 before it went to the client or was filed with the SEC, and whether Dowling authorized him to put her signature on this opinion).
- Preparing a draft of an 8-K document to be filed with the SEC. ECF No. 1-69.
- Providing a draft of a 10-K document to be filed with the SEC. ECF No. 1-99.
- Generally acting as an attorney for clients' SEC filings. *See* ECF Nos. 1-8 at 9-11 (Hackman invoking his Fifth Amendment rights when asked whether he worked as an attorney for all of the clients listed in two exhibits (ECF Nos. 1-107 and 1-108) and as an attorney on the clients' SEC filings, and whether Dowling or Gewerter supervised his work on any SEC filing for any of the clients listed), 22 (445:24-446:17) (Hackman invoking Fifth Amendment when asked whether he more likely than not functioned as an

attorney when a Gewerter Law client made an SEC filing in 2015 and 2016, whether he functioned as the attorney on the vast majority of SEC filings made by Gewerter Law clients in 2015-2016, and whether he functioned as counsel on the vast majority of SEC filings by EAD Law clients between 2016 and the present); 1-107; 1-108.

Hackman also directly communicated with SEC staff on behalf of a client. Joseph McCann, an attorney in the SEC's Division of Corporation Finance, testified that he reviewed a Form 10 registration statement and related filings filed by AS Capital, Inc. ECF No. 1-147 at 2. McCann testified that in June 2019, he participated in a phone call with individuals who he understood to be counsel to AS Capital and Xue Ran Gao, an individual who was purchasing a controlling interest in AS Capital. *Id.* at 2-3. He testified that counsel to AS Capital worked at EAD Law, was male, and was referred to as "Shawn" on the phone call. *Id.* On the call, Gao's counsel indicated Shawn was responsible for the Schedule 14-F filing which would result in Gao's purchase. *Id.* at 3. McCann testified that Hackman stated the filing would be amended to clarify certain facts and explain the contingencies to the purchase closing, and represented that AS Capital would file an amended Schedule 14-F to provide greater disclosure regarding the purchase. *Id.* Hackman invoked his Fifth Amendment rights when asked whether he was on this phone call and whether he believed this call violated his disbarment or the 2002 Order. ECF No. 1-8 at 49 (552:4-553:10).

With regard to Hackman's supervision at the Law Firms, Hackman estimated that Dowling worked 20 hours per week while he worked over 50 hours per week. ECF No. 1-7 at 35 (133:4-13). He invoked his Fifth Amendment rights when asked whether Dowling supervised his work on SEC filings for certain clients. ECF No. 1-8 at 11 (400:14-17; 403:15-17) and 25

(459:16-21). He also invoked his Fifth Amendment rights when asked whether Gewerter and Dowling supervised his work on SEC filings. *Id.* at 22 (444:18-445:23).

II. VIOLATION OF 2002 ORDER

Section 21(e)(1) of the Exchange Act authorizes me to issues writs of mandamus, injunctions, and orders commanding any person to comply with the Act and orders issued thereunder. 15 U.S.C. § 78u(e) ("Upon application of the Commission the district courts of the United States . . . shall have jurisdiction to issue writs of mandamus, injunctions, and orders commanding (1) any person to comply with the provisions of this chapter [or with] . . . the rules of a national securities exchange or registered securities association of which such person is a member or person associated with a member . . . ."). "Section 21(e) of the Exchange Act expressly permits the [SEC] to seek enforcement of its orders by making application to the district court." *SEC v. McCarthy*, 322 F.3d 650, 655 (9th Cir. 2003) (citing 15 U.S.C. § 78u(e)). I may enforce SEC orders that have been issued under the Exchange Act or the rules and regulations promulgated under it. *Id.* Because Rule 102(e) of the SEC's Rules of Practice was promulgated under the Exchange Act, § 21(e) authorizes me to issue an order commanding Hackman's compliance with the SEC's 2002 Order prohibiting him from practicing as an attorney before the SEC. *See SEC v. Moore*, Case No.: 2:15-cv-1865-LDG-(GWF), 2017 WL 1404318, at *9 (D. Nev. Apr. 18, 2017).

Practicing before the SEC includes "[t]ransacting any business with the [SEC] and . . . prepar[ing] . . . any statement, opinion or other paper by any attorney . . . or other professional or expert, filed with the [SEC] in any registration statement, notification, application, report or other document with the consent of such attorney . . . or other professional or expert." 17 C.F.R. § 201.102. Preparing statements or papers that are filed with the SEC constitutes practicing before the SEC. *See SEC v. Hooper*, 769 Fed. Appx. 457, 458 (9th Cir. 2019) (finding district court did not err when it concluded defendant practiced as an accountant before the SEC because he prepared financial statements for companies that were included in documents those companies filed with the SEC). In Nevada, what constitutes practicing law "must be determined on a case-by-case basis, bearing in mind the overarching principle that the practice of law is involved when the activity requires the exercise of judgment in applying general legal knowledge to a client's specific problem." *In re Discipline of Lerner*, 197 P.3d 1067, 1069 (Nev. 2008). Serving as a client's sole contact at a firm, advising a client about their legal rights, and recommending future actions to clients have been found to constitute practicing law. *Id.* at 1241-42; *see also In re Discipline of Crowley*, Nos. 64457, 68200, 2016 WL 2742371 at *1 (Nev. May 9, 2016) (finding suspended former attorney practiced law by meeting with client to review trust document and writing conclusion letter based on that review).

The SEC argues that Hackman transacted business with the SEC by communicating with SEC staff on behalf of clients at least twice, willingly preparing numerous documents he knew would be filed with the SEC, and consenting to those filings. The SEC argues Hackman practiced law as defined by Nevada law because he relied on the professional judgment he formed while a licensed attorney to advise clients about their legal obligations with regard to SEC filings, including the form, substance, and legal requirements. The SEC notes that clients specifically hired Hackman to function as their attorney, and that while Hackman's signature or name was not on any opinion or SEC filing, he performed the substantive legal work on these filings. The SEC also argues that Hackman's work, not his title, determines whether he practiced law. It contends that Gewerter and Dowling maintained no control or authority over Hackman's work product, and had minimal involvement in most filings. The SEC contends that even if

Hackman worked under the Law Firms' rules, Hackman does not explain how the Law Firms' rules comported with the requirements of the 2002 Order or with the Nevada Rules of Professional Conduct. The SEC also argues that Hackman agreed to undertake representations and served as clients' primary point of contact for legal issues and filings.

Hackman does not deny that he completed any of the actions that the SEC alleges he did. Instead, construing his response liberally, Hackman disputes only that his actions constitute practicing law. *See* ECF No. 6 at 2, ¶¶ 1-4 (Dowling was sole attorney at EAD Law; Hackman worked as a paralegal under the Law Firms' rules and supervision; clients were corrected when they referred to him as an attorney, though some continued to do so; business cards stated he was legal assistant or JD). Hackman presents no evidence in support of these arguments. He also argues that I may not draw inferences from his invoking his Fifth Amendment rights because after he attempted to cease the SEC's depositions entirely by invoking his Fifth Amendment rights, counsel for the SEC told him he could not make a blanket assertion of these rights but he could assert his right to specific questions during the deposition. Hackman presents no authority for this position and I am not aware of any. Hackman was free to invoke his Fifth Amendment rights and I may draw adverse inferences from his failure of proof. *SEC v. Colello*, 139 F.3d 674, 677 (9th Cir. 1998).

Regardless of what job title Hackman maintained while at the Law Firms, he practiced law under Nevada law by, for example, providing drafts of SEC filings to clients, advising clients on the substance of their SEC filings, recommending actions to clients regarding their SEC filings, and communicating to the SEC that a client would provide a forthcoming SEC filing. *See In re Discipline of Lerner*, 197 P.3d at 1074 (citing Florida Supreme Court case holding that a paralegal practiced law by, among other things, discussing legal strategy with clients). With regard to Hackman's argument that he was supervised at the Law Firms, he provides no evidence or showing of what this supervision consisted of, or why any such supervision would prevent my finding that he practiced law. Instead, Hackman invoked his Fifth Amendment rights when asked whether Gewerter and Dowling supervised his work on SEC filings and whether he worked as an attorney for dozens of specific clients. *E.g.*, ECF No. 1-8 at 9-11, 22. Hackman's lack of proof on these questions and the SEC's extensive evidence regarding his communication with and work on behalf of clients while at the Law Firms demonstrate that Hackman practiced law.

Hackman also practiced before the SEC in violation of the 2002 Order. For example, he prepared many documents for filing with the SEC on behalf of clients. *See, e.g.*, ECF Nos. 1-63; 1-64; 1-65; 1-66; 1-67; 1-68; 1-69; 1-71; 1-72; 1-86; 1-87; 1-99. On multiple occasions, Hackman invoked his Fifth Amendment rights when asked whether he functioned as SEC counsel for certain SEC filings. ECF No. 1-8 at 41-43. His lack of proof on this question and the numerous examples of Hackman preparing filings for the SEC on behalf of clients (which Hackman does not dispute) demonstrate that Hackman practiced before the SEC as an attorney in violation of the 2002 Order prohibiting him from doing so.

III. DISGORGEMENT

"[A]ctions for disgorgement of improper profits are equitable in nature" in the context of an SEC enforcement action and "[d]isgorgement plays a central role in the enforcement of the securities laws." *SEC v. Rind*, 991 F.2d 1486, 1491, 1493 (9th Cir. 1993). I have "broad equity powers to order the disgorgement of ill-gotten gains obtained through the violation of the securities laws." *SEC v. First Pac. Bancorp*, 142 F.3d 1186, 1191 (9th Cir. 1998) (quotation omitted); *see also Liu v. SEC*, 140 S. Ct. 1936, 1942 (2020) (concluding equity authorizes courts to strip wrongdoers of their ill-gotten gains). I may order disgorgement as an equitable remedy for the violation of a Rule 102(e) suspension. *See, e.g., SEC v. Jones*, 155 F. Supp. 3d 1180, 1185-86 (D. Utah 2015).

The SEC bears the ultimate burden of persuading me that its disgorgement amount reasonably approximates the amount of unjust enrichment. *SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1096 (9th Cir. 2010). Once the SEC establishes a reasonable approximation of the defendant's profits, the burden shifts to the defendant to demonstrate the disgorgement figure was not a reasonable approximation. *Id.* Though this results in the risk that the disgorgement measure ends up typically being actual profits, this risk of uncertainty should fall upon the defendant whose illegal conduct created the uncertainty. *Id.*

The SEC estimates Hackman was paid $817,438 for work that violated its 2002 Order, and it argues this amount is not just reasonable, but conservative. Based on checks Gewerter wrote to Hackman, the SEC estimates Gewerter paid Hackman approximately $478,884 in 2016-2017 and that 75% of this income was for securities work related to SEC filings.[7] *See* ECF Nos. 1-4 at 14 (¶150); 1-7 at 56 (215:25-216:20); 1-151 at 2-9. The SEC therefore estimates Hackman's total disgorgeable income from Gewerter is $359,162.

Based on checks and electronic payments Dowling made to Hackman, the SEC estimates Dowling paid Hackman approximately $48,622 in 2016, $110,765 in 2017, $215,300 in 2018, $207,739 in 2019, $82,385 in 2020, and $5,650 in 2021. *See* ECF Nos. 1-4 at 14 (¶ 150); 1-151

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[7] Hackman testified that 75% of his work in 2015 and 2016 for Gewerter was securities-related work. ECF No. 1-7 at 56 (215:25-216:20). The SEC applied this 75% figure to his work for Gewerter in 2017 as well, and performed the same extrapolation for the percentage of work attributable to securities work at EAD Law for years that Hackman did not provide an estimate. The SEC also extrapolated the lowest figure Hackman provided for his securities-related work in a single year (45%) to the income he received directly from clients. The SEC argues these extrapolations are reasonable and Hackman does not dispute that this is reasonable.

at 10-32; 1-153; 1-154; 1-155. Based on Hackman's testimony, the SEC estimated that 45% of Hackman's income from EAD Law in 2016, 2017, 2018, 2020, and 2021, and 50% of his income in 2019, was for work that violated the 2002 Order. ECF No. 1-7 at 55 (213:1-25)-56 (214:1-24). The SEC therefore estimates Hackman's total disgorgeable income from Dowling is $312,092.

Based on other evidence of direct payments, the SEC estimates clients paid Hackman $146,184 directly for work that violated the 2002 Order. *See* ECF No. 1-4 at 14-15 (¶¶ 151-52). The SEC calculated prejudgment interest on the total amount as $148,712.

Hackman argues that the SEC's estimation likely includes some things that do not constitute practice before the SEC.[8] He also contends that he will need time to pay any disgorgement ordered.

The SEC's $817,438 figure is based on records of payments and Hackman's own testimony. It reasonably approximates work done in violation of the 2002 Order. Hackman has not demonstrated that this figure is unreasonable because he presents no evidence or argument regarding which portion of it constitutes work not in violation of the 2002 Order.

I THEREFORE ORDER Shawn F. Hackman to comply with the United States Securities and Exchange Commission's 2002 Order suspending Hackman from appearing or practicing before the SEC as an attorney.

I FURTHER ORDER Hackman to pay total disgorgement of $817,438, representing net profits gained as a result of work he performed in violation of the 2002 Order, together with prejudgment interest in the amount of $148,712, for a total of $966,150, within **30 days** of entry of this order.

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[8] Hackman does not challenge the reasonableness of the SEC's treatment of his business expenses as *de minimis*. I find the SEC's approximation of Hackman's profits to be reasonable, including its treatment of business expenses, so I do not address Hackman's *de minimis* business expenses.

Hackman may transmit payments electronically to the Commission, which will provide detailed ACH/Fedwire instructions upon request. Payment may also be made directly from a bank account via pay.gov through https://pay.gov/public/form/start/39621196. Hackman may also pay by certified check, bank check, or United States postal money order payable to the Securities and Exchange Commission, which must be delivered to:

Enterprise Services Center
Accounts Receivable Branch
6500 South MacArthur Boulevard
HQ Bldg., Room 181, AMZ-341
Oklahoma, City, OK 73169

and must be accompanied by a letter identifying the case title, civil action number, and name of this Court; Hackman as the Respondent in this action; and specifying that payment is made pursuant to this order. Hackman must simultaneously transmit photocopies of evidence of payment and case-identifying information to the SEC's counsel in this action. By making this payment, Hackman relinquishes all legal and equitable right, title, and interest in such funds and no part of the funds shall be returned to Hackman. The SEC will hold the funds (collectively, the Fund) until further order of this court.

I FURTHER ORDER that post-judgment interest will accrue on any amounts owed pursuant to 28 U.S.C. § 1961.

I FURTHER ORDER the Clerk of Court to enter judgment accordingly.

DATED this 28th day of April, 2022.

ANDREW P. GORDON
UNITED STATES DISTRICT JUDGE

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2021–2022 in Review: Selected Opinions and Orders Issued by the Securities and Exchange Commission (July 23, 2022)

Benjamin L. Schiffrin
Kermit B. Kennedy

J.R. Ambrose

Attorneys in the Office of the General Counsel contributed to this outline. As a matter of policy, the Commission disclaims responsibility for any private publications or statements by any of its employees. The views expressed in this outline do not necessarily represent the views of the Commission or its staff. Portions of this outline may be used in connection with other continuing legal education programs.

INTRODUCTION TO THIS OUTLINE

This outline summarizes significant opinions and orders issued by the Securities and Exchange Commission between September 2021 and July 2022. It is intended to provide an overview of recent Commission adjudicative activity. The opinions and orders primarily concern appeals from actions taken by self-regulatory organizations and decisions in administrative proceedings set for hearings before the Commission or an administrative law judge.

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SELECTED COMMISSION OPINIONS

I. SELF-REGULATORY ORGANIZATION PROCEEDINGS

1. *Blair Edwards Olsen*
Exchange Act Release No. 93216 (Sept. 30, 2021)
2021 WL 4500130

The Commission dismissed an application for review filed by Blair Edwards Olsen that challenged FINRA action suspending and then barring Olsen for failing to respond to FINRA's requests for information. FINRA vacated the bar while Olsen's appeal was pending but kept the suspension in place until Olsen provided the requested information. The Commission dismissed Olsen's challenge to the suspension because he did not exhaust his administrative remedies. The Commission found that FINRA provided Olsen the opportunity to avail himself of its administrative process by: (1) taking corrective action to produce the requested information; (2) filing a request for a hearing in response to FINRA's notice of suspension; or (3) filing a request for termination of the suspension based on full compliance with FINRA's requests. The Commission found that, because Olsen did not take any of these steps, he failed to exhaust his administrative remedies and could not challenge the suspension on appeal.

2. *Shlomo Sharbat*
Exchange Act Release No. 93757 (Dec. 13, 2021)
2021 WL 5907832

The Commission dismissed an application for review filed by Shlomo Sharbat that challenged a FINRA disciplinary action barring him for failing to respond to FINRA's requests for testimony. The Commission dismissed Sharbat's application on the ground that he failed to exhaust his administrative remedies before FINRA and for the independent reason that it was untimely.

3. *Shad Nhebi Clayton*
Exchange Act Release No. 93760 (Dec. 13, 2021)
2021 WL 5907835

The Commission dismissed an application for review filed by Shad Nhebi Clayton that challenged a FINRA action barring him for failing to respond to FINRA's requests for information and documents. The

Commission dismissed Clayton's appeal on the grounds that he failed to exhaust his administrative remedies before FINRA.

4. *Bradley C. Reifler* Exchange Act Release No. 94026 (Jan. 21, 2022) 2022 WL 194504

The Commission sustained FINRA's findings that Bradley C. Reifler violated FINRA Rules 8210 and 2010 by refusing to answer dozens of questions at two on-the-record interviews. But the Commission remanded FINRA's sanctions determination for additional consideration because FINRA misapplied its Sanction Guidelines. In imposing a bar, FINRA analyzed Reifler's refusal to respond to certain questions as a complete failure to respond under its Guidelines. But, because Reifler answered some questions and had earlier provided some answers to written inquiries, the Commission held that FINRA should instead have evaluated Reifler's refusal to answer questions as a partial failure to respond under the Guidelines. The Commission further directed FINRA to consider and include in the record the full transcripts of the two interviews at issue, noting that the record before the Commission consisted of only a portion of those transcripts. According to the Commission, "[c]onsideration of the complete transcripts is necessary to apply the Sanction Guidelines because doing so will permit FINRA to determine what questions Reifler answered and not just those questions he refused to answer."

5. *KJM Secs., Inc.* Exchange Act Release No. 94059 (Jan. 25, 2022) 2022 WL 215647

The Commission sustained FINRA's findings that KJM Securities, Inc., violated Section 17(e) of the Securities Exchange Act of 1934, Exchange Act Rule 17a-5(d), and FINRA Rule 2010 by failing to file an annual report for 2019 that was audited by an accounting firm registered with the PCAOB. The Commission also sustained FINRA's determination to expel the firm. The Commission found that FINRA gave the firm numerous opportunities to file its 2019 annual report before FINRA expelled it. Among other things, the Commission rejected KJM's argument that its FINRA membership should be reinstated because it attempted to file the 2019 report after its expulsion. The Commission held that KJM's belated filing did not mitigate its violation, citing precedent holding that a self-regulatory organization should not have to bring a disciplinary proceeding in order to obtain compliance with its rules.

6. *J.W. Korth & Company, LP*
Exchange Act Release No. 94581 (Apr. 1, 2022)
2022 WL 990183

The Commission sustained FINRA disciplinary action finding that J.W. Korth & Company, LP, charged its customers excessive markups and markdowns in violation of FINRA and MSRB rules. The Commission also sustained the sanctions FINRA imposed on Korth—a censure, an order to pay restitution plus prejudgment interest, and a requirement that Korth retain an independent consultant to review the firm's pricing procedures.

7. *Equitec Proprietary Markets, LLC*
Exchange Act Release No. 95083 (June 10, 2022)
2022 WL 2103962

The Commission sustained disciplinary action taken against Equitec Proprietary Markets, LLC, by the Cboe Exchange, Inc., f/k/a Chicago Board Options Exchange, Inc. ("Cboe"). Cboe had found that Equitec violated Rule 15c3-5 under the Securities Exchange Act of 1934 (the "Market Access Rule") and Cboe Rule 4.2 by failing to implement and maintain risk management controls reasonably designed to prevent the entry of orders that exceeded its capital threshold and by failing to implement written supervisory procedures ("WSPs") reasonably designed to ensure compliance with all regulatory requirements. The Commission found that Equitec violated the Market Access Rule and Cboe Rule 4.2 by failing to account for executed proprietary orders in its capital threshold. The Commission also found that Equitec violated the Market Access Rule and Cboe Rule 4.2 because its WSPs did not adequately specify a process for preventing orders that exceeded its capital threshold. Finally, the Commission sustained the censure and the $50,000 fine Cboe had imposed on Equitec for these violations as remedial and not excessive or oppressive.

8. *Louis Ottimo* Exchange Act Release No. 95141 (June 22, 2022) 2022 WL 2239146

In 2018, the Commission sustained FINRA's finding that Louis Ottimo fraudulently omitted information about his work with a company called Jet One Jets from his biography in a private placement memorandum. The biography stated that Ottimo had co-founded Jet One Jets and grew the company to $18 million in revenues in approximately 18 months. But Ottimo omitted the facts that Jet One Jets ceased operations shortly thereafter, was never profitable, declared bankruptcy, and resulted in investor losses of over $1 million. Ottimo also did not disclose that the Department of Transportation had found Jet One Jets liable for engaging in an unfair and deceptive practice. Despite sustaining this fraud finding, the Commission reversed FINRA's additional finding that Ottimo had also fraudulently omitted to disclose adverse information about his work with another company. Because FINRA had imposed a single sanction for all of its fraud findings, the Commission remanded for FINRA to determine what sanction was appropriate for the portion of the fraud violations that was sustained.

After FINRA barred Ottimo on remand, Ottimo again appealed to the Commission, which sustained the bar. The Commission found that several aggravating factors justified the bar, including that Ottimo acted at least recklessly, that he benefitted financially from his misconduct, and that he pressured investors to claim that the omitted information would not have been material to them had he disclosed it. The Commission considered and rejected Ottimo's arguments that the bar FINRA imposed was excessive or oppressive and found that the bar was remedial and not punitive because it was necessary to protect the public from Ottimo's demonstrated propensity for fraudulently omitting material information in disclosures to investors. The Commission found the bar was warranted to remedy the risk that Ottimo would otherwise again defraud investors.

II. COMMISSION ADMINISTRATIVE PROCEEDINGS

Fidelity Transfer Services, Inc., and Ruben Sanchez Exchange Act Release No. 94545 (Mar. 29, 2022) 2022 WL 969898

The Commission had instituted proceedings to determine whether Fidelity Transfer Services, Inc., a transfer agent, and Ruben Sanchez, its only known officer, violated provisions of the Securities Exchange Act of 1934 relating to the registration of transfer agents and the furnishing of required books and records to Commission staff. The Commission found Fidelity to be in default; determined that it made inaccurate and untimely filings and failed to update its Form TA-1 in violation of Exchange Act Section 17A(d)(1) and Rules 17Ac2-1(c) and 17Ac2-2(a); and determined that Fidelity failed to furnish requested records to Commission staff in violation of Exchange Act Sections 17(a)(1), 17(a)(3), and 17(b)(1). As a result of this misconduct, the Commission determined that it was in the public interest to revoke Fidelity's registration as a transfer agent and to order Fidelity to cease and desist from future violations. The Commission dismissed the proceeding against Sanchez because the Division of Enforcement had been unable to serve Sanchez with the order instituting proceedings, although the Commission noted that its dismissal did "not preclude proceedings against Sanchez on these facts in the future."

SELECTED COMMISSION ORDERS

SELF-REGULATORY ORGANIZATION PROCEEDINGS

1. ***Keith Patrick Sequeira*** **Exchange Act Release No. 94472 (Mar. 18, 2022) 2022 WL 823505**

In 2019, the Commission dismissed Keith Patrick Sequeira's challenge to FINRA's determination to indefinitely suspend him from associating with FINRA member firms due to his failure to pay an arbitration award. After the United States Court of Appeals for the Third Circuit denied Sequeira's appeal of the Commission's order and his petitions for rehearing and rehearing *en banc*, Sequeira sent the Commission a letter again asking that his suspension be set aside. The Commission construed the letter as a request for reconsideration of its 2019 decision and denied the request as untimely. The Commission held that Rule of Practice 470, which governs requests for reconsideration, requires that a motion for reconsideration be made within ten days of the determination at issue. Accordingly, the Commission denied the request because Sequeira did not file his request within that ten-day period or seek an extension of time in which to do so.

2. *Lek Secs. Corp.* Exchange Act Release No. 95014 (May 31, 2022) 2022 WL 1769802

The Commission denied Lek Securities Corporation's request that the Commission stay action taken against Lek by the National Securities Clearing Corporation and Depository Trust Company (collectively, "DTCC"). On March 10, 2022, a hearing panel composed of members of DTCC's board of directors issued a decision finding that the DTCC would: (1) cease to act for Lek; (2) impose an "activity cap" on Lek's trading activity; and (3) impose fines and sanctions for Lek's violation of that activity cap. DTCC's actions were based on findings that: (1) Lek had weak capital and liquidity, particularly in relation to its level of risk activity; (2) Lek had significant deficiencies in its internal controls and had made misrepresentations relating thereto; and (3) Lek failed to report material changes in its financial and business condition.

The Commission denied Lek's request, finding that it had not met its burden for obtaining a stay. Specifically, the Commission found that Lek had not raised a serious question on the merits regarding the appropriateness of DTCC's actions because Lek's proposed solution to the deficiencies DTCC identified, the so-called "Lek Holdings Note Program," under which Lek's customers would loan Lek money on an unsecured basis "in an amount necessary to cover what [Lek] calculates to be the initial required margin" on its trades was "unreliable as a means for Lek to meet its margin requirements." The Commission further found that DTCC provided Lek the statutorily-required process under Section 17A(b)(3)(H) of the Securities Exchange Act of 1934 by notifying Lek in writing of the basis for DTCC's actions, providing an opportunity to be heard, holding a hearing and keeping a record of the hearing, and stating in writing the basis for DTCC's determinations.

The Commission further found that, while it did "not dispute that the cease to act determinations will cause Lek to suffer irreparable harm," the remaining stay factors weighed against granting Lek's request. Specifically, the Commission noted that "each [DTCC] member's ability to meet its margin requirements is crucial for ensuring the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions" and that, therefore, "it would not be in the public interest to stay" DTCC's actions.

NOTES

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Office of International Affairs

Staff in the Office of International Affairs contributed to this material. As a matter of policy, the Securities and Exchange Commission disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein do not necessarily represent the views of the Commission or its staff.

Table of Contents

I. INTRODUCTION

The Office of International Affairs (OIA) advances the SEC's mission by promoting international enforcement and supervisory cooperation; developing and implementing strategies to further SEC policy interests in the regulation and oversight of cross-border securities activities; coordinating the SEC's participation in international regulatory bodies; engaging in regulatory dialogues with international counterparts; and providing technical assistance to strengthen partnerships with foreign authorities.

OIA primarily operates in four areas: Regulatory Policy, Supervisory Cooperation, Enforcement Policy and Cooperation, and Technical Assistance.

II. REGULATORY POLICY

In 2021, SEC staff continued to participate in international organizations, including the International Organization of Securities Commissions (IOSCO), the Financial Stability Board (FSB), and engaged with foreign authorities on numerous securities-related topics. As part of SEC's staff involvement in these organizations, SEC staff led or participated in various international workstreams addressing international regulatory matters. Select developments and projects of the international bodies in which SEC staff participates are highlighted below.

A. International Organization of Securities Commissions

Non-bank Financial Intermediation

In early 2020, the IOSCO Board established the Financial Stability Engagement Group (FSEG), a Board-level group set up to enhance IOSCO's approach to financial stability issues, including with regard to its engagement with the FSB, international standard setting bodies, and other organizations. FSEG has led IOSCO's engagement with the FSB on financial stability issues and contributed to the FSB's financial stability agenda, described below.

Secondary Markets

As part of its 2021-22 work plan, IOSCO established a Corporate Bond Market Liquidity (CBML) working group through FSEG to analyze corporate bond market microstructure, resilience and liquidity provision during the COVID-19 induced market stresses of March 2020 and subsequent months. In April 2022, IOSCO published a Discussion Paper on *Corporate Bond Markets – Drivers of Liquidity during COVID-19 Induced Market Stress*[1] with a request for stakeholder feedback on possible ways to help improve market functioning and liquidity provision, by early July 2022. The Discussion Paper notes that possible areas of further inquiry include analyzing whether there could be greater use of "all-to-all" trading or ways to reduce the frictions currently inhibiting its wider use, as well as ways to advance the quantity, quality, and availability of public and private data.

IOSCO also published, in April 2022, a final report entitled *Market Data in the Secondary Equity Market: Current Issues and Considerations*.[2] The report discusses issues and challenges related to market data in the equity secondary markets, particularly as those markets have evolved to become largely electronic. The report highlights that market data is an essential element of efficient price discovery and for maintaining fair and efficient markets.

Market Intermediaries

In September 2021,[3] IOSCO published a final report entitled *The Use of Artificial Intelligence (AI) and Machine Learning (ML) by Market Intermediaries and Asset Managers*. Following up on its June 2021 consultation report, the report provides guidance to assist IOSCO members in supervising market intermediaries and asset managers that utilize AI and ML. The guidance consists of six measures that reflect expected standards of conduct by market intermediaries and asset managers using AI and ML. The report encourages IOSCO members to consider these measures carefully in the context of their legal and regulatory frameworks. It also encourages IOSCO members and firms to consider the proportionality of any response when implementing these measures.

In January 2022, IOSCO published a consultation report entitled *Report on Retail Distribution and Digitalization*.[4] The report analyzes the developments in online marketing and distribution of

1. Available athttps://www.iosco.org/library/pubdocs/pdf/IOSCOPD700.pdf.
2. Available athttps://www.iosco.org/library/pubdocs/pdf/IOSCOPD703.pdf.
3. Available athttps://www.iosco.org/library/pubdocs/pdf/IOSCOPD658.pdf.
4. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD695.pdf.

financial products to retail investors in IOSCO member jurisdictions, both domestically and on a cross-border basis. It presents proposed toolkits of policy and enforcement measures to help in addressing the issues and risks associated with online marketing and distribution, with guidance for IOSCO members to consider in their regulatory and supervisory frameworks.

Operational Resilience

In July 2022, IOSCO published a final report entitled *Operational resilience of trading venues and market intermediaries during the COVID-19 pandemic & lessons for future disruptions*.[5] Following up on a consultation report published in January 2022, the report summarizes some of the existing operational resilience work done by IOSCO and other international organizations; outlines how the pandemic impacted regulated entities; examines the key operational risks and challenges that regulated entities faced during the pandemic; and builds on existing IOSCO and other international organizations' principles and guidance on operational resilience by providing additional observations and identifying lessons learned from the pandemic.

Asset Management

Over the last few years, IOSCO has continued to work on asset management issues. In August 2021, IOSCO published the *Exchange Traded Funds Thematic Note – Findings and Observations during COVID-19 induced market stresses*, reviewing the operation and activities of the primary and secondary market of ETFs during March-April 2020 market turmoil.[6] In April 2022, IOSCO published a consultation report on *Exchange Traded Funds – Good Practices for Consideration*, with a view to supplement its 2013 principles for regulation of ETFs.[7] In addition, in January 2022, IOSCO published a first of its kind *Investment Fund Statistics Report*, which contains information on leverage, liquidity, counterparty risk, borrowing risk and collateral needs in hedge funds, open-ended funds, and closed-ended funds.[8] This report will be published

5. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD706.pdf.
6. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD682.pdf.
7. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD701.pdf.
8. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD693.pdf.

on an annual basis with the aim of presenting insights on the global investment funds industry and any potential emerging risks within it.

Crypto-assets

In March 2022, IOSCO published the *IOSCO Decentralized Finance (DeFi) Report*.[9] The report notes that DeFi is an important, evolving and expanding technological innovation that appears to present many similar risks to investors, market integrity and financial stability as do other financial products and services, as well as specific and unique risks and challenges for regulators to consider. The purpose of the report is to provide a general understanding of DeFi, including some areas of potential regulatory concern.

In July 2022, IOSCO published the *IOSCO Crypto-Asset Roadmap for 2022-2023*,[10] which sets out the planned work of the IOSCO Fintech Task Force (FTF) relating to crypto-assets. The roadmap notes that the IOSCO Board established the FTF in March 2022 and tasked the FTF with developing, overseeing, delivering, and implementing IOSCO's regulatory agenda with respect to Fintech and crypto-assets, as well as coordinating IOSCO's engagement with the FSB and other standard setting bodies on Fintech and crypto-related matters. The FTF's workplan for 2022-2023 will initially prioritize policy-focused work on crypto-asset markets and activities, while continuing to monitor and review activities and market developments related to broader Fintech-related trends and innovations. The FTF's work will initially be divided into two workstreams, one covering Crypto and Digital Assets and the other covering DeFi. Both workstreams will primarily focus on analyzing and responding to market integrity and investor protection concerns within the crypto-asset space.

Outsourcing

Since the publication of IOSCO´s principles on outsourcing for market intermediaries in 2005 and for markets in 2009, there have been new developments in markets and technology. In 2020 and 2021, IOSCO conducted work to consider risks related to outsourcing and the operational resilience of regulated entities. In October 2021,

9. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD699.pdf.
10. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD705.pdf.

IOSCO published a set of updated *Principles on Outsourcing*[11] for regulated entities that outsource tasks to service providers. The updated principles are based on the earlier Outsourcing Principles for Market Intermediaries and for Markets, but their application has been expanded and now includes trading venues, intermediaries, market participants acting on a proprietary basis and credit rating agencies.

World Investor Week

IOSCO continues to hold its annual World Investor Week.[12] In 2020 and 2021, capital markets regulators and other stakeholders from across the globe conducted activities in their jurisdictions to raise awareness and reinforce the importance of investor education and protection. Key themes in 2021 included sustainable finance and preventing frauds and scams, as well as reiterated themes from 2020, including online investing, digital learning, and investing basics. In the United States, SEC staff worked together with staff from the CFTC, FINRA, NASAA, and the NFA to encourage the promotion of World Investor Week goals through a variety of virtual and in person events.

Retail Market Conduct Task Force

IOSCO published a consultation report in March 2022 prepared by its Retail Market Conduct Task Force (Task Force)[13] that sought stakeholder feedback on issues related to the development of a regulatory toolkit for jurisdictions to consider when addressing emerging retail investor market conduct issues in today's rapidly changing retail investment landscape. Among other issues, this report discusses increasing gamification, self-directed trading, and the influence of social media on retail investor behavior.

This consultation report builds on an earlier report published in December 2020 by the Task Force, which described COVID-19 crisis impacts on firm and retail investor behavior.[14] It noted that retail investor vulnerability can take many forms and vulnerable investors may be more susceptible to financial exploitation during periods of market stress.

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11. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD687.pdf.
12. Information regarding IOSCO's World Investor Week is available at https://www.worldinvestorweek.org.
13. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD698.pdf.
14. Available at https://www.iosco.org/news/pdf/IOSCONEWS588.pdf.

Implementation and Assessment

In May 2021, IOSCO published a *Thematic Review on Business Continuity Plans with respect to Trading Venues and Intermediaries*.[15] The Thematic Review assessed the extent to which participating IOSCO member jurisdictions have implemented regulatory measures consistent with the recommendations and standards set out in IOSCO's 2015 *Mechanisms for Trading Venues to Effectively Manage Electronic Trading and Plans for Business Continuity Report* and *Market Intermediary Business Continuity and Recovery Planning Report.*

Market Fragmentation

In June 2020, IOSCO published *Good Practices on Processes for Deference*, which identified practices that authorities could consider to help make processes for deference assessments more efficient.[16] The report was based on work undertaken by IOSCO's Follow-Up Group (FUG) which was organized to examine market fragmentation following the work of the Task Force on Cross Border Regulation. The Good Practices Report describes the objectives of deference and different approaches to deference determinations that currently exist and identifies 11 good practices for deference determinations and describes how they are applied by various regulatory authorities. The good practices are designed to help regulatory authorities build trust, mitigate market fragmentation, and better manage risks in global cross-border markets.

In January 2022, IOSCO published *Lessons Learned from the Use of Global Supervisory Colleges*,[17] which contains an overview of the practices followed by global supervisory colleges in various sectors of financial services, a series of good practices regulators and supervisors could consider in the creation and use of such colleges in the securities markets, and a discussion of areas of the securities markets where the use of global supervisory colleges could be beneficial in the future.

15. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD675.pdf.
16. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD659.pdf.
17. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD696.pdf.

Sustainable Finance

In June 2021, IOSCO published a final report on *Sustainability-Related Issuer Disclosures*.[18] The final report summarized IOSCO's work to demonstrate investor demand for sustainability-related information, and the need for improvements in the current landscape of sustainability standard-setting. The final report identifies core elements of standard-setting that could help meet investor needs and provided guidance to the International Financial Reporting Standards (IFRS) Foundation as it develops an initial prototype climate reporting standard, as well as input to the IFRS Foundation on governance features and mechanisms for stakeholder engagement as it works to create an ISSB.

In November 2021, IOSCO published a final report on *Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management*.[19] The final report provides background on different regulatory approaches relating to asset manager and product-level disclosures. The recommendations cover several topics, including sustainability disclosures for asset managers, product-level disclosures, terminology, supervisory tools for curbing greenwashing practices, and investor education.

In November 2021, IOSCO published a final report on *Environmental, Social and Governance (ESG) Ratings and Data Products Providers*,[20] including a set of recommendations. IOSCO acknowledged that this market does not typically fall within the remit of securities regulators, and suggested that regulators could consider focusing greater attention on the use of ESG ratings and data products and the activities of ESG rating and data products providers in their jurisdictions. The recommendations directed to market participants address various topics, including transparency regarding the methodologies that ESG ratings and data product providers use in developing their products; procedures for managing conflicts of interest; and improving communication channels between providers and the entities covered by their ESG ratings or data products.

18. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD678.pdf.
19. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD679.pdf.
20. Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf.

B. Financial Stability Board

Non-bank Financial Intermediation

In November 2020, the FSB published a *Holistic Review of the March Market Turmoil*, which underscored the need to strengthen the resilience of non-bank financial intermediation (NBFI).[21] The Holistic Review set out an NBFI work plan, which focused on three areas: (i) work to examine and address specific risk factors and markets that contributed to amplification of the shock; (ii) enhancing understanding of systemic risks in NBFI and the financial system as a whole, including interactions between banks and non-banks and cross-border spill-overs; and (iii) assessing policies to address systemic risks in NBFI.

The FSB publishes an annual progress report on the work plan, including key findings and next steps.[22] The main focus of work to date has been on assessing and addressing vulnerabilities in specific areas that may have contributed to the build-up of liquidity imbalances and their amplification. This includes:

- A Final Report published in October 2021 on *Policy Proposals to Enhance Money Market Fund Resilience*;[23]
- Work to assess liquidity and its management in open-ended funds;
- Work to examine the structure and drivers of liquidity in core government and corporate bond markets during stress ;
- A Consultative Report published in October 2021 on *Review of Margining Practices*;[24] and
- An assessment of the fragilities in USD cross-border funding and their interaction with vulnerabilities in emerging market economies.[25]

The second part of the work plan aims to develop a systemic approach to NBFI, including strengthening ongoing monitoring, and, where appropriate, developing policies to address such risks.

21. Available at https://www.fsb.org/wp-content/uploads/P171120-2.pdf.
22. Available at https://www.fsb.org/wp-content/uploads/P011121.pdf.
23. Available at https://www.fsb.org/wp-content/uploads/P111021-2.pdf.
24. Available at https://www.bis.org/bcbs/publ/d526.pdf.
25. Available at https://www.fsb.org/wp-content/uploads/P260422.pdf.

Annual Monitoring Exercise

The FSB conducts an annual monitoring exercise to assess global trends, innovations, adaptations, and potential risks of credit intermediation in the non-bank financial system. The FSB published its eleventh annual monitoring report on December 16, 2021 (covering data through end-2020).[26]

Crypto-assets and FinTech

The FSB continues to monitor developments in Fintech and analyze their implications for financial stability. As part of its work, the FSB has recently reviewed the progress made on the implementation of its October 2020 High-Level Recommendations for the Regulation, Supervision and Oversight of "Global Stablecoin" Arrangements (High-Level Recommendations), updated its assessment of risks to financial stability from crypto-assets, and published a statement on international regulation and supervision of crypto-asset activities.

Stablecoins

In October 2021, the FSB published a progress report on the regulation, supervision and oversight of "global stablecoin" arrangements.[27] The report discusses key market and regulatory developments since the publication of the FSB's October 2020 High-Level Recommendations; takes stock of the implementation of the High-Level Recommendations across jurisdictions; describes the status of the review of the existing standard-setting body (SSB) frameworks, standards, guidelines and principles in light of the High-Level Recommendations; and identifies areas for consideration for potential further international work. The report notes that the FSB will continue to support the effective implementation of the FSB High-Level Recommendations and facilitate coordination among SSBs. The FSB will undertake a review of its recommendations in consultation with other relevant SSBs and international organizations. The review,

26. Available at https://www.fsb.org/2021/12/global-monitoring-report-on-non-bank-financial-intermediation-2021/.
27. Available at https://www.fsb.org/wp-content/uploads/P071021.pdf.

which will be completed in July 2023, will identify how any gaps could be addressed by existing frameworks and will lead to the update of the FSB's recommendations if needed.

Assessment of Financial Stability Risks from Crypto-Assets

In February 2022, the FSB published its *Assessment of Risks to Financial Stability from Crypto-assets*.[28] The report examines developments and associated vulnerabilities relating to three segments of the crypto-asset markets: unbacked crypto-assets (such as Bitcoin); so-called stablecoins; and DeFi and crypto-asset trading platforms. The report concludes that crypto-assets markets are fast evolving and could reach a point where they represent a threat to global financial stability due to their scale, structural vulnerabilities and increasing interconnectedness with the traditional financial system. The report states that the FSB will continue to monitor developments and risks in crypto-asset markets. The report notes that in 2022, the FSB will continue to monitor and share information on regulatory and supervisory approaches to help ensure the effective implementation of the High-Level Recommendations for stablecoins, and will explore potential regulatory and supervisory implications of unbacked crypto-assets.

Statement on International Regulation and Supervision of Crypto-asset Activities

In July 2022, the FSB published a *Statement on International Regulation and Supervision of Crypto-asset Activities*.[29] The statement notes that crypto-assets and markets must be subject to effective regulation and oversight commensurate to the risks they pose, both at the domestic and international level. It calls for adherence by so-called stablecoins and crypto-assets to relevant existing requirements where regulations apply to address the risks these assets pose. It also calls for crypto-asset service providers to ensure compliance with existing legal obligations in the jurisdictions in which they operate at all times. The statement also outlines the work the FSB is taking forward,

28. Available at https://www.fsb.org/wp-content/uploads/P160222.pdf.
29. Available at https://www.fsb.org/wp-content/uploads/P110722.pdf.

in collaboration with standard-setting bodies, including the Financial Action Task Force, on the regulation and supervision of so-called "unbacked" crypto-assets and "stablecoins," as well as on analyzing the financial stability implications of DeFi, noting that this work should provide a solid basis for a consistent and comprehensive regulation of crypto assets.

Bigtech

In March 2022, the FSB published a report on the accelerated trends towards digitalization during the pandemic and highlighted the importance of cooperation between financial, competition and data protection authorities.[30]

Sustainable Finance

FSB Climate Roadmap

In July 2021, the FSB published a *Roadmap for Addressing Financial Risks from Climate Change* covering four main areas: (i) disclosures; (ii) data; (iii) vulnerabilities analysis; and (iv) regulatory and supervisory practices and tools.[31] For each of these areas, the roadmap sets forth detailed deliverables and timelines.

1. **Disclosures**. The FSB's goal is to promote the establishment of international standards for consistent public company disclosures and regulatory reporting of climate-related risk. The Climate Roadmap notes that consistency in specific risk metrics used as part of disclosures is important for both comparison and aggregation purposes, which is necessary for both individual investors and for monitoring and assessing financial stability risk. The Climate Roadmap recognizes that, while international alignment may be desirable, authorities will move forward with work on disclosures based on timing that is dictated by their domestic mandates and regulatory requirements.

30. Available at https://www.fsb.org/2022/03/fintech-and-market-structure-in-the-covid-19-pandemic-implications-for-financial-stability.
31. Available at https://www.fsb.org/wp-content/uploads/P070721-2.pdf.

2. **Data**. The goal of this area of work is to promotework to establish a basis of comprehensive, consistent and comparable data for global monitoring and assessing of climate-related financial risks. In that regard, the Climate Roadmap notes that the availability of such data is a precondition for monitoring of financial stability risks and for vulnerabilities assessment. Accordingly, this area proposes the assessment of data availability and the identification of gaps, including future work to fill those gaps, such as the development of metrics on the financial impacts of climate change for financial and non-financial corporates and the broader financial system.

3. **Vulnerabilities analysis**. This area proposes the development of a global monitoring framework for climate-related risks followed by systematic and regular assessments of climate-related financial vulnerabilities and financial stability impacts. The FSB's goal is to integrate climate-related risks in its surveillance framework for global financial stability risks. This work includes the development of the Climate Vulnerabilities and Data working group under the Standing Committee on Assessment and Vulnerabilities

4. **Supervisory and regulatory practices**. This area proposes the promotion of consistent and effective supervisory and regulatory approaches to the assessment of climate-related risks.

In July 2022, the FSB published its first progress report regarding the Roadmap, taking stock of progress made after one year and noting that there continues to be a need for strong international coordination of actions in the coming years because of the importance of this issue for the global financial system and highlights milestones for each.[32]

Working Group on Climate Risk

The FSB Working Group on Climate Risk (WGCR), is tasked with exploring regulatory and supervisory practices related to monitoring, managing, and mitigating climate-related risks for

32. Available at https://www.fsb.org/wp-content/uploads/P140722.pdf.

their regulated financial institutions. In April 2022, the WGCR prepared a consultation report regarding the ways in which authorities assess climate-related risks and containing recommendations for future steps.[33] The goal of the report is to assist supervisory and regulatory authorities in developing their approaches to monitor, manage, and mitigate risks arising from climate change, and to promote consistent approaches to systemic risk analysis across sectors and jurisdictions. The consultation period ended in July 2022, and a final report is expected to be published in October 2022.

Report on Promoting Climate-Related Disclosures

In July 2021, the FSB published a report that explored financial authorities' current and planned practices and approaches on promoting climate-related disclosures.[34] The WSCD aimed to promote implementation of the TCFD recommendations as a basis for climate-related disclosures and to contribute to a more common approach among national/regional financial authorities.

Report on Availability of Data with Which to Monitor and Assess Climate-Related Risks to Financial Stability

In July 2021, the FSB published a report examining the availability of data with which to monitor and assess climate-related risks to financial stability.[35] The report discusses how climate-related risks differ from many other risks to the financial system, and what this implies for the data needed to monitor and assess them. The report examines the availability of data with which to monitor the drivers of climate-related risks, as well as non-financial entities' exposures to them. It looks at the availability of data with which to assess the financial system's exposures to climate-related risks and examines the availability of data with which to assess the resilience of the financial system to climate-related risks.

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33. Available at https://www.fsb.org/wp-content/uploads/P290422.pdf.
34. Available at https://www.fsb.org/wp-content/uploads/P070721-4.pdf.
35. Available at https://www.fsb.org/wp-content/uploads/P070721-3.pdf.

Implementation and Effects of G20 Reforms

The FSB, through the Standing Committee on Standards Implementation (SCSI), coordinates and oversees the monitoring of the implementation of agreed financial reforms and reports jurisdictions' progress to the G20 in an annual report.

Annual Report

In October 2021, the FSB published its *Annual Report*[36] describing its work to promote global financial stability. The Annual Report, which has been published annually since 2015, was revamped in 2021 to be more forward-looking and encompassing so that it describes the FSB's work to promote global financial stability.

Evaluations

In May 2022, the FSB published a *Thematic Review on Out-of-court Corporate Debt Workouts*.[37] The review found that FSB jurisdictions have adopted various approaches to complement in-court insolvency proceedings and facilitate restructurings through out-of-court frameworks. However, data about the use and outcomes of workouts is scarce, making it difficult to compare the performance of different frameworks within and across jurisdictions.

Vulnerabilities Assessment

In September 2021, the FSB published a new *Financial Stability Surveillance Framework* to identify and assess global financial system vulnerabilities.[38] The framework aims to increase the effectiveness of discussions among FSB members about vulnerabilities and improve the timeliness in which these discussions identify challenges to global financial stability. The FSB communicates its view on vulnerabilities through its Annual Report.

36. Available at https://www.fsb.org/wp-content/uploads/P271021.pdf.
37. Available at https://www.fsb.org/wp-content/uploads/P090522.pdf.
38. Available at FSB Financial Stability Surveillance Framework.

FSB Roundtable on External Audit

The FSB continues to hold its annual roundtable where participants discuss ways to promote financial stability by enhancing public confidence in external audits. Participants include senior representatives from FSB member authorities, regulatory standard-setting bodies, audit oversight bodies, the International Forum of Independent Audit Regulators, the Committee of European Auditing Oversight Bodies, the International Ethics Standards Board for Accountants and its oversight body, the Public Interest Oversight Board, and the six largest global audit networks. The FSB communicates issues covered via press release.[39]

Operational Resilience

In October 2020, the FSB published a final report entitled *Effective Practices for Cyber Incident Response and Recovery*.[40] The report contains a toolkit of effective practices for financial institutions' cyber incident response and recovery, which the FSB has encouraged authorities and organization to use to enhance their cyber incident response and recovery activities. The toolkit includes 49 practices for effective cyber incident response and recovery across seven components: (i) governance; (ii) planning and preparation; (iii) analysis; (iv) mitigation; (v) restoration and recovery; (vi) coordination and communication; and (vii) improvement. The final toolkit draws on the feedback from an April 2020 consultation report and four virtual outreach meetings.

In October 2021, the FSB published a report entitled *Cyber Incident Reporting: Existing Approaches and Next Steps for Broader Convergence*.[41] The report explores whether greater convergence in the reporting of cyber incidents from financial institutions to financial authorities could be achieved in light of increasing financial stability concerns, especially given the digitalization of financial services and increased use of third-party service providers. In the report, the FSB has identified three ways that the FSB will take work forward to achieve greater convergence in cyber incident reporting, including the development of best practices for cyber incident reporting; identifying common types of information to be shared

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39. The FSB's press release on the 2022 roundtable is available at: https://www.fsb.org/2022/06/fsb-holds-2022-roundtable-on-external-audit/.
40. Available at https://www.fsb.org/wp-content/uploads/P191020-1.pdf.
41. Available at https://www.fsb.org/wp-content/uploads/P191021.pdf.

relating to cyber incidents; and creating common terminologies for cyber incident reporting.

In November 2020, the FSB published a consultation report entitled *Discussion Paper on Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships*.[42] The paper provides an overview of the regulatory and supervisory landscape on outsourcing and third-party risk management in FSB member jurisdictions and was intended to facilitate and inform discussions among authorities. It did not propose any specific principles or standards but rather sought to promote greater global dialogue among financial institutions, supervisory authorities and third parties. The FSB received 39 responses to the paper from a wide range of stakeholders, including banks, insurers, asset managers, financial market infrastructures (FMIs), third-party service providers, industry associations, public authorities, and individuals, and also held a virtual outreach meeting in February 2021. In June 2021, the FSB published a note summarizing the main issues raised and views expressed in response to the public consultation.

COVID-19 Work

In July 2022, the FSB published a report titled *Interim report on COVID-19 Exit Strategies and Scarring Effects for the G20,*[43] which considers COVID-19 policy exit strategies through the lens of financial stability and the capacity of the financial system to finance equitable growth and prevent "scarring effects" of the pandemic. The report says that, on the one hand, a premature withdrawal of economic support measures could produce reduce economic growth potential through unnecessary insolvencies and unemployment. On the other hand, if support measures remain in place for too long, the report says that financial stability risks may gradually build, by distorting resource allocation and asset prices, increasing moral hazard and postponing necessary structural adjustment in the economy. This includes potential scarring through debt overhang (when low interest rates lead corporates to take on so much debt that they cannot continue to finance new projects). The FSB will invite feedback from stakeholders on the interim report, and produce a final report, to be delivered to the G20 in November 2022.

42. Available at https://www.fsb.org/wp-content/uploads/P091120.pdf.
43. Available at: https://www.fsb.org/2022/07/exit-strategies-to-support-equitable-recovery-and-address-effects-from-covid-19-scarring-in-the-financial-sector/.

C. Regulatory Oversight Committee (ROC, FKA LEI ROC)

The ROC was established in 2012 by public authorities from more than 40 countries to oversee a worldwide framework for legal entity identifiers (LEI), the Global LEI System (GLEIS).

In October of 2020 the ROC's mandate expanded to become the International Governance Body (IGB) of the globally harmonized Unique Transaction Identifier (UTI), the Unique Product Identifier (UPI) and the Critical Data Elements (CDE). The UPIs identify the products reported to trade repositories (TRs) consistently across FSB jurisdictions. The UTIs identify individual transactions reported to TRs and allow authorities to follow their modifications during their whole lifecycle. The CDEs capture other important characteristics of the transactions.

As IGB of the UTI, UPI and CDE, the ROC became the overseer of the designated UPI service provider, the Derivatives Service Bureau (DSB). Since the FSB transferred all governance and oversight responsibilities in relation to the UPI to the ROC, the ROC has been working with DSB to establish appropriately rigorous oversight arrangements.

In June 2021, the ROC and the DSB finalized a Memorandum of Understanding on the implementation of the governance arrangements of the globally harmonized UPI, representing a common understanding of the expected division of responsibilities for overseeing the UPI system.[44]

In September 2021, the ROC published a revised version of the CDE Technical Guidance (version 2),[45] which includes corrections that the ROC considers appropriate to facilitate its jurisdictional implementations.

In January of 2022, the ROC published its Progress Report for 2019-2021,[46] which summarizes a number of important developments that have taken place for the ROC between 2019 and 2021.

D. Organization for Economic Cooperation and Development (OECD)

In November 2021, the OECD Corporate Governance Committee launched its review of the 2015 *G20/OECD Principles of Corporate*

44. Available at https://www.leiroc.org/publications/gls/mou_dsb20210630.pdf.
45. Available at roc_20210922 (leiroc.org).
46. Available at https://www.leiroc.org/publications/gls/roc_20220125.pdf.

Governance,[47] with an expected conclusion in 2023.[48] This review aims to ensure the continuing high quality, relevance, and usefulness of the Principles, with the objective of adapting relevant elements to the post COVID-19 environment and taking into account other developments in the corporate sector and capital markets. The Principles are the international standard for corporate governance and one of the key standards designated by the FSB for sound financial systems.[49] The Principles and the OECD's Methodology for Assessing Implementation of the Principles[50] underlie the corporate governance component of the Report on the Observance of Standards and Codes initiative and are used by the World Bank to benchmark a country's corporate governance frameworks and listed company practices.

III. SUPERVISORY COOPERATION

OIA facilitates cooperation with foreign authorities in the oversight of SEC registrants located abroad, including in cross-border examinations.

In 2021, OIA's Supervisory Cooperation group:

- Assisted SEC staff in the supervision of cross-border regulated entities by facilitating cooperation with foreign counterparts through formal information-sharing arrangements and on an ad hoc basis, including in conducting correspondence examinations and asset verifications abroad,[51] and addressing cross-border registration issues;
- Responded to requests from foreign counterparts in supervisory matters; and
- Developed supervisory cooperation arrangements with foreign counterparts.

The SEC's supervisory memoranda of understanding and similar arrangements (MOUs) provide well-defined and reliable mechanisms for the SEC and its foreign counterparts to consult, cooperate, and share information on a confidential basis about regulated entities that operate

47. Available at https://doi.org/10.1787/9789264236882-en.
48. For background information see: https://www.oecd.org/corporate/review-oecd-g20-principles-corporate-governance.htm.
49. Information about the FSB's key standards is available at: https://www.fsb.org/work-of-the-fsb/about-the-compendium-of-standards/key_standards/.
50. Available at https://doi.org/10.1787/9789264269965-en.
51. Information about Division of Examinations' asset verification is available at: https://www.sec.gov/about/offices/ocie/routine_account_information_confirmation.pdf.

across borders.[52] The scope of these MOUs covers a wide range of regulated entities that may vary for each arrangement depending on the level and type of cross-border activity between the United States and the relevant jurisdiction. The coverage of the MOUs includes: exchanges and other trading venues; brokers or dealers; investment advisers; investment companies; clearing agencies; transfer agents; and credit rating agencies. In addition, the SEC has entered into protocols that cover information sharing and cooperation relating to the application of U.S. GAAP and International Financial Reporting Standards.

From December 2020 to October 2021, the SEC entered into MOUs with regulators from Germany, France, the United Kingdom, Switzerland, and Spain, as well as with the European Central Bank to support applications for substituted compliance for security-based swap dealers and major security-based swap participants located in those jurisdictions.[53] The SEC's rules require that the SEC enter into an MOU or other arrangement with the relevant foreign authorities prior to granting substituted compliance applications. The MOUs address the exchange of information as well as matters of supervisory and enforcement cooperation between the SEC and the respective foreign regulators.

OIA continues to work in conjunction with SEC Division of Examinations staff in seeking additional information regarding laws on data protection and privacy, among others, that may impact the cross-border transfer of records from offshore registered firms to the SEC through various channels in order to determine whether they can comply with inspection requirements.[54] In 2021, the United Kingdom's Information Commissioner's Office (ICO) provided guidance that SEC-registered firms located in the United Kingdom can rely on the public interest derogation under the local data protections law to transfer records containing personal data to SEC staff during examinations.

Additionally, the SEC engages in international collaboration and consultation related to the supervision of globally-active securities firms through supervisory colleges. Supervisory colleges afford regulators the opportunity to share experiences and information with one another and the

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52. The SEC's Supervisory Cooperation arrangements are publicly available at: http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.
53. The MOUs and other relevant materials relevant to the SEC's substituted compliance process, including the applications and relevant SEC orders, are available at https://www.sec.gov/tm/Jurisdiction-Specific-Apps-Orders-and-MOU.
54. Division of Examinations Examination Priorities (2021), https://www.sec.gov/files/2021-exam-priorities.pdf.

industry. SEC Division of Trading and Markets staff participates in supervisory colleges for some global financial complexes that include a broker-dealer entity for which the SEC is the functional regulator. SEC Office of Credit Ratings staff participates in colleges for three internationally active credit rating agencies – S&P Global Ratings (S&P), Moody's Investors Service, Inc. (Moody's), and Fitch Ratings, Inc. (Fitch) – and serves as chair of the colleges for S&P and Moody's. The European Securities and Markets Authority serves as chair of the college for Fitch.

IV. ENFORCEMENT POLICY AND COOPERATION

OIA's Enforcement Cooperation and Assistance team (OIA-ENF) supports the Division of Enforcement's cross-border investigations and litigation on a constantly increasing number of matters across the spectrum of US securities law violations.

Cooperating with the SEC's partners abroad is essential to thwarting fraudsters' use of foreign borders to shield wrongdoing. The IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU) is the main instrument that securities regulators around the world use to share enforcement information and evidence. Now a widening group of regulators is also sharing more forms of information internationally using the IOSCO Enhanced Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information.

OIA-ENF regularly obtains documents and testimony from across the globe to assist Division of Enforcement investigations. OIA-ENF also provides advice to the Division on international litigation issues, such as obtaining discovery from outside US borders using tools that include international treaties such as the Hague Service and Evidence Conventions. OIA-ENF also works with Enforcement in tracing, freezing, and repatriating securities fraud proceeds transferred outside the United States. In addition, OIA-ENF plays a significant role in international collections and enforcement of judgments.

Assistance from foreign securities regulators and other foreign government agencies is key to the SEC's actions against individuals and entities that target United States investors but operate abroad; and the SEC assists those foreign partners as well. OIA-ENF also continues to process increasing numbers of incoming and outgoing cross-border tips, complaints, and referrals. International enforcement coordination is vital to the SEC's investor protection mission.

A. Recent International Enforcement Cases

OIA supported the Division of Enforcement on an array of cases[55] having international components in 2020, 2021 and 2022, including:

CyberFraud

Securities and Exchange Commission v. Rahim Mohamed, Davies Wong, Glenn B. Laken, Richard C.S. Tang, Zoltan Nagy, Jeffrey D. Cox, Phillip G. Sewell, Breanne M. Wong, Christophe Merani, Anna Tang, Robert W. Seeley, Richard B. Smith, Christopher R. Smith, H.E. Capital SA, POP Holdings Ltd., Maximum Ventures Holdings LLC, Harmony Ridge Corp., and Avatele Group LLC:

On August 15, 2022, the SEC announced charges against 18 individuals and entities for their roles in a fraudulent scheme in which dozens of online retail brokerage accounts were hacked and improperly used to purchase microcap stocks to manipulate the price and trading volume of those stocks. Those charged include Rahim Mohamed of Alberta, Canada, who is alleged to have coordinated the hacking attacks, and several others in and outside the U.S. who allegedly benefited from or participated in the scheme.

According to the SEC's complaint, in late 2017 and early 2018, hackers accessed at least 31 U.S. retail brokerage accounts and used them to purchase the securities of Lotus Bio-Technology Development Corp. and Good Gaming, Inc. The unauthorized purchases allegedly enabled fraudsters, who already controlled large blocks of Lotus Bio-Tech and Good Gaming stock, to sell their holdings at artificially high prices and reap more than $1 million in illicit proceeds. According to the complaint, Davies Wong of British Columbia, Canada, and Glenn B. Laken of Illinois, respectively, controlled the majority of the Lotus Bio-Tech and Good Gaming stock that was sold while the hacking attacks were being carried out, and Mohamed coordinated with Wong, Laken, and others to orchestrate the attacks.

55. The cases listed below only reflect actions at a particular time in the litigation of the case. In addition, some of the summaries describe only the SEC allegations of violations of federal securities laws and allegations are not proof of and do not constitute a determination that the defendants or the respondents have committed such violations. Further information about the status of the cases can be obtained by referring to the SEC Index of Litigation Releases or Administrative Proceedings on the SEC's public website.

The complaint also alleges that Richard Tang of British Columbia, Canada, was involved with both the Lotus Bio-Tech and Good Gaming schemes.

The SEC's complaint charges violations of the antifraud and beneficial ownership reporting provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and names two relief defendants who received proceeds from the hacks. The SEC seeks the return of ill-gotten gains plus interest, penalties, bars, and other equitable relief.

The SEC received assistance from the Financial Industry Regulatory Authority, the Alberta Securities Commission, the Australia Securities and Investments Commission, the British Columbia Securities Commission, the Calgary Police Service, the Cayman Islands Monetary Authority, the Dubai Financial Services Authority, the French Autorité des Marchés Financiers, the Hong Kong Securities and Futures Commission, the Mauritius Financial Services Commission, the Ontario Securities Commission, the Quebec Autorité des Marchés Financiers, the Royal Canadian Mounted Police, the Securities Commission of the Bahamas, the Sûreté du Québec, the Superintendencia del Mercado de Valores de la República Dominicana, the Swiss Financial Market Supervisory Authority, and the United Kingdom Financial Conduct Authority.

Securities and Exchange Commission v. Rahim Mohamed, Davies Wong, Glenn B. Laken, Richard C.S. Tang, Zoltan Nagy, Jeffrey D. Cox, Phillip G. Sewell, Breanne M. Wong, Christophe Merani, Anna Tang, Robert W. Seeley, Richard B. Smith, Christopher R. Smith, H.E. Capital SA, POP Holdings Ltd., Maximum Ventures Holdings LLC, Harmony Ridge Corp., and Avatele Group LLC, Case 1:22-cv-03252-ELR (N.D. Ga. filed August 15, 2022).

Securities and Exchange Commission v. Vladimir Okhotnikov, Jane Doe a/k/a Lola Ferrari, Mikail Sergeev, Sergey Maslakov, Samuel D. Ellis, Mark F. Hamlin, Sarah L. Theissen, Carlos L. Martinez, Ronald R. Deering, Cheri Beth Bowen, and Alisha R. Shepperd:

On August 1, 2022, the SEC announced charges against 11 individuals for their roles in creating and promoting Forsage, a fraudulent crypto pyramid and Ponzi scheme that raised more than $300 million from millions of retail investors worldwide, including in the United States. Those charged include the four founders of Forsage, who were last known to be living in Russia, the Republic of Georgia, and Indonesia, as well as three U.S.-based promoters engaged by the founders to endorse Forsage on its website and social media platforms, and several members of the so-called Crypto Crusaders—the largest promotional group for the scheme that operated in the United States from at least five different states.

According to the SEC's complaint, in January 2020, Vladimir Okhotnikov, Jane Doe a/k/a Lola Ferrari, Mikhail Sergeev, and Sergey Maslakov launched Forsage.io, a website that allowed millions of retail investors to enter into transactions via smart contracts that operated on the Ethereum, Tron, and Binance blockchains. However, Forsage allegedly has operated as a pyramid scheme for more than two years, in which investors earned profits by recruiting others into the scheme. Forsage also allegedly used assets from new investors to pay earlier investors in a typical Ponzi structure.

Despite cease-and-desist actions against Forsage for operating as a fraud in September 2020 by the Securities and Exchange Commission of the Philippines and in March 2021 by the Montana Commissioner of Securities and Insurance, the defendants allegedly continued to promote the scheme while denying the claims in several YouTube videos and by other means.

In addition to charging the four founders, the complaint, filed in United States District Court in the Northern District of Illinois, also charges Cheri Beth Bowen, of Pelahatchie, Miss., Ronald R. Deering, of Coeur d' Alene, Idaho, Samuel D. Ellis, of Louisville, Ky., Mark F. Hamlin, of Henrico, Va., Carlos L. Martinez, of Chicago, Ill., Alisha R. Shepperd, of Dunedin, Fla., and Sarah L. Theissen, of Hartford, Wis., with violating the registration and anti-fraud provisions of the federal securities laws. The SEC's complaint seeks injunctive relief, disgorgement, and civil penalties.

Without admitting or denying the allegations, two of the defendants, Ellis and Theissen, agreed to settle the charges and to be permanently enjoined from future violations of the charged provisions and certain other activity. Additionally, Ellis agreed to pay disgorgement and civil penalties, and Theissen will be required to pay disgorgement and civil penalties as determined by the court. Both settlements are subject to court approval.

The SEC received the assistance of the Securities and Exchange Commission of the Philippines.

Securities and Exchange Commission v. Vladimir Okhotnikov, Jane Doe a/k/a Lola Ferrari, Mikail Sergeev, Sergey Maslakov, Samuel D. Ellis, Mark F. Hamlin, Sarah L. Theissen, Carlos L.

Martinez, Ronald R. Deering, Cheri Beth Bowen, and Alisha R. Shepperd, Case 1:22-cv-03978 (N.D. Ill. filed August 1, 2022).

Securities and Exchange Commission v. Vladislav Kliushin, a/k/a Vladislav Klyushin, Nikolai Rumiantcev, a/k/a Nikolay

Rumyantcev, Mikhail Irzak, Igor Sladkov, and Ivan Yermakov, a/k/a Ivan Ermakov:

On December 20, 2021, the SEC announced fraud charges against five Russian nationals for engaging in a multi-year scheme to profit from stolen corporate earnings announcements obtained by hacking into the systems of two U.S.-based filing agent companies before the announcements were made public. The filing agents assist publicly traded companies with the preparation and filing of periodic reports with the SEC, including quarterly reports containing earnings information.

The SEC's complaint, filed in federal district court in Massachusetts, alleges that defendant Ivan Yermakov used deceptive hacking techniques to access the filing agents' systems and directly or indirectly provided not-yet-public corporate earnings announcements stolen from those systems to his co-defendants Vladislav Kliushin, Nikolai Rumiantcev, Mikhail Irzak, and Igor Sladkov. According to the complaint, from 2018 through 2020, the traders used 20 different brokerage accounts located in Denmark, the United Kingdom, Cyprus and Portugal to generate profits of at least $82 million using the stolen information to make trades before over 500 corporate earnings announcements. The defendants allegedly shared a portion of their enormous profits by funneling them through a Russian information technology company founded by Kliushin and for which Yermakov and Rumiantcev serve as directors.

The SEC's complaint charges each of the defendants with violating the antifraud provisions of the federal securities laws and related SEC antifraud rules and seeks a final judgment ordering the defendants to pay penalties, return their ill-gotten gains with prejudgment interest, and enjoining them from committing future violations of the antifraud laws.

The SEC received the assistance of the Danish Financial Supervisory Authority and the Cyprus Securities and Exchange Commission.

Securities and Exchange Commission v. Vladislav Kliushin, a/k/a Vladislav Klyushin, Nikolai Rumiantcev, a/k/a Nikolay

Rumyantcev, Mikhail Irzak, Igor Sladkov, and Ivan Yermakov, a/k/a Ivan Ermakov, Case 1:21-cv-12088 (D. Mass. Filed December 20, 2021).

In the Matter of GTV Media Group, Inc., Saraca Media Group, Inc., and Voice of Guo Media, Inc.:

On September 13, 2021, the SEC charged New York City-based GTV Media Group Inc. and Saraca Media Group Inc., and Phoenix, Arizona-based Voice of Guo Media Inc., with conducting an illegal unregistered offering of GTV common stock. The SEC also announced charges against GTV and Saraca for conducting an illegal unregistered offering of a digital asset security referred to as either G-Coins or G-Dollars. The respondents have agreed to pay more than $539 million to settle the SEC's action.

According to the SEC's order, from April through June 2020, the respondents generally solicited thousands of individuals to invest in the GTV stock offering. During the same period, GTV and Saraca solicited individuals to invest in the digital asset offering. The order finds that the respondents disseminated information about the two offerings to the general public through publicly available videos on GTV's and Saraca's websites, as well as on social media platforms such as YouTube and Twitter. Through these two securities offerings, whose proceeds were commingled, the respondents collectively raised approximately $487 million from more than 5,000 investors, including U.S. investors. As stated in the order, no registration statements were filed or in effect for either offering, and the respondents' offers and sales did not qualify for an exemption from registration.

Without admitting or denying the SEC's findings that they violated Section 5 of the Securities Act of 1933, GTV and Saraca agreed to a cease-and-desist order, to pay disgorgement of over $434 million plus prejudgment interest of approximately $16 million on a joint and several basis, and to each pay a civil penalty of $15 million. Voice of Guo agreed to a cease-and-desist order, to pay disgorgement of more than $52 million plus prejudgment interest of nearly $2 million, and to pay a civil penalty of $5 million. The order establishes a Fair Fund to return monies to injured investors. The respondents also agreed to not participate, directly or indirectly, in any offering of a digital asset security, to assist the SEC staff in the administration of a distribution plan, and to publish notice of the SEC's order on their public websites and social media channels, including but not limited to, www.gtv.org and www.gnews.org.

The SEC received the assistance of the British Columbia Securities Commission.

In the Matter of GTV Media Group, Inc., Saraca Media Group, Inc., and Voice of Guo Media, Inc. Administrative Proceeding File No. 3-20537 (September 13, 2021).

Securities and Exchange Commission v. Stefan Qin*, *Virgil Technologies LLC, Montgomery Technologies LLC, Virgil Quantitative Research, LLC, Virgil Capital LLC, and VQR Partners LLC:

On December 28, 2020, the SEC announced that it filed an emergency action and obtained an order imposing an asset freeze and other emergency relief against Virgil Capital LLC and its affiliated companies in connection with an alleged securities fraud relating to Virgil Capital's flagship cryptocurrency trading fund, Virgil Sigma Fund LP. The Commission's action alleges that the fraud was directed by Stefan Qin, an Australian citizen and part-time resident of New York, who owns and controls Virgil Capital and its affiliated companies.

According to the SEC's complaint, Qin and his entities have been defrauding investors in the Sigma Fund since at least 2018 by making material misrepresentations about the fund's strategy, assets, and financial condition. The complaint alleges that the defendants misled investors to believe their money was being used solely for cryptocurrency trading based on a proprietary algorithm, while Qin and the entities used investment proceeds for personal purposes or for other undisclosed high-risk investments. Since at least July 2020, Qin and Virgil Capital have told investors who requested redemptions from the Sigma Fund that their interests would be transferred instead to another fund under the ultimate control of Qin but with separate management and operations, the VQR Multistrategy Fund LP. The complaint alleges that no funds were transferred and the redemption requests remain outstanding. The SEC's complaint further alleges that Qin is actively attempting to misappropriate assets from the VQR Fund and to raise new investments in the Sigma Fund.

The SEC's complaint, filed in the Southern District of New York on Dec. 22, 2020, charges Qin, Virgil Technologies LLC, Montgomery Technologies LLC, Virgil Quantitative Research LLC, Virgil Capital LLC, and VQR Partners LLC with violations of the antifraud provisions of the federal securities laws, and seeks permanent injunctions, including conduct-based injunctions, disgorgement with prejudgment interest, and civil penalties.

Securities and Exchange Commission v. Stefan Qin, Virgil Technologies LLC, Montgomery Technologies LLC, Virgil Quantitative Research, LLC, Virgil Capital LLC, and VQR Partners LLC, Case 1:20-cv-10849 (S.D.N.Y. December 22, 2020).

Securities and Exchange Commission v. FLiK, CoinSpark, Ryan S. Felton, William Q. Sparks, Owen B. Smith, Chance B. White; and In the Matter of Clifford Harris, Jr.:

On September 11, 2020, the SEC announced charges against five Atlanta-based individuals, including film producer Ryan Felton, rapper and actor Clifford Harris, Jr., known as T.I. or Tip, and three others who each promoted one of Felton's two unregistered and fraudulent initial coin offerings (ICOs). The SEC also charged FLiK and CoinSpark, the two companies controlled by Felton that conducted the ICOs. Aside from Felton, all of the individuals have agreed to settlements to resolve the charges against them.

The SEC's complaint alleges that Felton promised to build a digital streaming platform for FLiK, and a digital-asset trading platform for CoinSpark. Instead, Felton allegedly misappropriated the funds raised in the ICOs. The complaint also alleges that Felton secretly transferred FLiK tokens to himself and sold them into the market, reaping an additional $2.2 million in profits, and that he engaged in manipulative trading to inflate the price of SPARK tokens. Felton allegedly used the funds he misappropriated and the proceeds of his manipulative trading to buy a Ferrari, a million-dollar home, diamond jewelry, and other luxury goods.

In a settled administrative order, the SEC finds that T.I. offered and sold FLiK tokens on his social media accounts, falsely claiming to be a FLiK co-owner and encouraging his followers to invest in the FLiK ICO. T.I. also asked a celebrity friend to promote the FLiK ICO on social media and provided the language for posts, referring to FLiK as T.I.'s "new venture." The SEC's complaint alleges that T.I.'s social media manager William Sparks, Jr. offered and sold FLiK tokens on T.I.'s social media accounts, and that two other Atlanta residents, Chance White and Owen Smith, promoted SPARK tokens without disclosing they were promised compensation in return.

The complaint, filed in the U.S. District Court for the Northern District of Georgia, charges Felton with violating registration, antifraud, and anti-manipulation provisions of the federal securities laws. FLiK and CoinSpark are charged with violating registration and anti-fraud provisions. White and Smith are charged with violating registration and anti-touting provisions. Sparks is charged with violating registration provisions. The complaint seeks injunctive relief, disgorgement of ill-gotten gains, and civil monetary penalties, as well as an officer-and-director bar against Felton. Sparks agreed to disgorge his ill-gotten gains plus prejudgment interest, and Sparks, White, and Smith each agreed to pay a penalty of $25,000 and to conduct-based injunctions prohibiting them from participating in the issuance, purchase, offer, or sale of any digital asset security for a period of five years. The proposed settlements are subject to court approval. Three of Felton's family members and an LLC that he established were also named as relief defendants. The SEC's order against T.I. requires him to pay a $75,000 civil monetary penalty and not participate in offerings or sales of digital-asset securities for at least five years.

The SEC received assistance from the Australian Securities and Investments Commission.

Securities and Exchange Commission v. FLiK, CoinSpark, Ryan S. Felton, William Q. Sparks, Owen B. Smith, Chance B. White, 1:20-cv-03739-SCJ (N.D.Ga. September 10, 2020); and *In the Matter of Clifford Harris, Jr.* Administrative Proceeding File No. 3-19990 (September 11, 2020).

Retail Fraud

Securities and Exchange Commission v. Dean Shah, Henry Clarke, Julius Csurgo, and Antevorta Capital Partners, Ltd.; Securities and Exchange Commission v. Ronald Bauer aka Ronald J. Bauer and Ronald Jacob Bauer, and et al.;* and *Securities and Exchange Commission v. Domenic Calabrigo, Curtis Lehner, Hasan Sario, and Courtney Vasseur:

On April 18, 2022, the SEC announced charges against 16 defendants, located in the Bahamas, the British Virgin Islands, Bulgaria, Canada, the Cayman Islands, Monaco, Spain, Turkey, and the United Kingdom, for participating in multi-year fraudulent penny stock schemes that generated more than $194 million in illicit proceeds. The SEC investigations leading to these charges involved assistance from securities regulators and other law enforcement authorities in more than 20 countries.

The SEC's complaints, filed in the United States District Court for the Southern District of New York, charge all of the defendants with violating the antifraud and registration provisions of the federal securities laws. The charges, contained in three separate complaints, allege that several defendants played a variety of roles to accumulate the majority of shares in penny stocks via difficult to unveil, offshore nominee companies. It is also alleged that some of the defendants frequently used encrypted text and phone applications to avoid detection by regulators, and arranged to buy and sell penny stocks from multiple offshore accounts, in furtherance of the fraud.

According to the complaints, once some of the defendants had amassed a significant majority of the shares of the stocks, certain defendants secretly funded promotional campaigns to promote the stocks to unsuspecting investors in the United States and elsewhere. As alleged, when those campaigns triggered increases in the demand for and price of the stocks, some of the defendants sold the stocks via trading platforms in Asia, Europe and the Caribbean for significant profits.

The SEC is seeking permanent injunctions, disgorgement of allegedly ill-gotten gains plus interest, and civil penalties against all the defendants; penny stock bars against all the individual defendants; conduct-based injunctions against 11 of the 15 individual defendants; and officer and director bars against eight of the individual defendants. On the emergency applications, the Court issued orders on April 12 and April 15 freezing and directing repatriation of the assets of six defendants.

The SEC received assistance from the Alberta Securities Commission, the Securities Commission of the Bahamas, the British Columbia Securities Commission, the Cayman Islands Monetary Authority, the Curaçao Korps Landelijke Politiediensten, the Cyprus Securities and Exchange Commission, the Financial Supervisory Authority of Denmark, the Guernsey Financial Services Commission, the Hong Kong Securities and Futures Commission, the Italian Commissione Nazionale per le Società e la Borsa, the Japan Financial Services Agency, the Jersey Financial Services Commission, the Latvia Financial and Capital Market Commission, the Liechtenstein Financial Market Authority, the Malta Financial Services Authority, the Mauritius Financial Services Commission, the Mexican Comisión Nacional Bancaria y de Valores, the New Zealand Financial Markets Authority, the Ontario Securities Commission, the Panamanian Superintendencia del Mercado de Valores, the Securities Commission of Serbia, the Québec Autorité des Marchés Financiers, the Royal Canadian Mounted Police, the Monetary Authority of Singapore, the Swiss Financial Market Supervisory Authority, the

United Arab Emirates Securities and Commodities Authority, the Dubai Financial Services Authority, and the United Kingdom Financial Conduct Authority.

Securities and Exchange Commission v. Dean Shah, Henry Clarke, Julius Csurgo, and Antevorta Capital Partners, Ltd. 22-CV-3012 (S.D.N.Y. filed April 12, 2022)*; Securities and Exchange Commission v. Ronald Bauer aka Ronald J. Bauer and Ronald Jacob Bauer, and et al.* Case 1:22-cv-03089 (S.D.N.Y. filed April 14, 2022); and *Securities and Exchange Commission v. Domenic Calabrigo, Curtis Lehner, Hasan Sario, and Courtney Vasseur*, Case 1:22-cv-03096 (S.D.N.Y. filed April 14, 2022).

Securities and Exchange Commission v. Francis Biller, Raymond Dove, Chester Alvarez, Troy Gran-Brooks, and Justin Plaizier:

On March 15, 2022, the SEC announced fraud charges against five individuals for allegedly operating a call center in Medellin, Colombia, which used high pressure sales tactics and made false and misleading statements to retail investors to convince them to buy the stocks of small companies trading in the U.S. markets.

According to the SEC's complaint, filed on March 14, 2022, U.S. citizen Chester Alvarez, Canadian citizens Francis Biller, Raymond Dove, and Troy Gran-Brooks, and Dutch citizen Justin Plaizier operated call centers, set up as phony investment management firms, with fake names, websites, and phone numbers. The SEC's complaint alleges that, using the false personas, the defendants orchestrated a pump-and-dump scheme and made false and misleading statements when they promoted the stock of at least 18 issuers, and that they generated more than $58 million in trading from this scheme. The complaint also alleges that the defendants were paid approximately $10 million for promoting thinly traded stocks, which they misled investors to believe had high prospects for success.

The SEC's complaint, filed in the U.S. District Court for the Eastern District of New York, charges all defendants with violations of antifraud provisions of the securities laws and charges Alvarez with violating market manipulation provisions of the securities laws. It also seeks injunctive relief, disgorgement plus prejudgment interest, civil penalties, and a prohibition on participating in any offerings of penny stocks by all defendants.

The SEC received assistance from the Argentinian Comisión Nacional de Valores, the British Columbia Securities Commission, the Royal Canadian Mounted Police, the Hong Kong Securities and Futures Commission, the Malta Financial Services Authority, the Mauritius Financial Services Commission, the Mexican Comisión Nacional Bancaria y de Valores, the Panamanian Superintendencia del Mercado de Valores, the Monetary Authority of Singapore, the Dubai Financial Services Authority, the UAE Securities and Commodities Authority, the Superintendencia Financiera de Colombia, the Colombian Office the Attorney General, the Swiss Financial Market Supervisory Authority, and the Switzerland Federal Office of Justice.

Securities and Exchange Commission v. Francis Biller, Raymond Dove, Chester Alvarez, Troy Gran-Brooks, and Justin Plaizier, Case 1:22-cv-01406 (E.D.N.Y. filed March 14, 2022).

Securities and Exchange Commission v. Roger Nils-Jonas Karlsson (aka Euclid Diodorus, Steve Heyden, Joshua Millard, and Lars Georgsson):

On September 29, 2020, the SEC charged a Swedish national living in Thailand with conducting a multi-million dollar online offering fraud that victimized thousands of retail investors worldwide, including hundreds of investors from the Deaf, Hard of Hearing, and Hearing Loss communities.

The SEC's complaint alleges that from November 2012 to June 2019, Roger Nils-Jonas Karlsson, through his entity, Eastern Metal Securities, defrauded over 2,000 retail investors in nearly every state in the United States, as well as in over 45 countries around the world. According to the complaint, Karlsson solicited investors for what he described as a "Pre Funded Reversed Pension Plan," falsely claiming that the investment platform was run by award-winning economists and promising a payout based on the value of gold. Karlsson allegedly claimed that the investment had no risk of loss. At least 847 of the investors were members of a community for the Deaf that invested more than $2 million in Eastern Metal Securities since 2015 as their retirement investment. The SEC alleges that Karlsson raised $3.5 million from December 2017 through June 2019, and misappropriated at least $1.5 million to purchase real estate in Thailand and for other personal expenses.

The SEC alleges that Karlsson violated the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933 and the antifraud provisions of 17(a)(1) and 17(a)(3) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934 and Rules 10b-5(a) and 10b-5(c) thereunder, and seeks permanent injunctions, disgorgement with prejudgment interest, and civil penalties.

The SEC received the assistance of the securities and financial markets regulatory authorities in Austria, Finland, France, Hong Kong, Malaysia, Romania, Singapore and Thailand, and the National Bureau of Investigation of Finland.

Securities and Exchange Commission v. Roger Nils-Jonas Karlsson (aka Euclid Diodorus, Steve Heyden, Joshua Millard, and Lars Georgsson), Case 1:20-cv-04615 (E.D.N.Y. Filed September 29, 2020).

Securities and Exchange Commission v. BitConnect, Satish Kumbhani, Glenn Arcaro, and Future Money Ltd.:

On September 1, 2021, the SEC announced it had filed an action against BitConnect, an online crypto lending platform, its founder Satish Kumbhani, and its top U.S. promoter and his affiliated company, alleging that they defrauded retail investors out of $2 billion through a global fraudulent and unregistered offering of investments into a program involving digital assets.

According to the SEC's complaint, filed in the United States District Court for the Southern District of New York, from early 2017 through January 2018, Defendants conducted a fraudulent and unregistered offering and sale of securities in the form of investments in a "Lending Program" offered by BitConnect. The complaint alleges that, to induce investors to deposit funds into the purported Lending Program, Defendants falsely represented, among other things, that BitConnect would deploy its purportedly proprietary "volatility software trading bot" that, using investors' deposits, would generate exorbitantly high returns. However, the SEC alleges that instead of deploying investor funds for trading with the purported trading bot, defendants BitConnect and Kumbhani siphoned investors' funds off for their own benefit by transferring those funds to digital wallet addresses controlled by them, their top promoter in the U.S., defendant Glenn Arcaro, and others. The SEC's complaint further alleges that BitConnect and Kumbhani established a network of promoters around the world, and rewarded them for their promotional efforts and outreach by paying commissions, a substantial portion of which they concealed from investors. According to the complaint, among these promoters was Arcaro, the lead national promoter of BitConnect for the United States who used the website he created, Future Money, to lure investors into the Lending Program.

The SEC's complaint charges Defendants with violating the antifraud and registration provisions of the federal securities laws. The complaint seeks injunctive relief, disgorgement plus interest, and civil penalties. The SEC previously reached settlements with two of the five individuals it charged in a related action for promoting the BitConnect offering.

The SEC received the assistance of the Cayman Islands Monetary Authority, the Hong Kong Securities and Futures Commission, the Monetary Authority of Singapore, the Ontario Securities Commission, the Romanian Financial Supervisory Authority, and the Thailand Securities and Exchange Commission.

Securities and Exchange Commission v. BitConnect, Satish Kumbhani, Glenn Arcaro, and Future Money Ltd., Case 1:21-cv-07349 (S.D.N.Y. Filed September 1, 2021).

Securities and Exchange Commission v. Spot Option Tech House, Ltd. (formerly known as Spot Option, Ltd.), Malhaz Pinhas Patarkazishvili (aka Pini Peter and Pinhas Peter), and Ran Amiran:

On April 19, 2021, the SEC announced it charged Israeli-based Spot Tech House Ltd., formerly known as Spot Option Ltd., and two of its former top executives, Malhaz Pinhas Patarkazishvili (also known as Pini Peter) and Ran Amiran, with deceiving U.S. investors out of more than $100 million through fraudulent and unregistered online sales of risky securities known as binary options.

According to the SEC's complaint, Spot Option – under the control of Patarkazishvili, the company's founder and former chief executive officer, and Amiran, the company's former president – defrauded retail investors worldwide through a scheme involving the sale of online binary options. Binary options are securities whose payouts are contingent on the outcome of a yes/no proposition, typically whether an underlying asset will be above or below a specified price at the time the option expires. The SEC has previously charged several entities and individuals in connection with their involvement in the sale of binary options using the Spot Option platform, including in the *SEC v. Banc de Binary*, *SEC v. Beserglik*, and *SEC v. Senderov* cases.

The SEC alleges that the defendants developed nearly all of the products and services necessary to offer and sell binary options through the internet, including a proprietary trading platform, and that they licensed these products and services to entities they called "white label partners," who directly marketed the binary options. According to the complaint, Spot Option instructed its white label partners to aggressively market the binary options as a highly profitable investments for retail investors. As alleged, investors were not told that the defendants' white label partners were the counter-parties on all investor trades, and thus profited when the investors lost money. To ensure sufficient investor losses and make the scheme profitable, Spot Option allegedly, among other tactics, instructed its partners to permit investors to withdraw only a portion of the monies the investors deposited, devised a manipulative payout structure for binary options trades, and designed its trading platform to increase the probability that investors' trades would expire worthless. According to the complaint, the defendants' deceptive business practices caused U.S. and foreign investors to lose a substantial portion of the money they deposited to their trading accounts. The defendants allegedly made millions of dollars as a result.

The SEC's complaint, filed in federal district court in Nevada, charges Spot Option with violating the anti-fraud and registration provisions of the federal securities laws, and Malhaz Pinhas Patarkazishvili and Ran Amiran with violating the registration provisions of the federal securities laws and with controlling Spot Option in its violations of the anti-fraud provisions of the federal securities laws. The complaint seeks disgorgement of ill-gotten gains, prejudgment interest, financial penalties, and permanent injunctions against all three defendants.

The SEC received the assistance of the British Virgin Islands Financial Services Commission, the Financial Supervision Commission of Bulgaria, the Czech National Bank, the Hong Kong Securities and Futures Commission, the Central Bank of Ireland, the Israel Securities Authority, the Swiss Financial Market Supervisory Authority, and the United Kingdom Financial Conduct Authority.

Securities and Exchange Commission v. Spot Option Tech House, Ltd. (formerly known as Spot Option, Ltd.), Malhaz Pinhas Patarkazishvili (aka Pini Peter and Pinhas Peter), and Ran Amiran, Case 2:21-cv-00632 (D. Nev. Filed April 16, 2021).

Securities and Exchange Commission v. Dennis M. Jali. John E. Frimpong, Arley R. Johnson, The Smart Partners LLC, and 1st Million LLC:

On August 28, 2020, the SEC charged two Maryland companies and their principals for a scheme that allegedly defrauded approximately 1,200 investors, many of them African immigrants, of more than $27 million.

According to the SEC's complaint, Dennis Jali, John Frimpong, and Arley Johnson, directly and through their companies 1st Million LLC and The Smart Partners LLC, falsely told investors that their funds would be used by a team of skilled and licensed traders for foreign exchange and cryptocurrency trading, promising risk-free returns of between 6% and 42%. The complaint alleges that the defendants often targeted vulnerable African immigrants and exploited their common ancestry and religious affiliations. The complaint further alleges that Jali, who claimed to be a pastor and falsely held himself out as a self-made millionaire and expert trader, rented office space to conduct in-person meetings and give the appearance of a legitimate company. According to the complaint, the defendants diverted investor funds for personal use and to make Ponzi payments to prior investors.

The SEC's complaint, filed in federal court in Greenbelt, Maryland, charges the defendants with violating the antifraud provisions of the federal securities laws and seeks permanent injunctive relief, return of allegedly ill-gotten gains with prejudgment interest, and civil penalties. The SEC also named Access2Assets as a relief defendant, seeking the return of proceeds of the alleged fraud to which it had no legitimate claim.

The SEC received assistance from the Financial Sector Conduct Authority of South Africa and the Financial Conduct Authority in the United Kingdom.

Securities and Exchange Commission v. Dennis M. Jali. John E. Frimpong, Arley R. Johnson, The Smart Partners LLC, and 1st Million LLC, Case 8:20-cv-02491-PJM (D. Md. August 28, 2020).

Accounting and Disclosure Fraud

Securities and Exchange Commission v. Vale S.A.:

On April 28, 2022, the SEC charged Vale S.A., a publicly traded Brazilian mining company and one of the world's largest iron ore producers, with making false and misleading claims about the safety of its dams prior to the January 2019 collapse of its Brumadinho dam. The collapse killed 270 people, caused immeasurable environmental and social harm, and led to a loss of more than $4 billion in Vale's market capitalization.

According to the SEC's complaint, beginning in 2016, Vale manipulated multiple dam safety audits; obtained numerous fraudulent stability certificates; and regularly misled local governments, communities, and investors about the safety of the Brumadinho dam through its environmental, social, and governance (ESG) disclosures. The SEC's complaint also alleges that, for years, Vale knew that the Brumadinho dam, which was built to contain potentially toxic byproducts from mining operations, did not meet internationally-recognized standards for dam safety. However, Vale's public Sustainability Reports and other public filings fraudulently assured investors that the company adhered to the "strictest international practices" in evaluating dam safety and that 100 percent of its dams were certified to be in stable condition.

The SEC's complaint, filed in U.S. District Court for the Eastern District of New York, charges Vale with violating antifraud and reporting provisions of the federal securities laws and seeks injunctive relief, disgorgement plus prejudgment interest, and civil penalties.

The SEC received the assistance of the Brazilian Federal Prosecution Service, Ministério Público do Estado de Minas Gerais, and Brazil's Comissão de Valores Mobiliários.

Securities and Exchange Commission v. Vale S.A., Case 1:22-cv-02405 (E.D.N.Y. filed April 28, 2022).

Securities and Exchange Commission v. Luckin Coffee, Inc.:

On December 16, 2020, the SEC charged China-based company Luckin Coffee Inc. with defrauding investors by materially misstating the company's revenue, expenses, and net operating loss in an effort to falsely appear to achieve rapid growth and increased profitability and to meet the company's earnings estimates. Luckin, whose American Depositary Shares traded on Nasdaq until July 13, 2020, has agreed to pay a $180 million penalty to resolve the charges.

The SEC's complaint alleges that, from at least April 2019 through January 2020, Luckin intentionally fabricated more than $300 million in retail sales by using related parties to create false sales transactions through three separate purchasing schemes. According to the complaint, certain Luckin employees attempted to conceal the fraud by inflating the company's expenss by more than $190 million, creating a fake operations database, and altering accounting and bank records to reflect the false sales.

The complaint further alleges that the company intentionally and materially overstated its reported revenue and expenses and materially understated its net loss in its publicly disclosed financial statements in 2019. For example, Luckin allegedly materially overstated its reported revenue by approximately 28% for the period ending June 30, 2019, and by 45% for the period ending Sept. 30, 2019, in its publicly disclosed financial statements. The complaint alleges that during the period of the fraud, Luckin raised more than $864 million from debt and equity investors. After Luckin's misconduct was discovered in the course of the annual external audit of the company's financial statements, Luckin reported the matter to and cooperated with SEC staff, initiated an internal investigation, terminated certain personnel, and added internal accounting controls.

The SEC's complaint, filed in the Southern District of New York, charges Luckin with violating the antifraud, reporting, books and records, and internal control provisions of the federal securities laws. Without admitting or denying the allegations, Luckin has agreed to a settlement, subject to court approval, that includes permanent injunctions and the payment of a $180 million penalty. This payment may be offset by certain payments Luckin makes to its security holders in connection with its provisional liquidation proceeding in the Cayman Islands. The transfer of funds to the security holders will be subject to approval by Chinese authorities.

The SEC received assistance from the China Securities Regulatory Commission and the Swiss Financial Market Supervisory Authority.

Securities and Exchange Commission v. Luckin Coffee, Inc., Case 1:20-cv-10631 (S.D.N.Y. Filed December 16, 2020).

Insider Trading

Securities and Exchange Commission v. Moshe Strugano and Rinat Gazit:

On April 20, 2022, the SEC charged Israeli citizens Moshe Strugano and Rinat Gazit with insider trading ahead of the January 24, 2018 public announcement that Ormat Technologies, Inc. had signed a definitive agreement to acquire U.S. Geothermal Inc., a geothermal energy company based in Boise, Idaho.

According to the SEC's complaint, filed in federal district court in New York, Gazit, the former head of mergers and acquisitions at Ormat and resident of Tel Aviv, Israel, tipped her close friend, Strugano, an attorney and resident of Caesarea, Israel, with material, nonpublic information she had obtained concerning Ormat's potential acquisition of U.S. Geothermal. The SEC alleges that based on Gazit's tip, Strugano purchased more than 740,000 shares of U.S. Geothermal stock from December 19, 2017 through January 18, 2018. In the months following the merger announcement, Strugano sold all of these shares for a total profit of over $1.2 million.

The SEC's complaint charges Strugano and Gazit with violating the antifraud provisions of Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 thereunder, and it seeks a permanent injunction, civil penalties, and disgorgement with prejudgment interest against Strugano, and a permanent injunction, civil penalties, and an officer and director bar against Gazit.

The SEC received assistance from the Israel Securities Authority and Swiss Financial Market Supervisory Authority.

Securities and Exchange Commission v. Moshe Strugano and Rinat Gazit, 1:22-cv-03216 (S.D.N.Y. April 20, 2022).

Broker-Dealer Fraud

Securities and Exchange Commission v. Murchinson Ltd., Marc Bistricer, and Paul Zogala:

On August 17, 2021, the SEC announced it settled charges against Murchinson Ltd.; its principal, Marc Bistricer; and its trader, Paul Zogala (the respondents), for providing erroneous order-marking information that caused executing brokers to violate Regulation SHO. In addition, Murchinson and Bistricer settled charges for causing a dealer to fail to register with the SEC.

According to the SEC's order, from June 2016 through October 2017, the respondents provided erroneous order-marking information on hundreds of sale orders of their hedge fund client to the hedge fund's brokers, causing those brokers to mismark the hedge funds' sales as "long." The order finds that in providing the inaccurate information, the respondents also caused the hedge fund's brokers to fail to borrow or locate shares prior to executing the sales. The order further finds that Murchinson and Bistricer caused the hedge fund to engage in dealer activity without registering with the SEC or being exempt from registration.

The SEC's order finds that the respondents caused the hedge fund's executing brokers to violate the order-marking and locate requirements of Regulation SHO, and that Murchinson and Bistricer caused the hedge fund to violate the dealer registration requirements of the Securities Exchange Act of 1934. Without admitting or denying the findings, the respondents each agreed to cease-and-desist orders. In addition, Murchinson and Bistricer agreed to pay, jointly and severally, disgorgement of $7,000,000, with prejudgment interest of $1,078,183. Murchinson, Bistricer, and Zogala also agreed to pay penalties of $800,000, $75,000, and $25,000, respectively. Finally, Murchinson and Bistricer agreed to certain undertakings to ensure future compliance with Regulation SHO.

The SEC received assistance from the British Virgin Islands Financial Services Commission, the Hellenic Republic Capital Markets Commission, the Central Bank of Ireland, the Jersey Financial Services Commission, the Nova Scotia Securities Commission, and the Ontario Securities Commission.

Securities and Exchange Commission v. Murchinson Ltd., Marc Bistricer, and Paul Zogala, Administrative Proceeding File No. 3-20463 (August 17, 2021).

Investment Adviser Fraud

Securities and Exchange Commission v. Cornerstone Acquisition and Management Company LLC, Derren L. Geiger, and She Hwea Ngo:

On May 27, 2022, the SEC announced that it filed charges against previously registered Rancho Santa Fe, California investment adviser Cornerstone Acquisition & Management Company LLC ("Cornerstone"), its chief executive officer, portfolio manager, and chief compliance officer, Derren Lee Geiger, and its chief financial officer, She Hwea Ngo, for allegedly making false and misleading statements, committing other deceptive acts, and committing recordkeeping and compliance violations.

The SEC's complaint alleges that Cornerstone, Geiger, and Ngo engaged in a scheme to deceive investors in Cornerstone's private funds, including the Caritas Royalties Fund (Bermuda) Ltd. (the "Bermuda Fund"), which had U.S. tax-exempt and non-U.S. investors. The complaint alleges that their deceptive conduct included misstatements concerning the ownership of Cornerstone, the existence of collateral, and other material issues. The complaint also alleges that Cornerstone and Geiger failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and that Cornerstone and Ngo created inaccurate books and records.

The SEC's complaint, filed in federal district court in San Diego, California, charges (i) Cornerstone, Geiger, and Ngo with violations of the antifraud provisions of Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 thereunder; (ii) Cornerstone and Geiger with violations of Advisers Act Sections 206(4) and Rule 206(4)-8 thereunder and 207; (iii) Cornerstone with violations of Advisers Act Sections 204 and Rule 204-2 thereunder and 206(4) and Rule 206(4)-7 thereunder; (iv) Geiger with aiding and abetting Cornerstone's violations of Advisers Act Section 206(4) and Rule 206(4)-7 thereunder; and (v) Ngo with aiding and abetting Cornerstone's and Geiger's Advisers Act violations except for Advisers Act Section 206 and Rule 206(4)-7 thereunder. The SEC seeks permanent injunctions, disgorgement with prejudgment interest, and civil penalties against all defendants.

The SEC received assistance from the Bermuda Monetary Authority

Securities and Exchange Commission v. Cornerstone Acquisition and Management Company LLC, Derren L. Geiger, and She Hwea Ngo, Case 3:22-cv-00765-JLS-WVG (S.D. Cal. Filed May 27, 2022).

In the Matter of BlueCrest Capital Management Limited:

On December 8, 2020, the SEC announced that UK-based investment adviser BlueCrest Capital Management Limited has agreed to pay $170 million to settle charges arising from inadequate disclosures, material misstatements, and misleading omissions concerning its transfer of top traders from its flagship client fund, BlueCrest Capital International (BCI), to a proprietary fund, BSMA Limited, and replacement of those traders with an underperforming algorithm. The SEC will distribute the $170 million to harmed investors.

According to the SEC's order, BlueCrest created BSMA to trade the personal capital of BlueCrest personnel using primary trading strategies that overlapped with BCI's. As set forth in the order, members of BlueCrest's governing body, which made the relevant decisions regarding BSMA, had a 93 percent ownership interest in BSMA that peaked at $1.79 billion compared to its ownership interest of approximately $619 million in BCI.

The order finds that, over more than four years, BlueCrest made inadequate and misleading disclosures concerning BSMA's existence, the movement of traders from BCI to BSMA, the use of the algorithm in BCI, and associated conflicts of interest. According to the order, BlueCrest transferred a majority of its highest-performing traders from BCI to BSMA, and assigned many of its most promising newly hired traders, eligible to trade for either fund, to BSMA.

The order also finds that BlueCrest failed to disclose that it reallocated the transferred traders' capital allocations in BCI to a semi-systematic trading system, which was essentially a replication algorithm that tracked certain trading activity of a subset of BlueCrest's live traders. The order finds that BlueCrest did not disclose certain material facts about the algorithm to BCI's independent directors. According to the order, the algorithm generated significantly less profit with greater volatility than the live traders. The order finds that BlueCrest was able to keep more of any performance fees generated by the algorithm than by live traders.

The SEC's order finds that BlueCrest willfully violated antifraud provisions of the Securities Act of 1933 and Investment Advisers Act of 1940 as well as the Advisers Act's compliance rule. Without admitting or denying the SEC's findings, BlueCrest agreed to a cease-and-desist order imposing a censure, and must pay disgorgement and prejudgment interest of $132,714,506 and a penalty of $37,285,494, all of which will be returned to investors.

The SEC received assistance from the UK's Financial Conduct Authority.

In the Matter of BlueCrest Capital Management Limited, Administrative Proceeding File No. 3-20162 (December 8, 2020).

Market Manipulation

Securities and Exchange Commission v. Jay Scott Kirk Lee, Geoffrey Allen Wall, and Benjamin Thompson Kirk:

On December 10, 2021, the SEC announced it charged three Canadian citizens with carrying out a fraudulent scheme involving penny stocks which generated tens of millions of dollars in proceeds but left investors with nearly worthless shares of various public companies.

According to the SEC's complaint, between at least 2011 and 2016, Jay Scott Kirk Lee, Geoffrey Allen Wall, and Benjamin Thompson Kirk allegedly were able to utilize a network of offshore front companies to conceal their control of shares in penny stocks, unload those shares on unsuspecting retail investors, and disburse the proceeds of their fraud to various bank accounts throughout the world.

The SEC also alleges that Lee, Wall and Kirk hid their control from brokers and transfer agents who serve as "gatekeepers" to assure that shares controlled by company affiliates (including those who control 5% or more of a company's shares) were not sold to the public without proper disclosure in a registration statement.

The defendants charged in this case were some of the more prolific clients of Frederick L. Sharp and his offshore platform, which was essentially a complete service provider for all the illicit needs of those dedicated to committing penny stock fraud. The SEC filed an action against Sharp and his associates in August 2021 for violations of the anti-fraud and registration provisions of the federal securities laws arising from their creation, maintenance and profiting from this platform. (*SEC v. Frederick L. Sharp, et al.*, Case 1:21-cv-11276-WGY (D. Mass. August 5, 2021)).

The SEC's complaint, which was filed in federal district court in Boston, charges Lee, Wall and Kirk with violating the antifraud and registration provisions of the federal securities laws. The SEC is seeking permanent injunctions, conduct based injunctions, disgorgement of allegedly ill-gotten gains plus interest, civil penalties, and penny stock bars.

The SEC received the assistance of the British Columbia Securities Commission, the Mauritius Financial Services Commission, and the Curaçao Korps Landelijke Politiediensten.

Securities and Exchange Commission v. Jay Scott Kirk Lee, Geoffrey Allen Wall, and Benjamin Thompson Kirk, Case 1:21-cv-11997 (D. Mass. Filed December 9, 2021).

Securities and Exchange Commission v. Timothy Page, and et al.; and Securities and Exchange Commission v. Daniel Cattlin and William R. Shupe:

On September 23, 2021, the SEC filed two complaints in the United States District Court for the Eastern District of New York charging four individuals and five entities for their roles in an allegedly fraudulent microcap scheme that generated more than $10 million in unlawful stock sales. The SEC also is seeking an order to freeze the assets of seven of the defendants and one relief defendant.

According to the first of the two complaints, United Kingdom citizen Timothy Page, a recidivist, and his son, U.K. resident Trevor

Page, schemed with associates to acquire millions of shares in U.S. publicly traded microcap companies, disguise their control over the companies, and then dump their shares into the public markets in violation of the securities laws. The Pages allegedly used nominee entities, including the five entity defendants, to conceal their holdings in the companies, and then engaged in manipulative trading and hired boiler rooms to generate artificial demand for their stock by making misleading statements to investors.

The SEC's second complaint alleges that two of the Pages' associates, Utah resident William R. Shupe and U.K. resident Daniel Cattlin, used their insider roles as officers or majority shareholders at several of the microcap companies to hide the Pages' control. At the same time, they helped the Pages secretly acquire and then sell millions of the companies' shares. Shupe allegedly enabled the Pages to disguise their control over the companies by, among other things, holding the Pages' securities through a company Shupe formed and by helping the Pages conceal their funding of the microcap companies. Cattlin is alleged to have coordinated with the Pages to provide false and misleading information in response to investigative subpoenas issued by the SEC staff, and during an interview conducted by SEC staff in June 2020.

The SEC's complaints charge each of the nine defendants with violating the antifraud provisions of the federal securities laws. Timothy and Trevor Page and three of the entity defendants also are charged with violating the securities laws' registration provisions, and Timothy and Trevor Page and one entity are charged with violating the securities laws' reporting provisions. Timothy Page and Trevor Page also are charged with violating the market manipulation provisions of the federal securities laws. Cattlin and Shupe are charged with aiding and abetting the Pages' violations of the antifraud provisions of the securities laws. Timothy Page's wife, Janan Page, is named as a relief defendant for her alleged receipt of illicit proceeds from the Pages' fraudulent scheme. In addition to seeking an order freezing the assets of Timothy, Trevor, and Janan Page and the five entity defendants, the SEC seeks permanent injunctions, disgorgement of ill-gotten gains plus interest, and civil penalties against all the defendants. The SEC also seeks penny stock bars against Trevor Page, Cattlin, and Shupe, conduct-based injunctions against the Pages, and officer and director bars against Cattlin and Shupe.

The SEC received the assistance of the British Columbia Securities Commission, the Royal Canadian Mounted Police, the Malta Financial Services Authority, the Mauritius Financial Services Commission, the Hong Kong Securities and Futures Commission, Magyar Nemzeti Bank (The Central Bank of Hungary), and the Monetary Authority of Singapore.

Securities and Exchange Commission v. Timothy Page, and et al., Case 1:21-cv-05292-ARR-RLM (E.D.N.Y. September 23, 2021); *Securities and Exchange Commission v. Daniel Cattlin and William R. Shupe*, Case 1:21-cv-05294 (E.D.N.Y. September 23, 2021).

Securities and Exchange Commission v. Frederick L. Sharp, Zhiying Yvonne Gasarch, Courtney Kelln, Mike K. Veldhuis, Paul Sexton, Jackson T. Friesen, William T. Kaitz, Avtar S. Dhillon, and

Graham R. Taylor:

On August 9, 2021, the SEC announced an emergency action charging nine individuals, including a public company chairman, for their participation in long-running fraudulent schemes that collectively generated hundreds of millions of dollars from unlawful stock sales and caused significant harm to retail investors in the United States and around the world. The SEC has obtained emergency relief in court, including an order to freeze the defendants' assets.

According to the SEC's complaint unsealed on August 9, Canadian resident Frederick L. Sharp masterminded a complex scheme from 2011 to 2019 in which he and his associates – Canadian residents Zhiying Yvonne Gasarch and Courtney Kelln – enabled control persons of microcap companies whose stock was publicly traded in the U.S. securities markets to conceal their control and ownership of huge amounts of penny stock. They then surreptitiously dumped the stock into the U.S. markets in violation of federal securities laws. The services Sharp and his associates allegedly provided included furnishing networks of offshore shell companies to conceal stock ownership, arranging stock transfers and money transmittals, and providing encrypted accounting and communications systems. According to the complaint, Sharp and his associates facilitated over a billion dollars in gross sales in hundreds of penny stock companies.

The complaint alleges that one group of control persons comprised of Canadian residents Mike K. Veldhuis, Paul Sexton, and Jackson T. Friesen frequently collaborated with Sharp to dump huge stock positions while hiding their control positions and stock promotional activities from the investing public. The complaint further alleges that California resident Avtar S. Dhillon, who chaired the boards of directors of four of the public companies whose stocks were fraudulently sold during the schemes, reaped millions in illicit proceeds from those illegal sales. Dhillon was allegedly complicit with Veldhuis and his associates as well as with others, including Canadian resident Graham R. Taylor. According to the complaint, Maryland resident William T. Kaitz worked as a promoter and allegedly touted stocks that Veldhuis, Sexton, and Friesen simultaneously planned to sell, while concealing their roles.

The SEC filed a related action on August 4, 2021, charging Mexican resident Luis Jimenez Carrillo for engaging in deceptive penny stock schemes that generated more than $75 million from the fraudulent sales of multiple microcap companies' stock. Carrillo, who allegedly utilized Sharp's services, partnered with Canadian resident Amar Bahadoorsingh and United Kingdom residents Justin Roger Wall and Jamie Samuel Wilson on at least one of the schemes.

The SEC's complaint, which was filed in federal district court in Boston, charges Sharp, Kelln, Veldhuis, Sexton, Friesen, and Dhillon with violating the antifraud and registration provisions of the federal securities laws. Veldhuis, Sexton, Friesen, and Dhillon are also charged with violating reporting provisions of the federal securities laws. Taylor, Gasarch, and Kaitz are each charged with violating one or more of the antifraud provisions of the federal securities laws. Taylor, Sharp, Kelln, Gasarch, and Kaitz are also charged with aiding and abetting violations by other defendants. In addition to the asset freeze and other temporary relief obtained, the SEC is seeking permanent injunctions, conduct based injunctions, disgorgement of allegedly ill-gotten gains plus interest, civil penalties, penny stock bars, and an officer and director bar for Dhillon.

The SEC received the assistance of the Alberta Securities Commission, the British Columbia Securities Commission, the Royal Canadian Mounted Police, the Argentina Comisión Nacional de Valores, the Securities Commission of The Bahamas, the Colombia Fiscalía General de la Nación, the Curaçao Korps Landelijke Politiediensten, the Cayman Islands Monetary Authority, the Cyprus Securities and Exchange Commission, the Dominican Republic Superintendencia del Mercado de Valores, the German Bundesanstalt für Finanzdienstleistungsaufsicht, the Hong Kong Securities and Futures Commission, the Latvia Financial and Capital Market

Commission, the Liechtenstein Financial Market Authority, the Bank of Lithuania, the Malta Financial Services Authority, the Mauritius Financial Services Commission, the Mexican Comisión Nacional Bancaria y de Valores, the New Zealand Financial Markets Authority, the Panamanian Superintendencia del Mercado de Valores, the St. Lucia Financial Intelligence Authority, the Securities Commission of Serbia, the Monetary Authority of Singapore, the Swiss Financial Market Supervisory Authority, the United Arab Emirates Securities and Commodities Authority, the Dubai Financial Services Authority, and the United Kingdom Financial Conduct Authority.

Securities and Exchange Commission v. Frederick L. Sharp, Zhiying Yvonne Gasarch, Courtney Kelln, Mike K. Veldhuis, Paul Sexton, Jackson T. Friesen, William T. Kaitz, Avtar S. Dhillon, and Graham R. Taylor, 1:21-cv-11276-WGY (D. Mass. Filed August 5, 2021).

Securities and Exchange Commission v. Sean Wygovsky:

On July 2, 2021, the SEC announced fraud charges against Sean Wygovsky, a trader at a major Canada-based asset management firm, in connection with a long-running and lucrative front-running scheme that Wygovsky perpetrated in the accounts of his close family members, netting more than $3.6 million in illicit gains.

According to the SEC's complaint, from approximately January 2015 through at least April 2021, Wygovsky repeatedly traded in his family members' accounts held at brokerage firms in the United States ahead of large trades that were executed on the same days in the accounts of his employer's advisory clients. On over 600 occasions, Wygovsky allegedly bought or sold a stock for one his relatives' accounts either before the client accounts began executing a large order for the same stock on the same side of the market, or during the time period when tranches of such a large order were being executed. Then, typically before the client accounts completed their executions, Wygovsky allegedly closed out the just-established positions in his relatives' accounts, nearly always at a profit.

The SEC's complaint, filed in federal court in New York, charges Wygovsky with violating the antifraud provisions of the federal securities laws and seeks disgorgement of ill-gotten gains plus interest, penalties, and injunctive relief.

Securities and Exchange Commission v. Sean Wygovsky, Case 1:21-cv-05730 (S.D.N.Y. Filed July 2, 2021).

Securities and Exchange Commission v. Trevon Brown, Craig Grant, Joshua Jeppesen, Ryan Maasen, and Michael Noble:

On May 28, 2021, the SEC announced an action against five individuals alleging that they promoted a global unregistered digital asset securities offering that raised over $2 billion from retail investors.

According to the SEC's complaint, filed in the United States District Court for the Southern District of New York, from approximately January 2017 to January 2018, BitConnect used a network of promoters, including U.S.-based Trevon Brown (a.k.a. Trevon James), Craig Grant, Ryan Maasen, and Michael Noble (a.k.a. Michael Crypto) to market and sell securities in its "lending program." The SEC's complaint alleges that these promoters offered and sold the securities without registering the securities offering with the Commission, and without being registered as broker-dealers with the Commission, as required by the federal securities laws. The promoters advertised the merits of investing in BitConnect's lending program to prospective investors, including by creating "testimonial" style videos and publishing them on YouTube, sometimes multiple times a day. According to the complaint, the promoters received commissions based on their success in soliciting investor funds. Another U.S.-based individual, Joshua Jeppesen, served as a liaison between BitConnect and promoters and represented BitConnect at conferences and promotional events.

The SEC's complaint charges the promoter defendants with violating the registration provisions of the federal securities laws, and Jeppesen with aiding and abetting BitConnect's unregistered offer and sale of securities. The complaint seeks injunctive relief, disgorgement plus interest, and civil penalties.

The SEC received the assistance of the Cayman Islands Monetary Authority, the Hong Kong Securities and Futures Commission, the Monetary Authority of Singapore, the Ontario Securities Commission, the Romanian Financial Supervisory Authority, and the Thailand Securities and Exchange Commission.

Securities and Exchange Commission v. Trevon Brown, Craig Grant, Joshua Jeppesen, Ryan Maasen, and Michael Noble, Case 1:21-cv-04791 (Filed May 28, 2021).

Securities and Exchange Commission v. Ongkaruck Sripetch, Amanda Flores, Brehnen Knight, Andrew McAlpine, Ashmit Patel, Michael Wexler, Dominic Williams, Adtron Inc. aka Stockpalooza.com, ATG Inc., DOIT Ltd., Doji Capital, Inc., King Mutual Solutions Inc., Optimus Prime Financial Inc., Orca Bridge, Redline International, and UAIM Corporation:

On September 23, 2020, the SEC announced that it has obtained an asset freeze and other emergency relief to halt a series of microcap market manipulation schemes that defrauded retail investors.

According to the SEC's complaint, from 2013 to 2019, the defendants engaged in various schemes to manipulate microcap stocks and defraud retail investors, obtaining a total of over $6 million in illicit profits.

First, as alleged in the complaint, from at least 2013 to 2017, defendants Ongkaruck Sripetch, Amanda Flores, and Brehnen Knight with assistance on certain occasions from attorney Ashmit Patel orchestrated numerous fraudulent "scalping" schemes. According to the complaint, they purchased stock in over-the-counter issuers through various entities that they controlled, funded promotional campaigns recommending that investors buy those stocks, and then sold the stocks when their price and trading volume were inflated by those same unlawful promotional campaigns. The complaint also alleges that, from 2013 to 2016, Sripetch and Flores along with Dominic Williams and several entities controlled by Sripetch sold over 24 million shares of a microcap issuer they controlled and promoted. According to the complaint, these sales were not registered with the Commission or exempt from registration.

Second, the complaint alleges that in 2016, Sripetch, and Knight engaged in manipulative trading by executing matched trades and wash orders to create a fictitious, attractive price and volume trading history to prime the market in advance of a promotional campaign for a microcap stock.

Third, the complaint alleges that in 2018 and 2019, Sripetch and Knight along with Michael Wexler and Andrew McAlpine, planned and implemented pump-and-dump manipulations of the stock of a microcap issuer controlled by Wexler. According to the complaint, Sripetch and McAlpine were able to sell approximately 340,000 shares before the SEC suspended trading.

The SEC alleges that Flores, Knight, Sripetch, McAlpine, Wexler, and their companies, Adtron Inc., ATG Inc., DOIT Ltd., Doji Capital Inc., King Mutual Solutions Inc., Optimus Prime Financial

Inc., Orca Bridge, Redline International, and UAIM Corporation violated the antifraud provisions of the federal securities laws and that Patel aided and abetted certain of those violations. The SEC also alleges that Knight and Sripetch violated the anti-manipulation provisions of the federal securities laws and that Sripetch, Flores, Williams, DOIT, Doji, Optimus, Redline, and UAIM violated the registration provisions of the federal securities laws. The SEC seeks permanent injunctions, disgorgement plus prejudgment interest, civil penalties, and penny stock bars against the individual defendants as well as officer-and-director bars against Knight and Flores.

The Honorable Marilyn L. Huff of the U.S. District Court for the Southern District of California granted the SEC's request for a temporary restraining order and other emergency relief against defendants Sripetch, Flores, Knight and Patel as well as an asset freeze against Sripetch, Knight and Patel. Judge Huff scheduled a hearing for Oct. 5, 2020.

The SEC received assistance from the Alberta Securities Commission.

Securities and Exchange Commission v. Ongkaruck Sripetch, and et al., 3:20-cv-01864-CAB-AGS (Filed September 21, 2020).

Foreign Corrupt Practices Act (FCPA)

In the Matter of Tenaris S.A.: On June 2, 2022, the SEC announced that Tenaris, a Luxembourg-based global manufacturer and supplier of steel pipe products, will pay more than $78 million to resolve charges that it violated the Foreign Corrupt Practices Act (FCPA) in connection with a bribery scheme involving its Brazilian subsidiary.

According to the SEC's order, the resolution with Tenaris is the result of an alleged bribe scheme involving agents and employees of its Brazilian subsidiary to obtain and retain business from the Brazil state-owned entity Petrobras. Specifically, the order finds that between 2008 and 2013, approximately $10.4 million in bribes was paid to a Brazilian government official in connection with the bidding process at Petrobras. The bribes were funded on behalf of Tenaris' Brazilian subsidiary by companies affiliated with Tenaris' controlling shareholder.

This is not the first time Tenaris has been involved in a corruption scheme. In 2011, the company entered into a Non-Prosecution Agreement with the Department of Justice and a Deferred Prosecution Agreement with the SEC as a result of alleged bribes the company paid to obtain business from a state-owned entity in Uzbekistan.

Tenaris consented to the SEC's order without admitting or denying the findings that it violated the anti-bribery, books and records, and internal accounting controls provisions of the Securities Exchange Act of 1934 and agreed to pay more than $78 million in combined disgorgement, prejudgment interest, and civil penalties. The company also agreed to comply with undertakings for a two-year period related to its ongoing remedial efforts.

The SEC received assistance from the Superintendencia del Mercado de Valores (SMV) in Panama, the Brazilian Federal Prosecution Service, and the Procura della Repubblica presso il Tribunale di Milano, Italy.

In the Matter of Tenaris S.A., Administrative Proceeding File No. 3-20875 (June 2, 2022).

In the Matter of WPP plc:

On September 24, 2021, the SEC announced that London-based WPP plc, the world's largest advertising group, has agreed to pay more than $19 million to resolve charges that it violated the anti-bribery, books and records, and internal accounting controls provisions of the Foreign Corrupt Practices Act (FCPA).

According to the SEC's order, WPP implemented an aggressive business growth strategy that included acquiring majority interests in many localized advertising agencies in high-risk markets. The order finds that WPP failed to ensure that these subsidiaries implemented WPP's internal accounting controls and compliance policies, instead allowing the founders and CEOs of the acquired entities to exercise wide autonomy and outsized influence. The order also finds that, because of structural deficiencies, WPP failed to promptly or adequately respond to repeated warning signs of corruption or control failures at certain subsidiaries. For example, according to the order, a subsidiary in India continued to bribe Indian government officials in return for advertising contracts even though WPP had received seven anonymous complaints touching on the conduct. The order also documents other schemes and internal accounting control deficiencies related to WPP's subsidiaries in China, Brazil, and Peru.

Without admitting or denying the SEC's findings, WPP agreed to cease and desist from committing violations of the anti-bribery, books and records, and internal accounting controls provisions of the FCPA and to pay $10.1 million in disgorgement, $1.1 million in prejudgment interest, and an $8 million penalty.

The SEC received the assistance of the Securities and Exchange Board of India and Brazil's Comissão de Valores Mobiliários.

In the Matter of WPP plc, Administrative Proceeding File No. 3-20595 (September 24, 2021).

In the Matter of Amec Foster Wheeler Limited:

On June 25, 2021, the SEC announced charges against Amec Foster Wheeler Limited (Foster Wheeler) for violations of the Foreign Corrupt Practices Act (FCPA) arising out of a bribery scheme that took place in Brazil. As part of coordinated resolutions with the SEC, the U.S. Department of Justice, the Brazil Controladoria-General da Uniᾶo (CGU)/Advocacia-Geral da Uniᾶo (AGU) and the Ministério Publico Federal (MPF), and the United Kingdom Serious Fraud Office (SFO), the company has agreed to pay more than $43 million related to this scheme, including more than $10.1 million to settle the SEC's charges.

The SEC's order finds that Foster Wheeler, a company that provided project, engineering, and technical services to energy and industrial markets worldwide, engaged in a scheme to obtain an oil and gas engineering and design contract from the Brazilian state-owned oil company, Petroleo Brasileiro S.A. (Petrobras), known as the UFN-IV project. According to the order, from 2012 through 2014, Foster Wheeler's UK subsidiary, Foster Wheeler Energy Limited (FWEL), made improper payments to Brazilian officials in connection with its efforts to win the contract and establish a business presence in Brazil. The bribes were paid through third party agents, including one agent who failed Foster Wheeler's due diligence process, but was allowed to continue working "unofficially" on the UFN-IV project. According to the order, Foster Wheeler paid approximately $1.1 million in bribes in connection with obtaining the contract.

Foster Wheeler, which is currently owned by John Wood Group PLC, consented to the SEC's cease-and-desist order finding that it violated the anti-bribery, books and records, and internal accounting controls provisions of the FCPA and agreed to pay $22.7 million in disgorgement and prejudgment interest. The SEC's order provides for offsets for up to $9.1 million of any disgorgement paid to the CGU/AGU and the MPF in Brazil and up to $3.5 million of any disgorgement paid to the SFO in the United Kingdom. Therefore, the company's minimum payment to the SEC would be approximately $10.1 million.

The SEC received the assistance of the CGU/AGU and the MPF in Brazil and the SFO in the United Kingdom.

In the Matter of Amec Foster Wheeler Limited, Administrative Proceeding File No. 3-20373 (June 25, 2021).

In the Matter of The Goldman Sachs Group, Inc.:

On October 22, 2020, the SEC announced charges against The Goldman Sachs Group Inc. for violations of the Foreign Corrupt Practices Act (FCPA) in connection with the 1Malaysia Development Berhad (1MDB) bribe scheme, and as part of coordinated resolutions, it has agreed to pay more than $2.9 billion, which includes more than $1 billion to settle the SEC's charges.

According to the SEC's order, beginning in 2012, former senior employees of Goldman Sachs used a third-party intermediary to bribe high-ranking government officials in Malaysia and the Emirate of Abu Dhabi. The order finds that these bribes enabled Goldman Sachs to obtain lucrative business from 1MDB, a Malaysian government-owned investment fund, including underwriting approximately $6.5 billion in bond offerings.

The SEC's order finds that Goldman Sachs violated the anti-bribery, internal accounting controls, and books and records provisions of the federal securities laws. Goldman Sachs agreed to a cease-and-desist order and to pay $606.3 million in disgorgement and a $400 million civil penalty, with the amount of disgorgement satisfied by amounts it paid to the Government of Malaysia and 1MDB in a related settlement.

In December 2019, the SEC charged former Goldman Sachs Group Inc. participating managing director Tim Leissner for his role in the 1MDB bribery scheme. (*In the Matter of Tim Leissner*, Administrative Proceeding File No. 3-19619, December 16, 2019.)

The SEC received assistance from the United Kingdom's Financial Conduct Authority, the United Kingdom's Prudential Regulation Authority, the Monetary Authority of Singapore, the Securities Commission of Malaysia, and the Securities and Futures Commission of Hong Kong.

In the Matter of The Goldman Sachs Group, Inc., Administrative Proceeding File No. 3-20132 (October 22, 2020).

In the Matter of J&F Investimentos, S.A., JBS, S.A., Joesley Batista, and Wesley Batista:

On October 14, 2020, the SEC announced announced that Brazilian nationals Joesley Batista and Wesley Batista and their companies J&F Investimentos S.A. and JBS S.A., a global meat and protein producer, have agreed to pay nearly $27 million to resolve charges arising out of an extensive bribery scheme that took place over multiple years.

The SEC's order finds that the Batistas engaged in a bribery scheme in part to facilitate JBS's 2009 acquisition of U.S. issuer Pilgrim's Pride Corporation. According to the order, following that acquisition and while serving as board members of Pilgrim's, the Batistas made payments of approximately $150 million in bribes at the direction of a former Brazil Finance Minister using in part funds from intercompany transfers, dividend payments, and other means obtained from JBS operating accounts containing funds from Pilgrim's. As set forth in the order, the Batistas exerted significant control over Pilgrim's, which shared office space, overlapping board members and executives, accounting and SAP systems, and certain internal accounting controls and policy documents with JBS and its U.S. affiliate JBS USA. The order finds that as a result of that control, the Batistas caused the failure of Pilgrim's to maintain an adequate system of internal accounting controls and accurate books and records. The order also finds that the Batistas, who signed Pilgrim's Pride's financial statements, did not disclose their conduct to Pilgrim's Pride's accountants and independent public accountants.

Joesley Batista, Wesley Batista, J&F, and JBS consented to the SEC's order finding that they caused Pilgrim's Pride's violations of the books and records and internal accounting controls provisions of the FCPA and agreed to cease-and-desist orders. Further, JBS agreed to pay approximately $27 million in disgorgement and the Batistas each agreed to pay a civil penalty of $550,000. The parties must also comply with a three-year undertaking to self-report on the status of certain remedial measures. As also announced by the Department of Justice, J&F pleaded guilty to conspiracy to violate the FCPA and will pay a criminal penalty of over $256 million.

The SEC received assistance from the Ministerio Publico Federal and the Procuradoria-Geral da Republica in Brazil.

In the Matter of J&F Investimentos, S.A., JBS, S.A., Joesley Batista, and Wesley Batista, Administrative Proceeding File No. 3-20124 (October 14, 2020).

V. TECHNICAL ASSISTANCE

As reflected in the Commission's most recent Congressional Justification (for Fiscal Year 2023),[56] OIA's Technical Assistance program advances the Commission's policy objectives for international cooperation, including promoting best practices and overcoming obstacles with respect to cross-border enforcement-related information sharing. Consistent with the agency's enforcement priorities, which include a focus on investor protection and keeping pace with technological change, the TA team will continue to advance initiatives to address frauds that affect retail investors, such as cross-border pump-and-dump frauds. The TA program builds capacity and strong relationships with the foreign counterparts the SEC relies on for assistance in SEC enforcement cases and overseas examinations. In response to increased requests from foreign securities authorities, the TA staff will provide technical advice and virtual training; review regulatory oversight regimes and suggest improvements; and consult with foreign securities authorities on draft legislation and regulations and operational processes.

As reflected in a recent Report of the Attorney General,[57] the TA team has been active in providing effective TA to foreign counterparts in the digital assets area. Historically, SEC TA projects reach in the range of 1,600 to 2,000 foreign officials every year. With respect to digital assets, from the beginning of FY 2020 to the present, SEC staff have completed 17 TA projects, working with and training 334 foreign officials from more than 50 countries.

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56. Fiscal Year 2023, Congressional Budget Justification, Annual Performance Plan, FISCAL YEAR 2021, Annual Performance Report at https://www.sec.gov/files/FY%202023%20Congressional%20Budget%20Justification%20Annual%20Performance%20Plan_FINAL.pdf, pp. 51-52.

57. Report of the Attorney General Pursuant to Section 8(b)(iv) of Executive Order 14067: How To Strengthen International Law Enforcement Cooperation For Detecting, Investigating, And Prosecuting Criminal Activity Related To Digital Assets, at https://www.justice.gov/ag/page/file/1510931/download Annex C, International Training and Outreach Efforts, p. 45.

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Outline: Office of Municipal Securities

The Securities and Exchange Commission disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission, the Commissioners or any of the authors' colleagues on the staff of the Commission.

I. OFFICE OF MUNICIPAL SECURITIES

OMS is responsible for overseeing the municipal securities market and administering the Commission's rules pertaining to municipal securities brokers and dealers, municipal advisors, investors in municipal securities, and municipal issuers. OMS also coordinates with the Municipal Securities Rulemaking Board (MSRB), which includes reviewing and processing proposed MSRB rule changes, coordinating on SEC enforcement actions that relate to MSRB rules, and collaborating with the Division of Examinations on its periodic examinations of the MSRB. OMS advises the Commission on policy matters relating to the municipal securities market and is responsible for policy development, coordination, and implementation of Commission initiatives to improve the municipal securities market, as well as providing technical assistance to the Division of Enforcement and the Division of Examinations. OMS also acts as the Commission's liaison to the Financial Industry Regulatory Authority (FINRA), the Internal Revenue Service, the Department of the Treasury, a variety of investor and industry groups, and regulators on municipal securities issues.

II. MARKET STRUCTURE AND DISCLOSURE INITIATIVES

On July 31, 2012, the Commission issued a Report on the Municipal Securities Market ("2012 Report") that recommended a number of possible actions to improve the municipal securities market with respect to market structure and disclosure.[1]

Subsequently, on November 15, 2017, the Fixed Income Market Structure Advisory Committee (FIMSAC) was formed.[2] FIMSAC focused on the corporate bond and municipal securities markets, and provided advice to the Commission on the efficiency and resiliency of these markets and identifies opportunities for regulatory improvements. FIMSAC initially was established to exist for an initial two-year term, which was renewed for an additional year in November 2019,[3] and renewed again in October 2020.[4] In June 2018, FIMSAC established a Municipal Securities Transparency

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1. *See* U.S. Securities and Exchange Commission, Report on the Municipal Securities Market (July 31, 2012), https://www.sec.gov/news/studies/2012/munireport073112.pdf.
2. *See* SEC Announces the Formation and First Members of Fixed Income Market Structure Advisory Committee (Nov. 9, 2017), https://www.sec.gov/news/press-release/2017-209#.
3. *See* https://www.sec.gov/rules/other/2019/34-87482.pdf.
4. *See* https://www.sec.gov/rules/other/2020/34-90275.pdf.

Subcommittee and charged it with considering the impacts of transparency, both pre-trade and post-trade, on the municipal securities market.[5]

During its tenure, FIMSAC made several recommendations to the Commission regarding the municipal securities market.

- In April 2019, FIMSAC recommended that the Commission consider a rule that permits a broker-dealer that negotiates and underwrites a new-issue municipal bond or is co-manager or member of the selling group to meet the requirements of section 206(3) of the Investment Advisers Act (the "Advisers Act") when acting in a principal capacity to sell new-issue municipal bonds during the negotiated order period.[6]
- In July 2019, FIMSAC recommended that the SEC consider a rule that permits a broker-dealer to meet the requirements of section 206(3) of the Advisers Act when acting in a principal capacity to sell certain client bond positions within the normal liquidation process, by allowing dealers to submit a "blind bid" on a principal basis against its advisory clients.[7]
- In February 2020, FIMSAC made a series of recommendations designed to improve the timeliness of municipal securities disclosure. These recommendations included:
    - That the Commission be given additional statutory authority to provide a mechanism for the Commission to enforce compliance with continuing disclosure agreements and other obligations of municipal issuers to protect municipal securities bondholders;
    - That the Commission be given additional statutory authority to provide a safe harbor from private liability for forward-looking statements for municipal issuers that satisfy certain conditions;
    - That the Commission explore ways through which it could make disclosure deadlines for annual financial information and audited financial statements more certain and predictable;

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5. https://www.sec.gov/spotlight/fixed-income-advisory-committee/fixed-income-market-structure-advisory-committee-subcommittees.htm.
6. https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-negotiated-municipal-underwritings-recommendations.pdf.
7. https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-recommendation-muni-securities.pdf.

- ○ That the Commission seek wide ranging public comment about the concerns raised by market participants and the potential need for the SEC to establish a disclosure framework including timeframe obligations for municipal issuers; and
- ○ That the Commission explore ways through which it can raise awareness of the potential consequences of providing less timely and less robust disclosure information.[8]

- In June, 2020, FIMSAC recommended that the Commission determine whether there are effective actions that can be taken by the Commission, the MSRB, or others to provide additional pre-trade price transparency for the municipal market to the investing public.[9]

a. Market Structure

i. MSRB Best Execution Rule; MSRB and FINRA Best Execution Guidance

On December 5, 2014, the Commission approved an MSRB proposed rule change to require dealers to seek best execution of retail customer transactions in municipal securities.[10] The MSRB's best execution rule is generally harmonized with FINRA's best execution rule, with some tailoring for the municipal securities market, and subject to an exemption for transactions with sophisticated municipal market professionals.[11] In addition, the MSRB and FINRA have issued related practical guidance on their respective best execution rules.[12]

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8. https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-muni-financial-disclosures-recommendation.pdf.
9. https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-recommendations-pre-trade-transparency.pdf.
10. *See* Order Granting Approval of a Proposed Rule Change Consisting of Rule G-18, on Best Execution of Transactions in Municipal Securities, and Amendments to Rule G-48, on Transactions with Sophisticated Municipal Market Professionals ("SMMP"), and Rule D-15, on the Definition of SMMP, Exchange Act Release No. 73764 (Dec. 5, 2014), 79 Fed. Reg. 73658 (Dec. 11, 2014), https://www.sec.gov/rules/sro/msrb/2014/34-73764.pdf.
11. *Id.*
12. *See* MSRB Implementation Guidance on MSRB Rule G-18, on Best Execution (November 20, 2015), http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/~/media/860A5596734841799BD1CCDCD533E368.ashx; FINRA Regulatory Notice 15-46, Best Execution, Guidance on Best Execution Obligations in Equity,

ii. MSRB and FINRA Mark-Up Disclosure Rules; MSRB Prevailing Market Price Guidance; MSRB and FINRA Markup Disclosure and Prevailing Market Price Guidance

On November 17, 2016, the Commission approved an MSRB proposed rule change to require dealers to disclose on certain non-institutional customer confirmations the dealer's mark-up or mark-down for municipal securities[13] (MSRB Mark-up Filing) and a FINRA proposed rule change to require members to disclose on certain non-institutional customer confirmations the member's mark-up or mark-down for corporate and agency debt securities (FINRA Mark-up Filing).[14] The MSRB Mark-up Filing and FINRA Mark-up Filing impose substantially similar disclosure requirements. The MSRB Mark-up Filing also includes guidance for dealers on establishing the prevailing market price of a security, from which a dealer's mark-up or mark-down is determined.[15] The new mark-up disclosure requirements and prevailing market price guidance

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Options and Fixed Income Markets (November 2015), https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.

13. *See* Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to MSRB Rules G-15 and G-30 to Require Disclosure of Mark-ups and Mark-Downs to Retail Customers on Certain Principal Transactions and to Provide Guidance on Prevailing Market Price, Exchange Act Release No. 79347 (Nov. 17, 2016), 81 Fed. Reg. 84637 (Nov. 23, 2016), https://www.sec.gov/rules/sro/msrb/2016/34-79347.pdf.
14. Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Relating to FINRA Rule 2232 (Customer Confirmations) to Require Members to Disclose Additional Pricing Information on Retail Customer Confirmations Relating to Transactions in Certain Fixed Income Securities, Exchange Act Release No. 79346 (Nov. 17, 2016), 81 Fed. Reg. 84659 (Nov. 23, 2016), https://www.sec.gov/rules/sro/finra/2016/34-79346.pdf.
15. FINRA Rule 2121 provides guidance on establishing prevailing market price for non-municipal debt securities. The MSRB's prevailing market price guidance is substantially similar to and generally harmonized with the guidance contained in FINRA Rule 2121. *See* Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to MSRB Rules G-15 and G-30 to Require Disclosure of Markups and Mark-Downs to Retail Customers on Certain Principal Transactions and to Provide Guidance on Prevailing Market Price, Exchange Act Release No. 79347 (Nov. 17, 2016), 81 Fed. Reg. 84637 (Nov. 23, 2016), https://www.sec.gov/rules/sro/msrb/2016/34-79347.pdf.

became effective on May 14, 2018.[16] In addition, the MSRB and FINRA have issued interpretive guidance on their respective markup disclosure rules and prevailing market price guidance.[17]

iii. Ongoing Market Structure Initiatives

On August 2, 2022, the MSRB issued a Request for Comment on transaction reporting obligations under MSRB Rule G-14. Specifically, the MSRB is seeking input on a potential amendment to Rule G-14 to require that, absent an exception, transactions are reported as soon as practicable, but no later than within one minute of the Time of Trade.[18] Comments are due on October 3, 2022. On July 29, 2022, the MSRB announced that the Board had discussed working to develop coordinated proposals with fellow regulators on the collection of pre-trade data in the fixed income markets.[19] OMS staff continues to monitor developments on this and other market structure initiatives.

b. Disclosure

With respect to the 2012 Report's disclosure recommendations, on August 20, 2018, the Commission announced its adoption of amendments to Rule 15c2-12 substantially as proposed.[20] The amendments

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16. *See* New Disclosure Requirements Under MSRB Rule G-15 and Prevailing Market Price Guidance Pursuant to Rule G-30 Effective May 14, 2018, available at http://msrb.org/~/media/Files/Regulatory-Notices/Announcements/2016-28.ashx?n=1.
17. *See* Confirmation Disclosure and Prevailing Market Price Guidance: Frequently Asked Questions (March 19, 2018 (first published July 12, 2017)), http://msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-15.aspx?tab=2; Fixed Income Confirmation Disclosure: Frequently Asked Questions (March 2018 (first published July 2017)), http://www.finra.org/industry/faq-fixed-income-confirmation-disclosure-frequently-asked-questions-faq.
18. MSRB Notice 2022-07, https://msrb.org/-/media/Files/Regulatory-Notices/RFCs/2022-07.ashx?. FINRA also issued an analogous Request for Comment regarding time of trade reporting for securities reported to its TRACE system, available at https://www.finra.org/rules-guidance/notices/22-17.
19. *See* "MSRB Elects New Board Leadership and Announces New Members for FY 2023 at Quarterly Meeting," https://www.msrb.org/News-and-Events/Press-Releases/2022/Board-Meeting-Recap-July-2022.
20. *See* Exchange Act Release No. 34-83885 (August 20, 2018), 83 FR 44700 (August 31, 2018), *available at* https://www.sec.gov/rules/final/2018/34-83885.pdf. For the Proposing Release, *see* Exchange Act Release No. 34-80130 (March 1, 2017), 82 FR 13928 (March 15, 2017), *available at* https://www.sec.gov/rules/proposed/2017/34-80130.pdf.

address the need for timely disclosure of important information related to an issuer's or obligated person's financial obligations, facilitate timely access to important information regarding certain financial obligations incurred by issuers and obligated persons, which could impact an issuer's or obligated person's liquidity and overall creditworthiness and create risks for existing security holders. The amendments amend the list of event notices that a dealer acting as an underwriter in a primary offering of municipal securities subject to the Rule must reasonably determine that an issuer or obligated person has undertaken, in a written agreement, to provide to the MSRB within ten business days of their occurrence. Specifically, the amendments add two new events to the list of events included in the Rule: (1) incurrence of a financial obligation of the issuer or obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material; and (2) default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the issuer or obligated person, any of which reflect financial difficulties. The Commission defined the term "financial obligation" to mean a (i) debt obligation; (ii) derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation; or (iii) a guarantee of (i) or (ii).[21] The term financial obligation does not include municipal securities as to which a final official statement has been provided to the Municipal Securities Rulemaking Board consistent with Rule 15c2-12. The compliance date for the amendments was February 27, 2019.

On February 7, 2020, the staff of OMS published Staff Legal Bulletin No. 21, Application of Antifraud Provisions to Public Statements of Issuers and Obligated Persons of Municipal Securities in the Secondary Market.[22] The bulletin provides the views of OMS staff regarding the application of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder to public statements made by issuers of municipal securities and obligated persons in the secondary market. As more fully

21. As originally proposed, the term financial obligation would have meant a (i) debt obligation; (ii) lease; (iii) guarantee; (iv) derivative instrument; and (v) monetary obligation resulting from a judicial, administrative, or arbitration proceeding.

22. https://www.sec.gov/municipal/application-antifraud-provisions-staff-legal-bulletin-21.

discussed in the bulletin, the antifraud provisions apply to any statement of a municipal issuer or obligated person that is reasonably expected to reach investors and the trading markets.

On May 4, 2020, in response to the COVID-19 pandemic, then-SEC Chairman Jay Clayton and then-OMS Director Rebecca Olsen issued a joint statement entitled "The Importance of Disclosure for our Municipal Markets."[23] In the statement, Clayton and Olsen noted that the effects of COVID-19 raised uncertainties regarding the financial status of state and local governments and special purpose entities; encouraged municipal securities issuers to provide updated financial and other disclosures; and encouraged financial professionals to discuss these matters with "main street investors."

In response to another of the recommendations contained in the 2012 Report, the Commission hosted conferences on Municipal Securities Disclosure on December 6, 2018 and June 16, 2020.[24]

III. MARKET PARTICIPANTS

a. Municipal Advisor Regulation

The Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) imposed a new requirement that municipal advisors register with the SEC and provided for of the development of rules applicable to municipal advisors by the MSRB.[25] This registration requirement applies to persons who provide advice to municipal entities or obligated persons with respect to municipal financial products or the issuance of municipal securities, or who, under certain circumstances, solicit municipal entities or obligated persons. The Dodd-Frank Act also imposed a fiduciary duty on municipal advisors when advising municipal entities.

i. SEC Municipal Advisor Registration Rules

In September 2013, the Commission adopted final rules for municipal advisor registration.[26] The rules require municipal advisors

23. https://www.sec.gov/news/public-statement/statement-clayton-olsen-2020-05-04.
24. https://www.sec.gov/municipal/municipal-sec-conferences.
25. *See* 15 U.S.C. § 78o-4(b).
26. *See* Registration of Municipal Advisors, Exchange Act Release No. 70462 (Sept. 20, 2013), 78 Fed. Reg. 67468 (Nov. 12, 2013), http://www.sec.gov/rules/final/2013/34-70462.pdf. *See also* Office of Municipal Securities, SEC, Registration of

to file certain forms with the Commission to, as appropriate, obtain, maintain, or terminate their registration with the Commission and to make and maintain certain books and records. In addition, the rules interpret and provide guidance on the statutory definition of municipal advisor and the statutory exclusions from that definition, and provide certain additional regulatory exemptions. These registration requirements and regulatory standards were intended to mitigate some of the problems observed with the conduct of some municipal advisors, including failure to place the duty of loyalty to their municipal entity client ahead of their own interests, undisclosed conflicts of interest, advice rendered by financial advisors without adequate training or qualifications, and pay to play practices.

OMS is currently overseeing the registration of approximately 465 municipal advisory firms. Municipal advisors were required to comply with the SEC's registration rules as of July 1, 2014, including registering with the SEC using the final registration forms.[27] The SEC municipal advisor registration information is available to the public through the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system website.[28] OMS continues its significant responsibilities relating to implementation of the municipal advisor registration rules by monitoring and improving the SEC's registration system for municipal advisors, participating in the review of municipal advisor registrations, consulting with the Division of Examinations regarding inspections and examinations of municipal advisors, and coordinating with the MSRB and FINRA[29] to help

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Municipal Advisors Frequently Asked Questions (last updated Sept. 20, 2017), http://www.sec.gov/info/municipal/mun-advisors-faqs.pdf.

27. The rules require municipal advisors to register with the SEC by completing a Form MA and to provide information regarding natural persons associated with the municipal advisor and engaged in municipal advisory activities on such municipal advisor's behalf by completing a Form MA-I for each such natural person.

28. To search by a municipal advisor company's name, *see* http://www.sec.gov/edgar/searchedgar/companysearch.html.

29. In the adopting release, the Commission stated that it believed that Section 15A of the Securities Exchange Act of 1934 provides a registered national securities association, such as FINRA, with authority to conduct examinations of its members' activities as registered municipal advisors in order to evaluate their compliance with the Exchange Act, rules and regulations thereunder, and MSRB rules. *See* Registration of Municipal Advisors, Exchange Act Release No. 70462, pt. IV (Sept. 20, 2013), 78 Fed. Reg. 67468 (Nov. 12, 2013), http://www.sec.gov/rules/final/2013/34-70462.pdf; 15 U.S.C. § 78o-3. In addition, pursuant to Exchange Act Section 15B (as amended by the Dodd-Frank Act), the Commission designated FINRA to examine its members' activities as registered municipal advisors and

promote fair and uniform application of new rules applicable to municipal advisors.

ii. MSRB Municipal Advisor Rules

The Commission has approved several MSRB rules applicable to municipal advisors, some of which are described below. On December 22, 2010, the Commission approved a rule to apply the MSRB's core fair dealing rule for brokers, dealers, and municipal securities dealers (dealers) to municipal advisors[30] and on February 26, 2014, the Commission approved a proposed rule change to create new procedures for municipal advisors to register with the MSRB[31]. In addition, on October 23, 2014, the Commission approved new MSRB Rule G-44, which requires municipal advisors to establish a supervisory system and compliance procedures.[32] On February 26,

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evaluate compliance by such members with federal securities laws, Commission rules and regulations, and MSRB rules applicable to municipal advisors. *See* Registration of Municipal Advisors, Exchange Act Release No. 70462, pt. IV (Sept. 20, 2013), 78 Fed. Reg. 67468 (Nov. 12, 2013), http://www.sec.gov/rules/final/2013/34-70462.pdf; 15 U.S.C. § 78o-4.

30. *See* Order Granting Approval of Amendments to Rule G-5, on Disciplinary Actions by Appropriate Regulatory Agencies, Remedial Notices by Registered Securities Associations; and Rule G-17, on Conduct of Municipal Securities Activities, Exchange Act Release No. 63599 (Dec. 22, 2010), 75 Fed. Reg. 82119 (Dec. 29, 2010), https://www.sec.gov/rules/sro/msrb/2010/34-63599.pdf.

31. *See* Order Granting Approval of Proposed Rule Change, as Modified by Amendment No. 1, Consisting of Amendments to MSRB Rules A-12, on Initial Fee, G-14, on Reports of Sales or Purchases, and the Facility for Real-Time Transaction Reporting and Price Dissemination ("RTRS Facility"); Deletion of Rules A-14, on Annual Fee, A-15, on Notification to the Board of Change in Status or Change of Name or Address, and G-40, on Electronic Mail Contacts; Deletion of References to RTRS Testing Requirements under G-14(b)(v), G-14(c), on RTRS Procedures, and in the RTRS Facility; Elimination of MSRB Forms RTRS and G-40, and Adoption of a Single, Consolidated Electronic Registration Form, New Form A-12, Exchange Act Release No. 71616 (Feb. 26, 2014), 79 Fed. Reg. 12254 (Mar. 4, 2014), https://www.sec.gov/rules/sro/msrb/2014/34-71616.pdf. The MSRB's initial rule regarding the process for municipal advisors to register with the MSRB was effective November 15, 2010. *See* Notice of Filing and Immediate Effectiveness of Rule D-13, on a Definition of "Municipal Advisory Activities", Rule D-14, on a Definition of "Appropriate Regulatory Agency", and Amendments to Rule D-11 ("Associated Persons"), Rule G-40 on Electronic Mail Contacts, and Form G-40, on Electronic Mail Contacts, Exchange Act Release No. 63308 (Nov. 12, 2010), 75 Fed. Reg. 70335 (Nov. 17, 2010), https://www.sec.gov/rules/sro/msrb/2010/34-63308.pdf.

32. *See* Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Consisting

2015, the Commission approved an MSRB proposed rule change that establishes professional qualification requirements for municipal advisors.[33] On November 6, 2015, the Commission approved an MSRB proposed rule change that, among other things, extends the relevant existing provisions of MSRB Rule G-20 on gifts, gratuities and non-cash compensation to municipal advisors and their associated persons and to gifts given in relation to municipal advisory activities.[34] On December 23, 2015, the Commission approved new MSRB Rule G-42, which establishes the core standards of conduct and duties of municipal advisors when engaging in municipal advisory activities, other than municipal advisory solicitation activities.[35] On May 7, 2018, the Commission approved new MSRB Rule G-40, which establishes requirements relating to advertising by municipal advisors.[36] On November 20, 2018, the Commission

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of Proposed New Rule G-44, on Supervisory and Compliance Obligations of Municipal Advisors; Proposed Amendments to Rule G-8, on Books and Records to be Made by Brokers, Dealers and Municipal Securities Dealers; and Proposed Amendments to Rule G-9, on Preservation of Records, Exchange Act Release No. 73415 (Oct. 23, 2014), 79 Fed. Reg. 64423 (Oct. 29, 2014), https://www.sec.gov/rules/sro/msrb/2014/34-73415.pdf.

33. *See* Notice of Filing of Amendment No. 1 and Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change Consisting of Proposed Amendments to MSRB Rules G-1, on Separately Identifiable Department or Division of a Bank; G-2, on Standards of Professional Qualification; G-3, on Professional Qualification Requirements; and D-13, on Municipal Advisory Activities, Exchange Act Release No. 74384 (Feb. 26, 2015), 80 Fed. Reg. 11076 (Mar. 4, 2015), https://www.sec.gov/rules/sro/msrb/2015/34-74384.pdf.

34. *See* Order Granting Approval of a Proposed Rule Change Consisting of Proposed Amendments to Rule G-20, on Gifts, Gratuities and Non-Cash Compensation, and Rule G-8, on Books and Records to be Made by Brokers, Dealers, Municipal Securities Dealers, and Municipal Advisors, and the Deletion of Prior Interpretive Guidance, Exchange Act Release No. 76381 (Nov. 6, 2015), 80 Fed. Reg. 70271 (Nov. 13, 2015), https://www.sec.gov/rules/sro/msrb/2015/34-76381.pdf.

35. *See* Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1 and Amendment No. 2, Consisting of Proposed New Rule G-42, on Duties of Non-Solicitor Municipal Advisors, and Proposed Amendments to Rule G-8, on Books and Records to be Made by Brokers, Dealers, Municipal Securities Dealers, and Municipal Advisors, Exchange Act Release No. 76753 (Dec. 23, 2015), 80 Fed. Reg. 81614 (Dec. 30, 2015). https://www.sec.gov/rules/sro/msrb/2015/34-76753.pdf.

36. *See* Order Granting Approval of a Proposed Rule Change, Consisting of Amendments to Rule G-21, on Advertising, Proposed New Rule G-40, on Advertising by Municipal Advisors, and a Technical Amendment to Rule G-42, on Duties of Non-Solicitor Municipal Advisors, Exchange Act Release No. 83117 (May 7, 2018), 83 Fed. Reg. 21794 (May 10, 2018). https://www.sec.gov/rules/sro/msrb/2018/34-83177.pdf.

approved amendments to MSRB Rule G-3 establishing additional qualification requirements for municipal advisor principals.[37]

iii. Brokers, Dealers, and Municipal Securities Dealers

In addition to the elements described above regarding the regulation of brokers, dealers, and municipal securities dealers, on June 5, 2019, the Commission adopted Regulation Best Interest, which established a new standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer (collectively, "broker-dealers").[38] On June 25, 2020, the Commission approved amendments to certain MSRB rules to align t them with the standard established in Regulation Best Interest.[39] On June 23, 2022, the Commission approved amendments to certain MSRB rules to align them , with certain exemptions, with the standards of conduct in Regulation Best Interest for certain municipal securities transactions by municipal securities dealers that are not registered broker-dealers, not covered by the Commission's Regulation Best Interest.[40]

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37. *See* Order Granting Approval of a Proposed Rule Change, Consisting of Amendments to Rule G-3, on Professional Qualification Requirements to Require Municipal Advisor Principals to Become Appropriately by Passing the Municipal Advisor Principal Qualification Examination, Exchange Act Release No. 84630 (November 20 __, 2018), 83 Fed. Reg. 60927 (November 27, 2018), https://www.sec.gov/rules/sro/msrb/2018/34-84630.pdf.
38. See Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019) (File No. S7-07-18).
39. *See* Order Granting Approval of a Proposed Rule Change to Align Certain MSRB Rules to Securities Exchange Act Rule 15l-1, Regulation Best Interest, Exchange Act Release No. 89154 (June 25, 2020), 85 Fed. Reg. 39613 (July 1, 2020), https://www.sec.gov/rules/sro/msrb/2020/34-89154.pdf.
40. *See* Order Granting Approval of a Proposed Rule Change Consisting of Amendments to MSRB Rule G-19 Regarding Regulation Best Interest for Certain Municipal Securities Activities of Bank Dealers and MSRB Rule G-48 Regarding Quantitative Suitability for Institutional Sophisticated Municipal Market Professionals, Exchange Act Release No. 95145 (June 23, 2022), 87 Fed. Reg. 38795 (June 29, 2022), https://www.sec.gov/rules/sro/msrb/2022/34-95145.pdf.

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U.S. Securities and Exchange Commission, Staff Report on Nationally Recognized Statistical Rating Organizations, Office of Credit Ratings (January 2022)

OFFICE OF CREDIT RATINGS

Staff Report

ON

NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

As Required by Section 6
of the Credit Rating Agency
Reform Act of 2006 and
Section 15E(p)(3)(C) of
the Securities Exchange
Act of 1934

January 2022

U.S. SECURITIES AND EXCHANGE COMMISSION

This is a report of the Staff of the U.S. Securities and Exchange Commission. Staff reports, Investor Bulletins, and other staff documents represent the views of Commission staff and are not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved the content of these documents and, like all staff statements, they have no legal force or effect, do not alter or amend applicable law, and create no new or additional obligations for any person. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

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I. MESSAGE FROM THE DIRECTOR

I am pleased to share the Office of Credit Ratings' (OCR) Staff Report (Report) on nationally recognized statistical rating organizations (NRSROs) for calendar year 2021. During 2021, OCR, the U.S. Securities and Exchange Commission (the Commission or SEC), and the market continued to navigate the extraordinary circumstances caused by COVID-19. Through it all, OCR continued, without interruption, to excel at its mission of assisting the Commission in protecting investors, promoting capital formation, and maintaining fair, orderly, and efficient markets through the oversight of NRSROs.

In past years, OCR published two separate annual reports: The Annual Report to Congress and the Summary Examination Report. For the first time, OCR has prepared one report that combines the information from the two reports to present OCR's annual activity in a more integrated way. In addition to combining the reports, we have also made a variety of substantive and organizational changes to the Report to provide greater transparency about the NRSROs and their credit ratings businesses, and the market more broadly. For example, to increase transparency about OCR's exam findings, the Report organizes the NRSROs into three groups—"large," "medium," and "small"—instead of two groups ("larger" and "smaller") as in past years.

The Report includes a summary of the Commission staff's (the Staff) essential findings from the most recently completed examination of each NRSRO. These examinations covered the eight statutorily mandated review areas and focused on certain subjects and activities that the Staff, through its risk assessment process, identified as relevant to certain NRSROs, including Environmental, Social, and Governance (ESG) issues, COVID-19, and collateralized loan obligations (CLOs). In addition, the Report also includes, for the first time, the Staff's definitions of the terms "essential finding" and "material regulatory deficiencies" to provide greater transparency regarding OCR's work.

OCR's examinations have been successful in promoting greater compliance by NRSROs with applicable laws and rules as the NRSROs advance initiatives to address the Staff's recommendations. The Report includes a new section on essential findings trends from examinations conducted between 2016 and 2021.

The Report also discusses the state of competition, transparency, and conflicts of interest at NRSROs. Importantly, the Report illustrates that the small and medium NRSROs (as defined below) continue to compete with the largest three NRSROs, with each of the small and medium firms increasing its total number of ratings outstanding as compared to declines among two of the largest three firms. The data show these increases occurring across all rating categories and, though modest in total number, illustrate, in some cases, significant year-over-year increases in rating activity for some firms.

To help inform its risk assessment process, exam program, and policy initiatives, OCR monitors credit rating activity and industry developments, especially in connection with capital market and economic events and trends, such as ESG and COVID-19. Staff communicates with NRSROs and a variety of market participants, and reviews NRSRO publications, news reports, trade publications, academic papers, and government reports, among other information sources.

The year continued to see OCR leadership and Staff engaged in discussions about the issues and challenges of diversity, equity, and inclusion. Along with our partners in the Office of Minority and Women Inclusion, the Office of Equal Employment Opportunity, and the Office of the Chair we will continue to embrace these topics as we continuously work to fulfill our mission.

As proud as I am of everything OCR accomplished throughout 2021, I truly believe that the best is yet to come as OCR advances the SEC's mission through the dedicated oversight of NRSROs in the coming years. I hope you find the Report interesting and informative.

Ahmed Abonamah

II. INTRODUCTION

The Staff of the Commission provides this Report regarding NRSROs pursuant to Section 6 of the Credit Rating Agency Reform Act of 2006 (Rating Agency Act)[1] and Section 15E(p)(3)(C) of the Securities Exchange Act of 1934 (Exchange Act).[2] This Report generally focuses on the period from January 1, 2021 to December 31, 2021 (the Report Period).[3]

Section 6 of the Rating Agency Act requires the Commission to submit an annual report to the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate and the Committee on Financial Services of the U.S. House of Representatives that, with respect to the year to which the report relates:

- Identifies applicants for registration as NRSROs under Section 15E;
- Specifies the number of, and actions taken on, such applications; and
- Specifies the views of the Commission on the state of competition, transparency, and conflicts of interest among NRSROs.

Section 15E(p)(3)(C) requires the Commission to make available to the public an annual report summarizing:

- Essential findings of all Section 15E examinations, as deemed appropriate by the Commission;
- NRSROs' responses to any material regulatory deficiencies identified by the Commission; and
- Whether the NRSROs have appropriately addressed the recommendations of the Commission contained in previous annual reports on examinations.

This Report addresses the items specified in Section 6 of the Rating Agency Act and Section 15E(p)(3). This is a report of the Staff and, as such, reflects solely the Staff's views.

1 Pub. L. No. 109-291, 120 Stat. 1327 (Sept. 29, 2006).

2 Unless otherwise noted, all Section and Rule references in this report are to the Exchange Act and rules under the Exchange Act.

3 The Annual Report and the Summary Examination Report covered different time periods. In order to align the time periods, Sections II.A and IV. of this Report include information about applications for registration as NRSROs and views of the Commission on the state of competition, transparency, and conflicts of interest among NRSROs from June 26, 2020 through December 31, 2021 (the December 2020 Annual Report reported this information through June 25, 2020). Section V of this Report includes information about activities relating to NRSROs from December 1, 2020 through December 31, 2021 (the December 2020 Annual Report included this information through November 30, 2020).

Information regarding the topics covered in this Report with respect to prior periods can be found on the OCR page of the Commission's website.[4]

Information regarding the registration and oversight program for credit rating agencies that are registered with the Commission as NRSROs can be found in Section VI. of this Report.

A. STATUS OF REGISTRANTS AND APPLICANTS

In 2007, the Commission began granting registrations to credit rating agencies that applied to be registered as an NRSRO. Section 3(a)(62) defines a "nationally recognized statistical rating organization" as a credit rating agency that is registered under Section 15E and issues credit ratings certified by qualified institutional buyers, in accordance with Section 15E(a)(1)(B)(ix), with respect to:

(i) Financial institutions, brokers, or dealers;
(ii) Insurance companies;
(iii) Corporate issuers;
(iv) Issuers of asset-backed securities (as that term is defined in 17 CFR 229.1101(c));
(v) Issuers of government securities, municipal securities, or securities issued by a foreign government; or
(vi) A combination of one or more categories of obligors described in any of clauses (i) through (v) above.[5]

As of December 31, 2021, there were nine credit rating agencies registered as NRSROs.[6] Chart 1 below lists each NRSRO registered with the Commission, the categories of credit ratings described in clauses (i) through (v) of Section 3(a)(62)(A) in which each NRSRO is registered, and the location of each NRSRO's principal office.[7]

4 The prior annual reports pursuant to Section 6 of the Rating Agency Act, through December 2020, can be found under "Annual Reports to Congress" in the "Reports and Studies" section of the OCR webpage, available at https://www.sec.gov/ocr/ocr-reports-and-studies.html. Separately, the prior summary reports of the Staff's examinations of NRSROs pursuant to Section 15E(p)(3), through December 2020, can be found under "Summary Examination Reports" in the "Reports and Studies" section of the OCR webpage, available at https://www.sec.gov/ocr/ocr-reports-and-studies.html.

5 Section 3(a)(62)(A).

6 Section 15E(a) sets out registration procedures for a credit rating agency to voluntarily apply to be registered with the Commission as an NRSRO.

7 *See* each NRSRO's current Form NRSRO for any updates to this information. Each NRSRO must file with the Commission on EDGAR a Form NRSRO for annual certification and registration updates pursuant to Rule 17g-1(e) and (1)(f), and each NRSRO must make its current Form NRSRO publicly and freely available on its website pursuant to Rule 17g-1(i). Form NRSRO filings are available on the EDGAR system at https://www.sec.gov/edgar/searchedgar/companysearch.html. Links to each NRSRO's website can be found under the "Current NRSROs" section of the OCR webpage, available at https://www.sec.gov/ocr/ocr-current-nrsros.html.

Chart 1. Table of NRSROs

NRSRO	Categories of Credit Ratings	Principal Office
A.M. Best Rating Services, Inc. (AMB)	(ii), (iii), and (iv)	U.S.
DBRS, Inc. (DBRS)	(i) through (v)	U.S.
Egan-Jones Ratings Company (EJR)	(i) through (iii)	U.S.
Fitch Ratings, Inc. (Fitch)	(i) through (v)	U.S.
HR Ratings de México, S.A. de C.V. (HR)	(i), (iii), and (v)	Mexico
Japan Credit Rating Agency, Ltd. (JCR)	(i), (ii), (iii), and (v)	Japan
Kroll Bond Rating Agency, Inc. (KBRA)	(i) through (v)	U.S.
Moody's Investors Service, Inc. (MIS)	(i) through (v)	U.S.
S&P Global Ratings (S&P)	(i) through (v)	U.S.

For purposes of this Report only, we refer to Fitch, MIS, and S&P as "large NRSROs"; AMB, DBRS, and KBRA as "medium NRSROs"; and EJR, HR, and JCR as "small NRSROs" based on revenue.[8]

Applications for initial registration by a credit rating agency and for registration by a current NRSRO in additional rating categories are filed on Form NRSRO.[9] A credit rating agency may choose not to apply for registration as an NRSRO, in which case it may issue credit ratings as a credit rating agency but it may not issue credit ratings as an NRSRO.[10] In addition, a credit rating agency may choose to apply for registration as an NRSRO in one or more rating categories.[11] As noted in Chart 1 above, certain NRSROs are registered in all of the rating categories and certain NRSROs are registered in fewer than all of the rating categories.

No applications for initial registration as an NRSRO or for registration by a current NRSRO in additional rating categories were filed with the Commission in the Report Period.

8 OCR's prior reports categorized the NRSROs in two groups: the "larger NRSROs" (Fitch, MIS, and S&P) and the "smaller NRSROs" (AMB, DBRS, EJR, HR, JCR, and KBRA). Beginning with this Report, we have re-categorized the NRSROs into three groups based on revenue as reported on each NRSRO's most recently filed Rule 17g-3(a)(3) financial report.

9 *See* Section 15E(a) and Rule 17g-1; *see also* Form NRSRO, available at https://www.sec.gov/about/forms/formnrsro.pdf. In addition, Section 15E(b) requires NRSROs to promptly amend Form NRSRO if any information or document provided therein becomes materially inaccurate.

10 Section 3(a)(60) defines the term "credit rating," Section 3(a)(61) defines the term "credit rating agency," and Section 3(a)(62) defines the term "nationally recognized statistical rating organization." For additional information about credit ratings, *see* Updated Investor Bulletin: The ABCs of Credit Ratings (Oct. 12, 2017), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_creditratings.

11 *See* Section 3(a)(62)(A)(i) – (vi).

III. EXAMINATIONS AND MONITORING

A. OVERVIEW

Generally, the purpose of NRSRO examinations is to promote compliance with applicable federal securities laws and rules by identifying potential instances of non-compliance of NRSROs with their statutory and regulatory obligations and encouraging remedial action. Examinations also inform the Commission and the NRSROs' compliance personnel of regulatory obligations and noteworthy industry developments.

To facilitate and promote compliance by NRSROs with their statutory and regulatory obligations, the Staff sends each NRSRO an examination summary letter that discusses its findings related to that NRSRO and recommends remedial measures. When appropriate, the Staff may refer findings to the Commission's Division of Enforcement for investigation.

Section 15E(p)(3)(B) provides that each NRSRO examination shall include a review of the following eight topic areas (Section 15E Review Areas):

- Whether the NRSRO conducts business in accordance with its policies, procedures, and rating methodologies;
- Management of conflicts of interest by the NRSRO;
- Implementation of ethics policies by the NRSRO;
- Internal supervisory controls of the NRSRO;
- Governance of the NRSRO;
- Activities of the Designated Compliance Officer (DCO) of the NRSRO;
- Processing of complaints by the NRSRO; and
- Policies of the NRSRO governing the post-employment activities of its former staff.

B. RISK ASSESSMENT

The 2021 Section 15E examinations encompassed all of the statutorily required Section 15E Review Areas. Within each of the Section 15E Review Areas, the Staff determined areas of emphasis and issues of focus for each NRSRO based upon an NRSRO-specific risk assessment performed by the Staff, while also considering how to limit the amount of personal data collected in the examination process. The NRSRO-specific risk assessments considered a number of factors, including, but not limited to:

- NRSROs' rating activities and operations;
- Staff's findings, recommendations, and other observations from prior examinations;
- Impact of a potential or actual internal control or compliance failure by the NRSRO;
- Recent industry developments affecting NRSROs and the asset classes in which the NRSRO is registered;
- NRSROs' filings with the Commission and public disclosures;

- NRSROs' self-identified weaknesses; and
- Relevant Tips, Complaints, and Referrals (TCRs) received by the Commission.

The 2021 Section 15E examinations also focused on certain subjects and activities that the Staff, through its risk assessment process, identified as relevant to certain NRSROs, as summarized below.

- **ESG Factors and Products:** NRSROs and their affiliates have developed and are offering an increasing number of ESG-related products and services.[12] Development in the area has grown rapidly, and competition has increased among NRSRO and non-NRSRO providers, leading the Staff to identify several areas of potential risk to NRSROs. These include the risks that, in incorporating ESG factors into ratings determinations, NRSROs may not adhere to their methodologies or policies and procedures, consistently apply ESG factors, make adequate disclosure regarding the use of ESG factors applied in rating actions, or maintain effective internal controls involving the use in ratings of ESG-related data from affiliates or unaffiliated third parties. The Staff also identified the potential risk for conflicts of interest if an NRSRO offers ratings and non-ratings ESG products and services.
- **COVID-19 Related Risk Areas:** COVID-19 caused a sudden economic shock that led to NRSROs downgrading certain ratings, changing their macroeconomic forecasts and assumptions, and revising some methodologies. The Staff identified as potential risks whether the NRSROs have sufficient controls in place to ensure that changes to assumptions and inputs are applied and disclosed in ratings determinations, and whether data collected by NRSROs during the pre-COVID period and used in ratings determinations was adjusted to reflect how assets will perform in a COVID-affected economy. The Staff noted that such risks could have a heightened effect on the assignment and surveillance of ratings in particular sectors.
- **CLOs:** Qualitative adjustments may be made during the rating process for certain CLOs. The Staff identified a potential risk that NRSROs may not adhere to their policies, procedures, and methodologies in making such adjustments, as well as the risk that the practice could lead to inconsistent use of ratings symbols.
- **Commercial Real Estate:** Commercial real estate assets experienced a period of economic distress that could have an effect on credit ratings associated with such properties. The Staff identified a potential risk that NRSROs may not adhere to their policies and procedures regarding surveillance of such ratings, or to their methodologies with respect to the use of data associated with determining cash flows from the underlying properties and property valuations.

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12 Some NRSROs offer ESG products and services separate from their credit ratings, and corporate affiliates of NRSROs, which are entirely separate from the NRSROs, may also offer ESG products and services. Examples of such ESG products and services include: evaluations of the environmental benefits of a project financed with the proceeds of a "green" bond issuance; ESG scores based on the expected impact of ESG factors on a company's growth, profitability, capital efficiency, and risk exposure; and assessments of a company's risk from climate-related scenarios. These products and services are not credit ratings and are therefore not directly regulated by OCR.

- **Consumer Asset-Backed Securities:** The COVID-19 economic shock reduced consumer incomes resulting in potential impact to ratings on consumer asset-backed securities. The Staff identified potential risks to credit ratings with regard to repayment challenges, a lack of standardization with regard to servicers, reporting standards and treatment of forbearances, deferrals, and extensions, and the absence of standardized definitions of default in the sector, if NRSROs did not adhere to their relevant policies, procedures, and methodologies.
- **Low-Investment Grade-Rated Corporates:** The proportion of U.S. corporate debt rated in the BBB category increased over several years, reaching a historically high level in 2020. The Staff identified a risk posed to credit ratings if NRSROs did not adhere to their relevant surveillance practices, policies, procedures, and methodologies regarding such debt.
- **Municipal Securities:** An NRSRO did not make a timely discovery of incorrect information it received regarding when securities had been paid off and also failed to identify existing rating errors where a rating had gone through the surveillance process. The Staff identified as a potential risk, particularly for NRSROs with a large volume of municipal ratings, that such NRSROs may lack adequate controls for detecting rating errors or may not adhere to policies and procedures used to determine when municipal ratings should be withdrawn.

The foregoing were incorporated into the Section 15E examinations as appropriate for each NRSRO.

C. MONITORING

To help inform its risk assessment process and exam program, the Staff also actively monitored credit rating activity and industry developments during the Report Period, especially in connection with capital market and economic events and trends, such as ESG, COVID-19, cybersecurity, and digital assets. The Staff communicated with NRSROs and market participants, and reviewed NRSRO publications, news reports, trade publications, academic papers, and government reports, among other information sources.

The Staff's monitoring efforts included, for example, discussions that covered the scope and nature of rating actions for which NRSROs cited the impact of COVID-19 and resulting business shutdowns as material credit considerations and how NRSROs incorporated ESG considerations into credit ratings and communicated such considerations to the market. Monitoring also covered NRSRO considerations of distributed ledger technologies, digital assets, and smart contracts in credit ratings[13] and NRSRO perspectives on cyber risk management and the vulnerability to and financial impact of cyber attacks.

13 OCR continues to monitor these developing areas and has observed limited NRSRO ratings activity. For example, in early 2020, DBRS rated debt securities issued on a blockchain, noting that the structuring consultant intends to issue security tokens to all investors and record the transaction on the Ethereum blockchain. *See* Press Release: DBRS Morningstar Finalizes Provisional Ratings on FAT Brands Royalty I, LLC (Mar. 9, 2020), available at https://www.dbrsmorningstar.com/research/357772/dbrs-morningstar-finalizes-provisional-ratings-on-fat-brands-royalty-i-llc.

The Staff also monitored other industry events during the Report Period, including, for example, the NRSRO response to Archegos Capital Management,[14] the NRSRO approach to rating companies emerging from special purpose acquisition company (SPAC) transactions,[15] and the NRSRO response to financial stress experienced by Chinese property and development companies.[16] Monitoring also covered NRSRO projections for inflation, perceptions of its causes, and views as to the potential credit impacts on entities and transactions across different market sectors.

D. 2021 SECTION 15E(p)(3) EXAMINATIONS

1. 2021 Section 15E Examinations

The 2021 Section 15E examinations generally focused on the NRSROs' activities for the period covering January 1, 2020 through December 31, 2020 (the Review Period). Examinations also reviewed certain activities or credit rating actions from outside the Review Period.[17]

The 2021 Section 15E examinations reviewed the Section 15E Review Areas and examined each NRSRO's adherence to Section 15E and Rules 17g-1 through 17g-10. For example, the Staff reviewed a sample of rating actions of each NRSRO in certain asset classes for which it is registered and for certain issuers and obligors to determine whether the NRSRO operated in accordance with its policies, procedures, and rating methodologies. The Staff also reviewed rating files and documentation to evaluate whether each NRSRO adhered to recordkeeping requirements.[18]

During the Review Period, the Staff also continued to participate in meetings that involved rating agency regulators globally, including those of the supervisory colleges that were formed for the largest internationally active credit rating agencies. The supervisory colleges were formed to enhance communication among credit rating agency regulators globally with respect to examinations of the relevant credit rating agencies.[19] During the Review Period, each college conducted periodic

14 *See e.g.*, Fitch, Archegos Fallout Signals Heightened Counterparty, Regulatory Risk, available at https://www.fitchratings.com/research/banks/archegos-fallout-signals-heightened-counterparty-regulatory-risk-01-04-2021.

15 *See e.g.*, S&P, Credit FAQ: SPACs and Credit Quality: S&P Global Ratings' Recent Ratings Experience, available at https://www.spglobal.com/ratings/en/research/articles/210312-credit-faq-spacs-and-credit-quality-s-p-global-ratings-recent-ratings-experience-11868991.

16 *See e.g.*, Moody's, Research Announcement: Chinese Property Developers' Liquidity Stress Will Continue Amid Tight Credit Conditions and Lowered Sales, available at https://www.moodys.com/research/Moodys-Chinese-property-developers-liquidity-stress-will-continue-amid-tight--PBC_1311317.

17 For example, the Staff may review information relating to TCRs in a current examination, even if the referenced activities occurred outside of the Review Period.

18 To select rating actions and rating files to review, the Staff used a risk-based sampling process that is consistent with its overall risk assessment approach described in this Report. The Staff also considered factors including, but not limited to, the size of the rated asset class in the financial markets and the NRSRO's business, the NRSRO's activity in the rated asset class, the likelihood of impact on investors if a rating was not determined in accordance with the NRSRO's methodologies and procedures, news reports and developments concerning the NRSROs or particular asset classes, TCRs, and information the Staff learned during examinations.

19 *See* IOSCO, Supervisory Colleges for Credit Rating Agencies, Final Report (July 2013), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD416.pdf. The SEC serves as chair of the colleges for S&P and MIS, and OCR Staff represents the SEC in this regard. The European Securities and Markets Authority serves as chair of the college for Fitch.

calls to discuss supervisory activities related to the credit rating agencies. The Staff also conducted additional discussions with international regulators, as appropriate.

2. Terms Used in This Report

Section 15E(p)(3)(C)(i)-(iii) requires this Report to contain a summary of, respectively, the essential findings of the annual examinations, as deemed appropriate by the Commission; the NRSROs' responses to any material regulatory deficiencies identified by the Commission; and whether the NRSROs have appropriately addressed the recommendations of the Commission contained in previous reports.[20]

For purposes of this Report, the Staff considers an "essential finding" to be any instance of apparent non-compliance by an NRSRO with the federal securities laws or related Commission rules applicable to NRSROs, except those instances attributable to a non-recurring and non-significant clerical or ministerial error or omission.

For purposes of this Report, the Staff considers "material regulatory deficiencies" to be essential findings that involve:

- Conduct or a deficiency that could undermine the quality of a credit rating or impair the objectivity of an NRSRO's credit rating process; or
- Conduct that may be inconsistent with the anti-fraud provisions of the federal securities laws.

The Staff's determination that an NRSRO appropriately addressed a recommendation does not constitute its endorsement of that NRSRO or its policies, procedures, internal controls, or operations. In a future examination, the Staff may reevaluate the NRSRO's response to recommendations that it previously deemed to be appropriately addressed by, for example, assessing whether the NRSRO fully implemented remedial measures and whether those remedial measures appear to be effective. The Staff may also review and make recommendations concerning the NRSRO's policies, procedures, internal controls, or operations related to the general subject matter of a recommendation that it previously deemed to be appropriately addressed. The determination of whether an NRSRO appropriately addressed a recommendation reflects solely the Staff's view and does not necessarily reflect the views of the Commission.

The Staff's assessment of whether an NRSRO has appropriately addressed a recommendation depends on the specific facts and circumstances, including, but not limited to, the promptness of the NRSRO's response, the severity of the conduct at issue, and whether the remedial action undertaken by the NRSRO is expected to fully resolve the Staff's concerns.

20 In this Report, essential findings are organized by NRSRO within the applicable large, medium, and small groups. This Report uses the phrases "significant," "numerous," "several," and "some" to describe and distinguish the frequency of conduct or instances underlying certain essential findings. The particular phrase used generally reflects the number of instances during the Review Period, recognizing that the number of instances may be reflective of a test sample and not necessarily an NRSRO's comprehensive activities during the Review Period.

3. Summary of Essential Findings and Responses to Material Regulatory Deficiencies

a. Large NRSRO #1

(1) The NRSRO did not report an allegation of fraud and therefore did not appear to comply with Section 15E(u) or the NRSRO's policies and procedures. The NRSRO issued a credit rating on a bond after the underwriter for the bond communicated to an analyst of the NRSRO an allegation of potential fraud relating to the authenticity of a letter of credit upon which such credit rating was based. The Staff also noted that the NRSRO did not withdraw the credit rating for some months during which the NRSRO had knowledge of a potential fraud. The Staff recommended that the NRSRO adhere to its policies and procedures to ensure that it fulfils its obligations under Section 15E(u).

The Staff identified such essential finding as a material regulatory deficiency.

The NRSRO stated in its response that, while the analyst inquired of the underwriter and its counsel, the analyst did not report the matter because communication with the underwriter led him to believe that the matter was under review by the bank that provided the letter of credit. The NRSRO also stated that the failure of the transaction to close was not itself indicative of fraud because transactions can fail to close for other reasons. The NRSRO agreed that the allegation should have been reported to the compliance department, and the NRSRO conducted an internal investigation, resulting in discipline of the analyst. Furthermore, the NRSRO issued a communication to all employees regarding their obligations to internally report allegations that may implicate the NRSRO's obligations under Section 15E(u), encouraging them to consult with a compliance officer if they have any doubt as to whether a particular matter should be reported.

(2) The NRSRO did not appear to preserve certain documents in the manner that the NRSRO's policies and procedures require, and the NRSRO did not promptly produce complete copies of records required to be retained in accordance with Rule 17g-2(b)(2). The NRSRO also did not timely provide to the Staff other documents in accordance with Rule 17g-2(f). The Staff recommended that the NRSRO ensure that it includes all relevant documents in its productions and retains required records in a way that enables it to promptly furnish complete copies of such records in response to requests from the Staff.

(3) The NRSRO did not appear to evaluate and record all potential complaints in the manner that its policies and procedures required. The NRSRO also did not document its conclusion with respect to handling a complaint, contrary to the NRSRO's policies and procedures. The Staff recommended that the NRSRO ensure that all complaints are subject to its policies and procedures for the receipt, retention, and treatment of complaints.

b. Large NRSRO #2

(1) The NRSRO did not appear to comply with Rule 17g-7(a) disclosure requirements when taking a significant number of rating actions. As a result of a coding error that the NRSRO identified in its systems, the NRSRO did not

timely publish information disclosure forms for a significant number of surveillance rating actions during some years. The Staff recommended that the NRSRO ensure compliance with Rule 17g-7(a) disclosure requirements.

(2) The NRSRO did not appear to enforce its policies and procedures as required by Section 15E(h)(4)(A) and (5)(A). The NRSRO produced to the Staff a report that identified a number of instances where the NRSRO did not appear to comply with its policies and procedures related to statutorily-mandated post-employment requirements. Among other things, such report indicated that the NRSRO did not submit certain Employment Transition Reports to the Commission. The Staff recommended that the NRSRO enforce its policies and procedures related to post-employment requirements.

c. Large NRSRO #3

(1) The NRSRO made clarifying changes to a draft rating report for an issuer's credit rating after receiving comments from the issuer, and such changes did not appear to be approved in the manner required by the NRSRO's policies and procedures. The Staff recommended that the NRSRO ensure that it adheres to its policies and procedures for documentation evidencing approval of changes to a rating report requested by an issuer.

(2) The NRSRO did not appear to have effective internal controls pursuant to Section 15E(c)(3)(A) to ensure that it does not inadvertently withdraw certain active credit ratings. Specifically, the NRSRO reported two instances in which it inadvertently withdrew from its website a significant number of credit ratings for active securities. Such instances were based on the NRSRO incorrectly processing third party data. The Staff recommended that the NRSRO establish effective internal controls to ensure that it does not inadvertently withdraw certain active credit ratings.

d. Medium NRSRO #1

(1) The NRSRO issued and maintained some credit ratings that appeared to be prohibited by Rule 17g-5(c)(2). Contrary to the NRSRO's policies and procedures, certain NRSRO employees held restricted securities in a managed account and the NRSRO's compliance department did not routinely perform post-trade reviews of brokerage statements for managed accounts. On some occasions, an analyst participated in a rating committee while holding securities of the rated entity in a managed account. The Staff recommended that the NRSRO establish, maintain, and enforce written policies and procedures reasonably designed to address and manage conflicts of interest with respect to securities held in employees' managed accounts.

The Staff identified such essential finding as a material regulatory deficiency.

In its response, the NRSRO stated that it has commenced an action plan designed to strengthen relevant systems, practices, policies, resources, and personnel. The action plan includes, among other things: (i) changes to the organizational design and staffing of a relevant team; (ii) selection and deployment of a new system used to monitor and enforce compliance with applicable procedures; (iii) an organizational initiative led by senior management to foster adherence to policies and procedures;

(iv) a review, led by counsel, of (and appropriate enhancements to) policies, procedures and practices focused on avoidance or management of actual, potential or perceived conflicts of interest relating to the issuance of credit ratings; (v) improvements to certain compliance reporting to senior management; and (vi) outreach by compliance to analytical personnel regarding their responsibilities and obligations under applicable policies and procedures, with a particular focus on securities held in managed accounts. The NRSRO has completed some measures of such action plan, and others are still on-going. The NRSRO will continue assessing the robustness of its action plan and may implement additional measures.

(2) The NRSRO did not appear to enforce its policies and procedures in some instances as Section 15E(g)(1) requires, by granting access to certain information without required approval, mistakenly sending certain information intended for one recipient to numerous recipients, and not taking reasonable steps to protect confidential information from inadvertent disclosure. The Staff recommended that the NRSRO enforce its policies and procedures with respect to the protection of material non-public information.

(3) The NRSRO did not appear to follow Section 15E(b)(2), Rule 17g-1(f), and the Form NRSRO Instructions when filing certain information with the Commission. The NRSRO filed with the Commission some Form NRSRO Exhibits that included incomplete transition/default matrices, incomplete and potentially inaccurate identifications of conflicts of interest relating to the issuance of credit ratings, and incomplete information about the NRSRO's DCO. The Staff recommended that the NRSRO ensure that all Form NRSRO filings adhere to the Form NRSRO Instructions and the required information is accurate and complete.

e. Medium NRSRO #2

(1) The NRSRO did not appear to adhere to Rule 17g-7(a)(1)(iii) when publishing Rule 17g-7(a) information disclosure forms. Such forms did not contain an attestation that was signed as the rule requires. In addition, the attestation provided was inconsistent with the requirements of the rule. The Staff recommended that the NRSRO ensure that a person with responsibility for the rating action signs the information disclosure forms and attests to the statements contained therein and that all such statements are consistent with the requirements of Rule 17g-7(a)(1)(iii).

(2) The NRSRO did not appear to make certain disclosures that Rule 17g-7(a)(1)(ii)(B) requires relating to the version of the NRSRO's rating methodology used for certain rating actions. The Staff recommended that the NRSRO ensure that it discloses in information disclosure forms the version of the methodology used to determine credit ratings.

(3) The NRSRO did not appear to comply with Rule 17g-7(a)(1)(ii)(L)(1) for certain credit ratings. Specifically, the NRSRO's information disclosure form for certain rating actions did not include applicable information related to the historical performance of the relevant credit

rating. The Staff recommended that the NRSRO ensure that its information disclosure forms for all rating actions contain the information that Rule 17g-7(a)(1)(ii)(L)(1) requires.

(4) The NRSRO did not appear to provide a required disclosure about the conflict of interest described in Rule 17g-5(b)(6) in Exhibit 6 of Form NRSRO, given that the NRSRO's policies and procedures allowed employees, in certain circumstances, to own securities of issuers or obligors subject to a credit rating determined by the NRSRO. Also, the NRSRO recorded that during the Review Period, eight employees held or purchased restricted securities contrary to such policies and procedures. The Staff recommended that the NRSRO disclose conflicts of interest related to securities ownership by its employees, as the Instructions to Form NRSRO require, and establish, maintain, and enforce written policies and procedures designed to address and manage conflicts of interest.

(5) The NRSRO's policies and procedures did not appear to be reasonably designed to ensure that it will promptly publish the notice of the existence of a significant error as Rule 17g-8(a)(4)(ii) requires. The NRSRO's policies and procedures required the NRSRO to publish notice of the existence of a significant error identified in a procedure or methodology only after the development and approval of a revised procedure or methodology. Application of these policies and procedures is likely to delay publication of such notice. The Staff recommended that the NRSRO establish, maintain, enforce, and document policies and procedures reasonably designed to ensure that it promptly publishes notice of the existence of a significant error as Rule 17g-8(a)(4)(ii) requires.

f. Medium NRSRO #3

(1) The NRSRO did not appear to adhere to Rule 17g-7(a)(1)(iii) when publishing Rule 17g-7(a) information disclosure forms. Such forms contained an attestation that was inconsistent with the requirements of the rule. The Staff recommended that the NRSRO ensure the attestation statement in information disclosure forms is consistent with Rule 17g-7(a)(1)(iii) text.

(2) The NRSRO did not appear to enforce its policies and procedures with regard to publishing on an easily accessible portion of its website information relating to material changes to methodologies, as Rule 17g-8(a)(4)(i) requires. The NRSRO's reason for certain material changes to methodologies and disclosure about the likelihood those changes will result in changes to any current credit ratings were not easily accessible on the NRSRO's website, as its policies and procedures require. The Staff recommended that the NRSRO ensure that it promptly publishes on an easily accessible portion of its website material changes to methodologies, the reason for the changes, and the likelihood the changes will result in changes to current credit ratings.

(3) The NRSRO did not withdraw credit ratings on certain matured bonds that the NRSRO stated it should have withdrawn and, accordingly, it did not appear that the NRSRO maintained effective internal supervisory controls as

required by Section 15E(c)(3)(A). The Staff recommended that the NRSRO enhance its internal controls to ensure that credit ratings on bonds that have matured are promptly detected and withdrawn.

(4) The NRSRO's policies and procedures regarding complaints by employees did not appear to adequately address all of the requirements of Section 15E(j)(3). Specifically, such policies and procedures did not address complaints from employees regarding credit ratings, models, and methodologies and did not address employee complaints about the NRSRO or certain other third parties. The Staff recommended that the NRSRO establish procedures for the receipt, retention, and treatment of complaints to adequately address the requirements of Section 15E(j)(3) for complaints from employees.

g. Small NRSRO #1

(1) The NRSRO did not appear to have reasonably designed procedures to ensure accurate, reliable, and consistent revenue information to effectively monitor and prevent the occurrence of the conflict of interest identified in Rule 17g-5(c)(1). The Staff recommended that the NRSRO establish, maintain, and enforce written policies and procedures, including policies and procedures regarding the recognition of revenue in accordance with applicable accounting standards, reasonably designed to ensure that the NRSRO does not issue or maintain credit ratings subject to the prohibited conflict of interest specified in Rule 17g-5(c)(1).

The Staff identified such essential finding as a material regulatory deficiency.

In its response, the NRSRO stated that it is drafting a new policy and procedure to address the finding and recommendation in accordance with applicable standards relating to revenue from customer contracts. The NRSRO further stated that the new policy and procedure will provide requirements to ensure that revenue is recognized according to the new policy and procedure and will also include provisions addressing treatment for Rule 17g-5(c)(1) purposes where a client is billed in separate years. The NRSRO represented that it will begin complying with the new policy and procedure by January 1, 2022.

(2) The NRSRO published information disclosure forms that did not appear to comply with Rule 17g-7(a)(1)(ii)(J)(1), (K), and (M). Specifically, several such forms did not include required disclosures regarding the source of payment for the credit rating, the potential volatility of the credit rating, and the sensitivity of the credit rating to assumptions made by the NRSRO. The Staff recommended that the NRSRO ensure that its information disclosure forms contain all the disclosures that Rule 17g-7(a)(1)(ii) requires.

(3) The NRSRO's policies and procedures did not appear to be reasonably designed pursuant to Section 15E(h)(1) to prevent the occurrence of the prohibited conflict of interest in Rule 17g-5(c)(7). The NRSRO's policies and procedures allowed employees to receive gifts with a specified limited dollar amount, but did not limit such gifts to items provided in the context of normal business activities such as meetings. The Staff recommended that the NRSRO establish, maintain, and enforce written policies

and procedures reasonably designed to ensure that it does not issue or maintain credit ratings subject to the prohibited conflict of interest specified in Rule 17g-5(c)(7).

(4) The NRSRO appeared to misrepresent the effect of its registration as an NRSRO in certain rating reports. The NRSRO made a statement in several reports accompanying a non-credit rating product that appeared to misrepresent the effect of the NRSRO's registration as an NRSRO and could lead recipients of the reports to mistakenly conclude that such product is an NRSRO rating. The Staff also noted that certain templates for reports and letters of the NRSRO potentially could result in misrepresentations or false statements in the future. The Staff recommended that the NRSRO revise its templates for reports and letters so that they do not contain any statements about its registration with the SEC as an NRSRO that are incorrect or misleading or that misrepresent the effect of such registration.

(5) The NRSRO's policies and procedures for the receipt, retention, and treatment of complaints appeared to improperly exclude certain complaints. The Staff recommended that the NRSRO revise its policies and procedures for the receipt, retention, and treatment of complaints to ensure that they cover all complaints contemplated under Section 15E(j)(3).

(6) The NRSRO's policies and procedures did not appear to require the disclosure of the information that Rule 17g-7(a)(1)(ii)(J)(3)(i) and (J)(3)(ii) require for rating revisions and affirmations, respectively, resulting from a look-back review. The Staff recommended that the NRSRO establish, maintain, and enforce policies and procedures that are reasonably designed to ensure that the information required by Rule 17g-7(a)(1)(ii)(J)(3) is included with the publication of a revised credit rating or affirmation following a look-back review that determines that a conflict of interest had influenced the rating.

h. Small NRSRO #2

(1) The NRSRO did not appear to adhere to Rule 17g-7(a) and its policies and procedures with regard to the publication of an information disclosure form for a credit rating withdrawal. Such policies and procedures did not appear to accurately reflect the Rule 17g-7(a) disclosure requirements, and the NRSRO did not publish a required information disclosure form for the withdrawal. Also, the NRSRO did not appear to generate a certain report as the NRSRO's policies and procedures require. The Staff recommended that the NRSRO ensure it adheres to its policies and procedures, and all applicable requirements under Rule 17g-7(a), when it withdraws a credit rating.

(2) The NRSRO did not appear to have effective internal controls pursuant to Section 15E(c)(3)(A) governing surveillance of certain ratings and did not appear to adhere to the applicable methodology. Specifically, the NRSRO did not perform surveillance of a credit rating in accordance with the enumerated time period in the NRSRO's methodology. Also, such methodology did not clearly indicate how frequently the NRSRO must conduct surveillance on such rating. The Staff recommended that the NRSRO

enhance its internal controls with respect to its policies and procedures governing surveillance of certain credit ratings. The Staff also recommended that the NRSRO ensure that it adheres to the applicable methodology.

(3) The NRSRO did not appear to have effective internal controls pursuant to Section 15E(c)(3)(A) governing the review and testing of its credit rating models. Specifically, the NRSRO used a model in determining credit ratings which contained data that was not consistent with the NRSRO's policies and procedures. Such model also contained errors with one or more formula references. The Staff recommended that the NRSRO enhance its internal controls governing the review and testing of its credit rating models.

i. Small NRSRO #3

(1) The NRSRO did not appear to have effective internal controls pursuant to Section 15E(c)(3)(A) with respect to credit ratings that are linked to other credit rating actions. Specifically, the NRSRO took a rating action on an outstanding credit rating without taking appropriate action with respect to a linked credit rating, and the NRSRO did not have an effective internal control at the relevant time to ensure that the NRSRO takes such action. The Staff recommended that the NRSRO establish, maintain, enforce, and document effective internal controls to ensure that it correctly issues and maintains credit ratings that are linked to other credit rating actions.

4. Responses to Recommendations from the 2020 Section 15E Examinations

To assess whether NRSROs appropriately addressed findings from the 2020 Section 15E examinations, the Staff reviewed each NRSRO's written response describing its planned remedial measures, and participated in calls with each NRSRO to discuss its written response.

During the 2021 Section 15E examinations, the Staff assessed each NRSRO's progress in implementing remedial measures such as establishing new or enhancing existing policies or procedures or internal controls, or adding personnel and other resources in areas such as compliance, information technology, or analytics. The Staff takes into account that NRSROs may not be able to fully implement remedial measures and the Staff may not be able to fully assess the effectiveness of these measures during the 2021 examination.

The Staff has determined all findings from the 2020 Section 15E examinations have been appropriately addressed, except in one instance. In such instance, the Staff issued a finding relating to a small NRSRO's revenue recognition practices related to the NRSRO's obligations under Rule 17g-5(c)(1) and recommended that the NRSRO establish, maintain, and enforce policies and procedures that are reasonably designed to ensure that it does not issue or maintain ratings subject to the Rule 17g-5(c)(1) prohibited conflict of interest. However, as discussed further in Section III.C.3(g), the Staff observed in the 2021 examination that, despite efforts to address the previous finding, the NRSRO did not appear to have reasonably designed procedures to ensure accurate, reliable, and consistent revenue information to effectively monitor and prevent the occurrence of the conflict of interest identified in Rule 17g-5(c)(1). Except for such instance, NRSROs generally addressed 2020 recommendations by taking remedial measures such as adopting new or enhancing existing policies or procedures, internal controls, or systems and processes, and by adding personnel and other resources.

5. Essential Findings Trends

Chart 2 depicts the percentage of essential findings by Section 15E Review Area for all NRSROs from the Section 15E examinations conducted from 2016 to 2021. Of the 487 total essential findings arising from the Section 15E examinations conducted from 2016 to 2021, internal supervisory controls, adherence, and conflicts of interest were the top Section 15E Review Areas, accounting for 42.3%, 30.6%, and 11.5%, respectively, of all essential findings.

The other five Section 15E Review Areas each accounted for less than 5% of the total essential findings from 2016 to 2021. Certain essential findings may relate to more than one Section 15E Review Area but are categorized in only one category for counting purposes. For example, the Staff did not make any essential findings based solely on an NRSRO's implementation of ethics policies and procedures, as such essential findings were accounted for in other Section 15E Review Areas. OCR continues to review all eight statutorily mandated review areas as required by Section 15E, described in Section III.A.

Chart 2. Essential Findings by Section 15E Review Area: 2016 to 2021

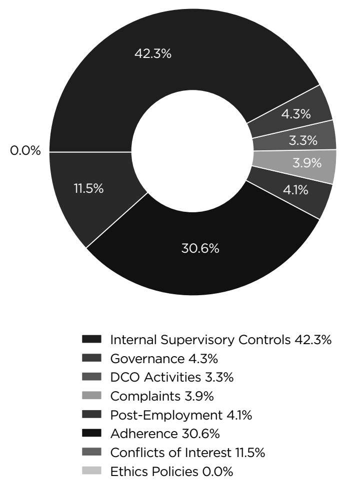
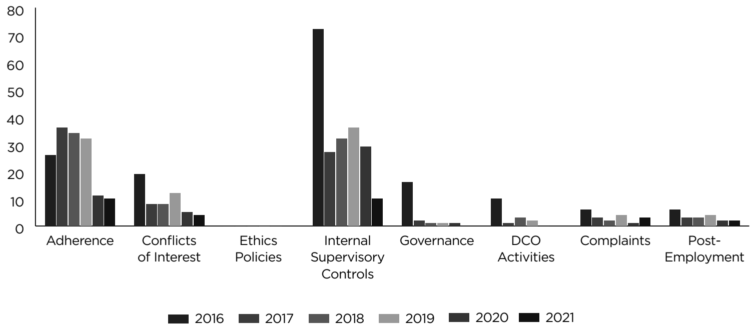


Chart 3 shows the number of essential findings by Section 15E Review Area from the Section 15E examinations conducted from 2016 to 2021. The number of essential findings from the 2016 examination cycle was higher in several review areas, which was likely related to the new and amended rules that became effective in 2015.[21] Essential findings have generally decreased in subsequent exam cycles, which indicates the NRSROs' greater awareness of applicable laws and their obligations as regulated entities.

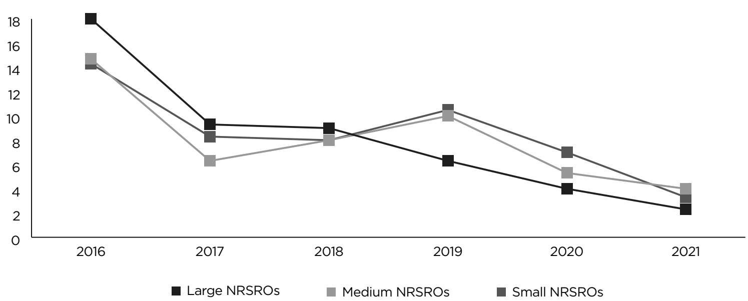
21 *See* note 21.

Chart 3. Number of Essential Findings by Section 15E Review Area: 2016 to 2021



From the Section 15E examinations conducted from 2016 to 2021, there were 147 essential findings for large NRSROs, 145 essential findings for medium NRSROs, and 195 essential findings for small NRSROs.[22] Chart 4 shows the average number of essential findings the large, medium, and small NRSROs for each examination cycle from 2016 to 2021. From 2016 to 2021, the large NRSROs had an average of 8.2 essential findings per exam cycle, the medium NRSROs had an average of 8.1 essential findings per exam cycle, and the small NRSROs had an average of 8.6 essential findings per exam cycle.

Chart 4. Average Number of Essential Findings by Large, Medium, and Small NRSROs: 2016 to 2021



22 The number of essential findings is based on the findings identified in prior summary reports of the Staff's examinations of NRSROs pursuant to Section 15E(p)(3). For purposes of this Section of the Report, MCR is considered a "small NRSRO" for the Section 15E examinations conducted in 2016, 2017, 2018, and 2019.

IV. STATE OF COMPETITION, TRANSPARENCY, AND CONFLICTS OF INTEREST

A. COMPETITION

1. Select NRSRO Statistics

Sections IV.A.1.a through 1.c below summarize and discuss certain information reported by NRSROs on Form NRSRO or pursuant to Rule 17g-3 that provides insight into the state of competition among NRSROs. While this information indicates that the large NRSROs continue to account for the highest percentages of outstanding ratings, the small and medium NRSROs continue to compete with the large NRSROs with each increasing its total number of ratings outstanding as compared to declines among two of the large NRSROs. The information also suggests that some medium NRSROs have gained ratings share in the asset-backed securities category. None of the small NRSROs is registered with the Commission in the asset-backed securities category.[23]

a. NRSRO Credit Ratings Outstanding

Each NRSRO annually reports not later than March 31st the number of credit ratings outstanding, as of the end of the preceding calendar year, in each rating category for which it is registered.[24] This information, for the calendar year ending December 31, 2020, is summarized in Charts 5 through 10 below and can be useful in determining the breadth of an NRSRO's coverage with respect to issuers, obligors, and securities or money market instruments within a particular rating category:

- Chart 5 depicts the number of credit ratings each NRSRO had outstanding in each rating category for which it was registered as of December 31, 2020.
- Chart 6 shows the percentage change of credit ratings outstanding from 2019 to 2020 for each NRSRO.

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23 *See* Chart 1. As discussed in Section IV.A.2 of this Report, information available on the websites of *Commercial Mortgage Alert* (https://www.greenstreet.com/news/library/commercial-mortgage-alert) and *Asset-Backed Alert* (https://www.greenstreet.com/news/library/asset-backed-alert) regarding NRSRO market shares in the asset-backed securities category indicates that some of the medium NRSROs have developed significant market shares in such rating category over the past few years. In addition, Section IV.A.2 of this Report provides examples of certain asset classes in which it has been reported that medium NRSROs have gained market share.

24 Annual certifications on Form NRSRO must be filed with the Commission on EDGAR pursuant to Rule 17g-1(f) and made publicly available without cost on each NRSRO's website pursuant to Rule 17g-1(i). The number of outstanding credit ratings for each rating category for which an NRSRO is registered is reported on Item 7A of Form NRSRO.

- Chart 7 illustrates the relative size of each rating category based on the aggregate number of ratings reported outstanding by all NRSROs.
- Chart 8 shows the percentage change of credit ratings outstanding from 2019 to 2020 for large NRSROs compared to small and medium NRSROs across all rating categories.
- Chart 9 depicts the percentage of ratings each NRSRO had outstanding across all rating categories other than the government securities category.
- Chart 10 depicts the percentage of ratings each NRSRO had outstanding in the government securities category.

While comparing the number of ratings *outstanding* among NRSROs (Chart 5) illustrates one dimension of the current state of competition, comparing the number of ratings *issued* by such NRSROs in a given period provides a more real-time picture of competition among NRSROs. For example, certain NRSROs (particularly the large NRSROs) have a longer history of issuing ratings and their ratings include those for debt obligations and obligors that were rated well before the establishment of the newer entrants.[25] Consequently, the information described in Section IV.A.2 of this Report (relating to recent market share developments in the asset-backed securities rating category), which provides information about ratings issued each year since 2019, may provide additional insight regarding competition among the NRSROs in the asset-backed securities rating category.

There are additional limitations to assessing the state of competition in each rating category and in the aggregate based on the number of outstanding ratings. For instance, some NRSROs have pursued business strategies to specialize in particular rating categories or sub-categories.[26] Also, the reported information does not reflect any credit ratings being issued by NRSROs in rating categories in which they are not registered with the Commission, nor does it reflect ratings issued by an affiliate of an NRSRO unless the affiliate is identified as a credit rating affiliate on Item 3 of Form NRSRO.

Further, when reporting its outstanding ratings, each NRSRO makes its own determination of the applicable rating category into which each of its ratings falls. The classification of ratings into the five rating categories is not necessarily consistent across NRSROs.[27]

25 The ratings counts disclosed on Item 7A of Form NRSRO include outstanding credit ratings, regardless of when they were issued. As a result, the ratings counts of the more established NRSROs may include credit ratings that were issued before the newer entrants began issuing credit ratings.

26 For example, AMB has traditionally focused on rating insurance companies and their affiliates.

27 Effective January 1, 2015, Item 7A of Form NRSRO and the corresponding Instructions were amended to clarify the manner in which the number of outstanding credit ratings should be calculated and presented. The clarifying amendments were designed to help ensure that disclosures on Item 7A of Form NRSRO are consistent across NRSROs. *See Nationally Recognized Statistical Rating Organizations*, Release No. 34-72936 (Aug. 27, 2014), 79 FR 55078, 55220-22 (Sept. 15, 2014) ("2014 Adopting Release"), available at https://www.govinfo.gov/content/pkg/FR-2014-09-15/pdf/2014-20890.pdf (discussing the clarifying amendments to Item 7A of Form NRSRO). It may be more difficult to draw rating comparisons to rating counts disclosed prior to January 1, 2015.

Chart 5 provides the number of outstanding credit ratings reported by each NRSRO in its annual certification for the calendar year ending December 31, 2020, in each of the five rating categories identified in Section 3(a)(62)(A) for which the NRSRO is registered, as applicable, as well as the percentage change in total ratings for each NRSRO from 2019 to 2020.

Chart 6 provides a visual representation of the year-over-year changes in each firm's percentage share of the aggregate number of NRSRO ratings outstanding from 2019 to 2020.

Chart 5. Number of Outstanding Credit Ratings as of December 31, 2020 by Rating Category

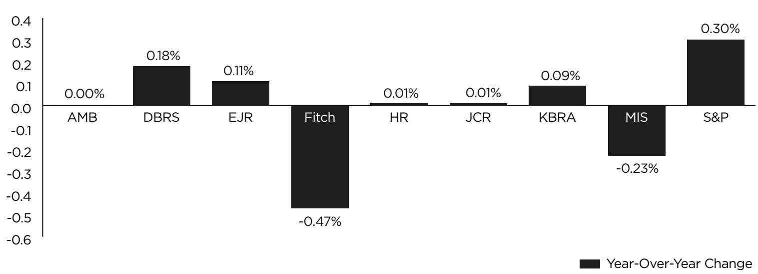
NRSRO	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government Securities	Total Ratings	Year-Over-Year Change in Total Ratings (2019 to 2020)
AMB	N/R	7,251	985	5	N/R	8,241	0.82%
DBRS	11,214	192	4,327	23,482	22,556	61,771	6.76%
EJR	10,119	975	9,339	N/R	N/R	20,433	13.81%
Fitch	33,440	3,198	20,318	34,108	177,665	268,729	-3.42%
HR	796	N/R	396	N/R	469	1,661	19.41%
JCR	950	86	2,971	N/R	348	4,355	4.61%
KBRA	1,326	132	224	14,470	141	16,293	13.52%
MIS	34,540	2,557	32,738	47,411	560,892	678,138	-0.52%
S&P	50,798	6,846	55,758	36,821	927,144	1,077,367	0.79%
Total	**143,183**	**21,237**	**127,056**	**156,297**	**1,689,215**	**2,136,988**	**0.20%**

N/R indicates that the NRSRO was not registered in the applicable rating category as of the reporting date.

Percentages have been rounded to the nearest one-hundredth of one percent.

Source: NRSRO annual certifications for the 2019 and 2020 calendar years, Item 7A on Form NRSRO.

Chart 6. Year-Over-Year Changes in Percentage Share of Total Number of Ratings Outstanding from 2019 – 2020



Percentages have been rounded to the nearest one-hundredth of one percent.

Source: NRSRO annual certifications for the 2019 and 2020 calendar years, Item 7A on Form NRSRO.

Chart 7 displays the percentage of each NRSRO's outstanding credit ratings of the total outstanding credit ratings of all NRSROs, for each rating category in which the NRSRO was registered, as reported by each NRSRO in its annual certification for the calendar year ending December 31, 2020, as well as the percentage increase or decrease in total ratings from 2019 to 2020.[28]

Chart 7. Percentage by Rating Category of Each NRSRO's Outstanding Credit Ratings of the Total Outstanding Credit Ratings of all NRSROs as of December 31, 2020

NRSRO	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government Securities	Total Ratings	Change in % of Total Ratings from 2019 to 2020
AMB	N/R	34.1%	0.8%	0.0%	N/R	0.4%	0.00%
DBRS	7.8%	0.9%	3.4%	15.0%	1.3%	2.9%	0.18%
EJR	7.1%	4.6%	7.4%	N/R	N/R	1.0%	0.11%
Fitch	23.4%	15.1%	16.0%	21.8%	10.5%	12.6%	-0.47%
HR	0.6%	N/R	0.3%	N/R	0.0%	0.1%	0.01%
JCR	0.7%	0.4%	2.3%	N/R	0.0%	0.2%	0.01%
KBRA	0.9%	0.6%	0.2%	9.3%	0.0%	0.8%	0.09%
MIS	24.1%	12.0%	25.8%	30.3%	33.2%	31.7%	-0.23%
S&P	35.5%	32.2%	43.9%	23.6%	54.9%	50.4%	0.30%

N/R indicates that the NRSRO was not registered in the applicable rating category as of the reporting date.

Percentages have been rounded to the nearest one-tenth of one percent and nearest one-hundredth of one percent with respect to the change from 2019 to 2020.

Source: NRSRO annual certifications for the 2019 and 2020 calendar years, Item 7A on Form NRSRO.

The large NRSROs accounted for 94.7% of all the ratings outstanding as of December 31, 2020—slightly lower than their 95.1% share as of December 31, 2019.[29] The share of outstanding credit ratings of the large NRSROs decreased in all five categories, most significantly in the financial institutions, corporate issuers, and asset-backed securities categories, which each decreased by at least 1.5 percentage points.

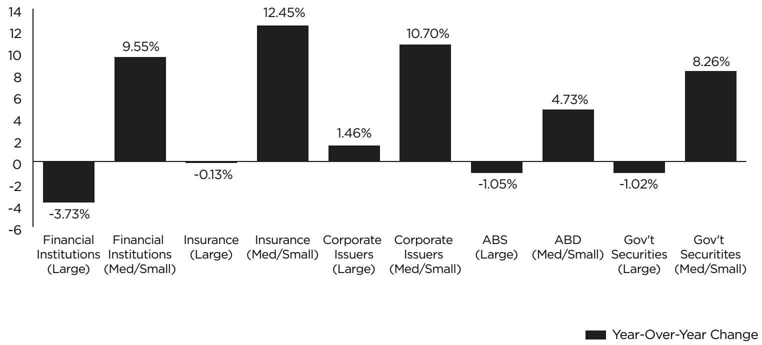
28 For example, according to Chart 5, AMB reported that it had 7,251 insurance company credit ratings, and the total of the credit ratings in that category reported by all NRSROs was 21,237. Therefore, the percentage of NRSRO insurance company ratings attributable to AMB was approximately 34.1% (i.e., 7,251 divided by 21,237, expressed as a percentage), as shown on Chart 7.

29 In 2007, the year when NRSROs began reporting outstanding ratings on Form NRSRO, the large NRSROs accounted for 98.8% of all outstanding ratings.

Charts 5 and 7 also show that AMB, one of the medium NRSROs, had the most credit ratings outstanding in the insurance category. In each of the past seven years, AMB reported that it had the most credit ratings outstanding in the insurance category.[30]

Chart 8 shows the percentage change of total ratings outstanding per asset class from 2019 to 2020 when comparing large NRSROs to small and medium NRSROs.

Chart 8. Percentage Change of Total Ratings Outstanding Per Asset Class 2019 to 2020 – Large NRSROs Compared to Small/Medium NRSROs



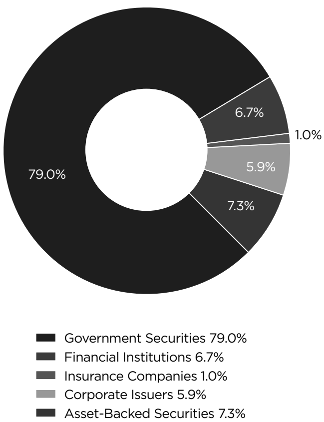
Percentages have been rounded to the nearest one-hundredth of one percent.

Source: NRSRO annual certifications for the 2019 and 2020 calendar years, Item 7A on Form NRSRO.

30 *See* Annual Reports for prior years, which can be found under "Annual Reports to Congress" in the "Reports and Studies" section of the OCR webpage, available at https://www.sec.gov/ocr/ocr-reports-and-studies.html.

Chart 9 depicts the percentages of outstanding credit ratings attributable to each rating category, as reported by the NRSROs in their annual certifications for the calendar year ending December 31, 2020.

Chart 9. Breakdown of Ratings Reported Outstanding by Rating Category as of December 31, 2020



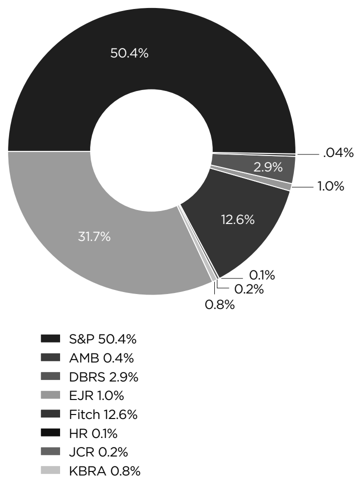
Percentages have been rounded to the nearest one-tenth of one percent.

Source: NRSRO annual certifications for the 2020 calendar year, Item 7A on Form NRSRO.

As illustrated by Chart 9, as of December 31, 2020, the largest proportion of the aggregate credit ratings reported to be outstanding were in the government securities category, which may be attributable to the large number of government bond issuers (e.g., issuers of municipal securities) and their multiple debt offerings. The government securities category accounted for 79.0% of the total number of credit ratings reported across all categories and, as shown on Chart 7 and Chart 12, is also the most concentrated rating category, with the large NRSROs accounting for 98.6% of all outstanding government ratings.

Chart 10 depicts the percentages of the credit ratings outstanding that are attributable to each NRSRO over all the rating categories, as reported by each NRSRO in its annual certification for the calendar year ending December 31, 2020.

Chart 10. Breakdown of Ratings Reported Outstanding by NRSRO as of December 31, 2020

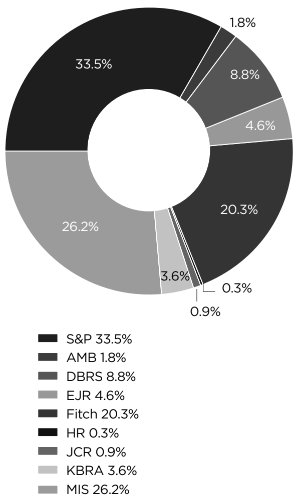


Percentages have been rounded to the nearest one-tenth of one percent.

Source: NRSRO annual certifications for the 2020 calendar year, Item 7A on Form NRSRO.

Chart 11 depicts the percentages of the credit ratings outstanding that are attributable to each NRSRO over all the rating categories other than the government securities category, as reported by each NRSRO in its annual certification for the calendar year ending December 31, 2020.

Chart 11. Breakdown of Non-Government Securities Ratings Reported Outstanding by NRSRO as of December 31, 2020

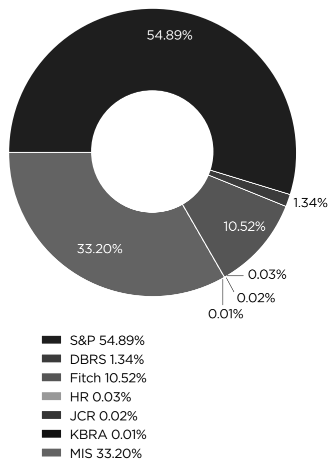


Percentages have been rounded to the nearest one-tenth of one percent.

Source: NRSRO annual certifications for the 2020 calendar year, Item 7A on Form NRSRO.

Chart 12 depicts the percentages of the credit ratings outstanding that are attributable to each applicable NRSRO in the government securities category, as reported by each NRSRO in its annual certification for the calendar year ending December 31, 2020.

Chart 12. Breakdown of Government Securities Ratings Reported Outstanding on December 31, 2020



Percentages have been rounded to the nearest one-hundredth of one percent.

This chart only includes the NRSROs that are registered in the government securities category.

Source: NRSRO annual certifications for the 2020 calendar year, Item 7A on Form NRSRO.

A comparison of Chart 10 to Chart 11 illustrates that there is less concentration in the non-government securities rating categories. S&P's and MIS's percentage share of all outstanding ratings declines by 16.9 and 5.5 percentage points, respectively, when government securities are excluded. Fitch's percentage share of outstanding ratings, on the other hand, increases by 7.8 percentage points when government securities are excluded. The percentage share for all the remaining NRSROs also increases when government securities are excluded. Chart 10 again shows that the government securities category makes up the largest number of credit ratings reported across all categories and is the most concentrated within the three large NRSROs.

Further, when government securities are included in the total calculation, each of the small and medium NRSROs, except for DBRS and EJR, has 1.0% or less of all outstanding ratings, making it difficult to assess their relative rating shares. When government securities are excluded, a clearer picture of the relative percentage shares of the small and medium NRSROs in the categories in which they are active can be observed, as illustrated in Chart 11. The percentage share of each small and medium NRSRO for all rating categories other than government securities as of December 31, 2020 did not change significantly compared to its percentage share as of December 31, 2019.[31]

b. NRSRO Analytical Staffing Levels

Chart 13 reports the number of credit analysts (including credit analyst supervisors) and the number of credit analyst supervisors employed by each of the NRSROs, as reported on Exhibit 8 to Form NRSRO.[32]

Chart 13. NRSRO Credit Analysts and Credit Analyst Supervisors

NRSRO	Credit Analysts (Including Credit Analyst Supervisors)	Credit Analyst Supervisors	% Change in Analytical Staff (Including Supervisors) from 2019 to 2020
AMB	160	62	3.9%
DBRS	428	131	-9.9%
EJR	25	12	8.7%
Fitch	1,301	331	1.9%
HR	63	10	21.2%
JCR	62	30	0.0%
KBRA	176	54	2.3%
MIS	1,830	271	5.7%
S&P	1,560	122	0.1%
Total	**5,605**	**1,023**	**1.8%**

Percentages have been rounded to the nearest one-tenth of one percent.

Source: Exhibit 8 to Form NRSRO, in effect as of each NRSRO's annual certification for the 2020 calendar year filed on or before March 31, 2021.

31 A comparison of Chart 11 in this Report with Chart 5 in Section IV.A.1 of the December 2020 Annual Report (available at https://www.sec.gov/files/2020-annual-report-on-nrsros.pdf) shows that each small and medium NRSRO's total non-government market share as of December 31, 2020 remained constant or increased modestly compared to the market shares as of December 31, 2019.

32 Effective January 1, 2015, the Instructions for Exhibit 8 to Form NRSRO were amended to clarify that NRSROs must include credit analyst supervisors in the total number of credit analysts disclosed on Exhibit 8. This amendment was designed to enhance consistency of the disclosures on Exhibit 8 of Form NRSRO. *See* 2014 Adopting Release, 79 FR at 55222 (discussing the clarifying amendments to Exhibit 8 of Form NRSRO).

The large NRSROs report employing 4,691 credit analysts (including supervisors), which is approximately 83.7% of the total number employed by all of the NRSROs. The small and medium NRSROs, in the aggregate, employ approximately 16.3% of all credit analysts employed by NRSROs.[33] Some of the small NRSROs have reported significant increases in their analytical staff. Between the 2019 and 2020 calendar years, the number of credit analysts (including credit analyst supervisors) employed by small NRSROs, in the aggregate, increased 9.5%, compared to an increase of 2.7% at the large NRSROs, in the aggregate. Between the 2019 and 2020 calendar years, the number of credit analysts (including credit analyst supervisors) employed by medium NRSROs, in the aggregate, decreased 4.6%.[34]

c. NRSRO Revenue

Chart 14 shows the percentage of total NRSRO revenues since 2017 attributable to the large NRSROs, medium NRSROs, and small NRSROs.[35] With the exception of fiscal year 2020, the percentage of aggregate NRSRO revenue reported by the large NRSROs has gradually declined over this time period and the percentage of total revenue reported by the medium and small NRSROs has correspondingly gradually increased.

Chart 14. NRSRO Fiscal Year Revenue as a Percentage of Aggregate Reported Revenue

	2020	2019	2018	2017
Large NRSROs	94.1%	93.3%	93.5%	94.1%
Medium NRSROs	5.1%	5.9%	5.8%	5.3%
Small NRSROs	0.8%	0.8%	0.7%	0.6%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Percentages have been rounded to the nearest one-tenth of one percent.

Source: Financial reports filed with the Commission under Rule 17g-3(a)(3) for the fiscal years ended 2017 through 2020. For the preparation of this Report, if an NRSRO reported revenue in a foreign currency, the revenue was converted to U.S. dollars using the average exchange rate over all U.S. banking days in the fiscal year of such NRSRO.

33 Based on reports by the NRSROs on their annual certifications for the applicable calendar year, the small and medium NRSROs, in the aggregate, employed approximately 11.4% of all NRSRO analysts in 2014, 12.8% of all NRSRO analysts in 2015, 14.6% of all NRSRO analysts in 2016, 15.2% of all NRSRO analysts in 2017, 15.4% of all NRSRO analysts in 2018, and 17.0% of all NRSRO analysts in 2019.

34 As described in the December 2020 Annual Report, in 2019, DBRS and MCR combined analytical operations following a corporate combination. Prior to the combination, the two NRSROs had reported a total of 515 analysts as of December 31, 2019. At the end of 2019, the combined entity had a total of 475 analysts. At the end of 2020, the combined entity had a total of 428 analysts. The reduction in analytical staff at the combined entity may be the primary driver behind the overall reduction among the medium-sized NRSROs.

35 Under Rule 17g-3(a)(3), each NRSRO is required to file annually with the Commission an unaudited report providing revenue information, including revenue from determining and maintaining credit ratings, revenue from subscribers, revenue from granting licenses or rights to publish credit ratings, and revenue from other services and products. These reports are not required to be made publicly available by the NRSROs.

Further revenue information is available for NRSROs that are owned, in whole or in part, by public companies. The following information is from the 2020 annual reports of public companies with an ownership interest in an NRSRO:

- Moody's Corporation, which is MIS's parent company, reported a 15% increase in external revenue at MIS compared to 2019 results. The increase, according to the report, was largely driven by higher corporate debt issuance (both investment-grade and high-yield) as issuers bolstered liquidity positions in response to COVID-19 uncertainties and issued opportunistically for refinancing needs. The corporate finance group, financial institutions group, and public, project and infrastructure finance group of MIS had an increase in revenue compared to 2019 results. In comparison, the structured finance group of MIS had a decrease in revenue compared to 2019 results.[36]
- S&P Global Inc. (S&P Global), which is S&P's parent company, indicated that revenue at S&P increased by 16% compared to its 2019 results, due to an increase in transaction revenue. S&P Global attributed the increase in S&P's revenue to an increase in corporate bond ratings revenue primarily driven by higher corporate bond issuance in the U.S. mainly resulting from borrowers' need for increased liquidity in light of the COVID-19-related economic downturn, historically low borrowing costs, and central bank lending actions initially announced at the end of the first quarter of 2020. This was partially offset by a decrease in bank loan ratings revenue and structured finance revenues.[37]

36 *See* Moody's Corporation, Annual Report on Form 10-K for the year ended December 31, 2020, available at https://www.sec.gov/ix?doc=/Archives/edgar/data/1059556/000105955621000010/mco-20201231.htm.

37 *See* S&P Global Inc., Annual Report on Form 10-K for the year ended December 31, 2020, available at https://www.sec.gov/ix?doc=/Archives/edgar/data/64040/000006404021000063/spgi-20201231.htm.

- Morningstar, Inc. (Morningstar), which is DBRS's parent company, reported that for the year ended December 31, 2020, DBRS's revenue was $207.3 million, accounting for 14.9% of Morningstar's consolidated revenue. Morningstar reported that its transaction-based revenue grew 49.2% during 2020, primarily driven by the contribution of DBRS—approximately 59.9% of the revenue generated by DBRS came from one-time, transaction-based fees driven by its provision of ratings on newly issued securities, with the remainder comprised of recurring revenue from surveillance, credit research, or other services. Morningstar attributed strong Canadian corporate credit issuances as the primary driver of DBRS's revenue growth for 2020.[38]

Recent regulatory filings also show increases in revenue at MIS and S&P in the first half of 2021. Moody's Corporation reported a 16% increase in MIS external revenue in the first half of 2021, as compared to the first half of 2020, due to strong growth mainly driven by leveraged finance issuance as issuers refinanced existing debt and funded M&A activity, and increased CLO and commercial mortgage-backed securities (CMBS) activity amid favorable market conditions.[39] S&P Global reported a 14% increase in S&P transaction revenue in the first half of 2021, as compared to the first half of 2020, due to an increase in bank loan ratings revenue driven by increased M&A activity and an increase in structured finance revenue primarily driven by increased issuance of U.S. CLOs, partially offset by a decrease in corporate bond ratings revenue driven by decreased investment-grade issuance volumes.[40]

Morningstar, Inc. reported a 29.4% increase in DBRS revenue in the first half of 2021, as compared to the first half of 2020, due to stronger issuance activity in both commercial mortgage-backed and asset-backed securities, which offset lower issuance activity in the Canadian corporate markets. Recurring annual fees tied to surveillance, research, and other transaction-related services represented 36.5% of DBRS's revenue in the first six months of 2021.[41]

38 *See* Morningstar, Inc., Annual Report on Form 10-K for the year ended December 31, 2020, available at https://www.sec.gov/ix?doc=/Archives/edgar/data/1289419/000128941921000039/morn-20201231.htm.

39 *See* Moody's Corporation, Quarterly Report on Form 10-Q for the period ended June 30, 2021, available at https://www.sec.gov/ix?doc=/Archives/edgar/data/0001059556/000105955621000025/mco-20210630.htm.

40 *See* S&P Global Inc., Quarterly Report on Form 10-Q, for the period ended June 30, 2021, available at https://www.sec.gov/ix?doc=/Archives/edgar/data/64040/000006404021000155/spgi-20210630.htm.

41 *See* Morningstar, Inc., Quarterly Report on Form 10-Q for the period ended June 30, 2021, available at https://www.sec.gov/ix?doc=/Archives/edgar/data/1289419/000128941921000186/morn-20210630.htm.

2. Developments in the State of Competition Among NRSROs

a. Market Share Observations in the Asset-Backed Securities Rating Category

As noted in Section IV.A.1.a of this Report, the number of ratings recently issued by NRSROs may give a clearer picture of competition than the number of ratings each NRSRO currently has outstanding. For example, Chart 7 indicates that, as of December 31, 2020, the medium NRSROs collectively had 24.3% of the ratings outstanding in the asset-backed securities rating category. However, the market share data discussed in this Section IV.A.2[42] shows that higher market share percentages have been obtained by medium NRSROs in recent years for ratings issuance with respect to certain types of asset-backed securities. This market share data continues the growth trend the Staff has observed since 2011 for some medium NRSROs in the asset-backed securities rating category.[43]

Section IV.A.2.a.i and 2.a.ii below discuss NRSRO market share information with respect to certain asset-backed securities, as reported on the *Commercial Mortgage Alert* and *Asset-Backed Alert* websites.[44] *Commercial Mortgage Alert* shares information on one category of asset-backed securities: CMBS.[45] *Asset-Backed Alert* reports NRSRO market share information on three categories of asset-backed securities: (i) ABS;[46] (ii) MBS;[47] and (iii) CLO.[48]

42 Unless noted otherwise, all market share percentages in this Section IV.A.2 are based on dollar amounts of issuance. The information in this Section IV.A.2 is from the *Asset-Backed Alert*'s ABS database as of July 26, 2021.

43 EJR, HR, and JCR are not registered with the Commission in the asset-backed securities category. *See* Chart 1. While AMB is registered to rate asset-backed securities, as shown in Chart 5, it only has five outstanding asset-backed securities ratings as of December 31, 2020, all of which were issued before 2019. For these reasons, this section only discusses observations related to DBRS, Fitch, KBRA, MIS, and S&P, which are the five NRSROs with current rating activity in the asset-backed securities category.

44 *See Commercial Mortgage Alert* website, available at https://www.greenstreet.com/news/library/commercial-mortgage-alert and *Asset-Backed Alert* website, available at https://www.greenstreet.com/news/library/asset-backed-alert. The information in Charts 15 through 18 is based on the *Commercial Mortgage Alert*'s CMBS database as of July 26, 2021, and the information in Charts 19 through 21 is based on the *Asset-Backed Alert*'s ABS database as of July 26, 2021. Although the information available on these websites may provide insight into recent developments regarding the state of competition among NRSROs in the asset-backed securities rating category, it has certain limitations. For instance, the information treats each transaction as one undivided whole. An NRSRO is counted as having rated a transaction, and the aggregate amount of securities issued, even if the NRSRO rated only a portion of it.

45 The "CMBS" category is comprised of transactions collateralized by mortgages or leases on commercial or multi-family income-producing properties (excluding commercial real estate collateralized debt obligations). *See Commercial Mortgage Alert* website, available at https://www.greenstreet.com/news/library/commercial-mortgage-alert.

46 The "ABS" category is comprised of securities that are collateralized by assets other than the following: CMBS; MBS; Fannie Mae and Freddie Mac issues (other than risk transfer transactions); issuances by municipalities; tax exempt issues; issues that are fully retained by an affiliate of the deal sponsor; commercial paper and other continuously offered securities such as medium-term notes; CLOs and other collateralized debt obligations; and refinancing of previously offered securities. *See Asset-Backed Alert* website, available at https://www.greenstreet.com/news/library/asset-backed-alert.

47 The "MBS" category is comprised of securities secured by U.S. first-lien mortgages on residential properties (excluding Fannie Mae and Freddie Mac issues, securities secured by non-performing or re-performing mortgages, subprime mortgages, or mortgages financing single-family rental businesses, and refinancings of previously offered securities). *See id.*

48 The "CLO" category is comprised of arbitrage collateralized loan obligations secured by broadly syndicated corporate loans and middle market collateralized loan obligations secured by loans to small to medium sized enterprises. *See id.*

i. CMBS

Charts 15 through 18 provide information concerning U.S.[49] CMBS ratings by NRSROs,[50] as reported in *Commercial Mortgage Alert*. NRSRO market share varies between the conduit CMBS and single-borrower CMBS segments,[51] the two segments that account for most of the non-agency[52] U.S. CMBS transactions rated by NRSROs. The charts include reported market share information for total non-agency U.S. CMBS transactions,[53] U.S. conduit CMBS transactions, U.S. single-borrower CMBS transactions, and agency CMBS transactions[54] for calendar year 2019, calendar year 2020, and the first half of calendar year 2021.

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49 *See id*. References to "U.S." CMBS, MBS, ABS, and CLO issuance and market shares in this Section IV.A.2 reflect securities issued for sale primarily in the U.S., which include securities issued publicly and those issued under Rule 144A under the Securities Act of 1933 (the "Securities Act"). *Commercial Mortgage Alert* website, available at https://www.greenstreet.com/news/library/commercial-mortgage-alert.

50 For purposes of Charts 15 through 18, all rating activity for pre-integration DBRS, MCR, and DBRS has been aggregated and presented for DBRS for calendar year 2019. Please refer to the December 2020, January 2020, and December 2018 Annual Reports for information for pre-integration DBRS and MCR, which can be found under "Annual Reports to Congress" in the "Reports and Studies" section of the OCR webpage, available at https://www.sec.gov/ocr/ocr-reports-and-studies.html.

51 The term "conduit" refers to a financial intermediary that functions as a link, or conduit, between the lender(s) originating loans and the ultimate investor(s). The conduit makes loans or purchases loans from third party correspondents under standardized underwriting parameters and once sufficient volume has accumulated, pools the loans for sale to investors in the CMBS market. *See* https://www.crefc.org/uploadedFiles/Site_Framework/Industry_Resources/Glossary%20Revised%202014%20-Update.pdf. In contrast, a single-borrower transaction includes commercial mortgage loans made to a single borrower.

52 "Non-agency" CMBS refers to CMBS that are not issued or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. "Agency" CMBS generally refers to CMBS that are issued or guaranteed by such entities.

53 Total U.S. CMBS transactions include conduit CMBS, single-borrower CMBS, and other types of CMBS, such as distressed/non-performing CMBS transactions and re-securitizations of CMBS transactions.

54 Only agency CMBS transactions with a rating from one or more NRSROs are included for determining NRSRO market share in the agency CMBS category. *See Commercial Mortgage Alert* website, available at https://www.greenstreet.com/news/library/commercial-mortgage-alert.

Chart 15. Rating Agency Market Share for Total Non-Agency U.S. CMBS Issued in 2019, 2020, and First Half of 2021

1H-2021 Rank	NRSRO	1H-2021 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2020 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2019 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)
1	Fitch	31,114	27	68.1/45.8	38,037	46	64.2/52.3	56,048	66	57.3/46.2
2	KBRA	23,053	20	50.4/33.9	25,825	32	43.6/36.4	45,924	56	47.0/39.2
3	DBRS	18,350	25	40.1/42.4	21,893	34	36.9/38.6	42,425	56	43.4/39.2
4	MIS	16,409	21	35.9/35.6	25,076	42	42.3/47.7	42,184	55	43.1/38.5
5	S&P	15,927	23	34.8/39.0	23,275	27	39.3/30.7	49,634	70	50.8/49.0
	Total Rated Market	**45,722**	**59**		**59,254**	**88**		**97,767**	**143**	

Chart 15 reflects market share percentages based on dollar amounts of issuance and number of deals rated. The sum of the market share percentages exceeds 100% because more than one NRSRO may rate a particular transaction. Likewise, the aggregate issuance volume and number of deals represented above exceed the Total Rated Market values for each time period.

Source: Based on information from the *Commercial Mortgage Alert*'s CMBS database as of July 26, 2021, available at https://www.greenstreet.com/news/library/commercial-mortgage-alert. For calendar year 2019, the Staff has adjusted the presentation of the information by aggregating individual pre-integration DBRS and MCR information to present the information consistently as a combined entity, DBRS. *See* note 43.

Chart 16. Rating Agency Market Share for U.S. Conduit CMBS Issued in 2019, 2020, and First Half of 2021

1H-2021 Rank	NRSRO	1H-2021 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2020 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2019 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)
1	Fitch	15,184	16	100.0/100.0	26,953	30	100.0/100.0	49,154	52	100.0/100.0
2	KBRA	12,244	13	80.6/81.3	17,400	20	64.6/66.7	32,755	36	66.6/69.2
3	S&P	11,409	11	75.1/68.8	14,769	14	54.8/46.7	35,582	36	72.4/69.2
4	DBRS	4,305	4	28.4/25.0	9,553	10	35.4/33.3	18,318	18	37.2/34.6
5	MIS	2,560	3	16.9/18.8	11,457	15	42.5/50.0	14,836	17	30.2/32.7
	Total Rated Market	**15,184**	**16**		**26,953**	**30**		**49,154**	**52**	

Chart 16 reflects market share percentages based on dollar amounts of issuance and number of deals rated. The sum of the market share percentages exceeds 100% because more than one NRSRO may rate a particular transaction. Likewise, the aggregate issuance volume and number of deals represented above exceed the Total Rated Market values for each time period.

Source: Based on information from the *Commercial Mortgage Alert*'s database as of July 26, 2021, available at https://www.greenstreet.com/news/library/commercial-mortgage-alert. For calendar year 2019, the Staff has adjusted the presentation of the information by aggregating individual pre-integration DBRS and MCR information to present the information consistently as a combined entity, DBRS. *See* note 43.

Chart 17. Rating Agency Market Share for U.S. Single-Borrower CMBS Issued in 2019, 2020, and First Half of 2021

1H-2021 Rank	NRSRO	1H-2021 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2020 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2019 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)
1	Fitch	15,930	11	52.2/25.6	8,582	12	36.1/25.5	6,894	14	15.0/16.9
2	DBRS	14,045	21	46.0/48.8	10,108	20	42.5/42.6	23,368	35	50.7/42.2
3	MIS	13,849	18	45.4/41.9	11,388	23	47.9/48.9	26,518	36	57.6/43.4
4	KBRA	10,809	7	35.4/16.3	7,231	9	30.4/19.1	12,506	18	27.2/21.7
5	S&P	4,517	12	14.8/27.9	3,154	8	13.3/17.0	12,638	30	27.4/36.1
	Total Rated Market	**30,537**	**43**		**23,776**	**47**		**46,060**	**83**	

Chart 17 reflects market share percentages based on dollar amounts of issuance and number of deals rated. The sum of the market share percentages exceeds 100% because more than one NRSRO may rate a particular transaction. Likewise, the aggregate issuance volume and number of deals represented above exceed the Total Rated Market values for each time period.

Source: Based on information from the *Commercial Mortgage Alert*'s CMBS database as of July 26, 2021, available at https://www.greenstreet.com/news/library/commercial-mortgage-alert. For calendar year 2019, the Staff has adjusted the presentation of the information by aggregating individual pre-integration DBRS and MCR information to present the information consistently as a combined entity, DBRS. *See* note 43.

Chart 18. Rating Agency Market Share for Agency CMBS Issued in 2019, 2020, and First Half of 2021

1H-2021 Rank	NRSRO	1H-2021 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2020 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2019 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)
1	Fitch	12,275	10	100.0/100.0	26,820	21	90.9/91.3	16,767	12	59.2/60.0
2	DBRS	8,954	7	72.9/70.0	15,011	12	50.9/52.2	15,995	11	56.5/55.0
3	KBRA	3,322	3	27.1/30.0	14,480	11	49.1/47.8	12,311	9	43.5/45.0
4	MIS	0	0	0.0/0.0	2,671	2	9.1/8.7	5,862	4	20.7/20.0
5	S&P	0	0	0.0/0.0	0	0	0.0/0.0	5,677	4	20.1/20.0
	Total Rated Market	**12,275**	**10**		**29,491**	**23**		**28,306**	**20**	

Chart 18 reflects market share percentages based on dollar amounts of issuance and number of deals rated. The sum of the market share percentages exceeds 100% because more than one NRSRO may rate a particular transaction. Likewise, the aggregate issuance volume and number of deals represented above exceed the Total Rated Market values for each time period.

Source: Based on information from the *Commercial Mortgage Alert's* CMBS database as of July 26, 2021, available at https://www.greenstreet.com/news/library/commercial-mortgage-alert. For calendar year 2019, the Staff has adjusted the presentation of the information by aggregating individual pre-integration DBRS and MCR information to present the information consistently as a combined entity, DBRS. *See* note 43.

Charts 15 through 17 show that in 2019, 2020, and the first half of 2021 the large NRSROs generally held a large percentage of the market shares in rating non-agency U.S. CMBS transactions, but DBRS and KBRA have achieved significant market shares as well.[55]

As illustrated in Chart 15, in the first half of 2021, KBRA and DBRS had the second and third-highest market shares, respectively, in the non-agency U.S. CMBS segment. KBRA has consistently attained a market share of at least 43% in each of 2019, 2020, and the first half of 2021, and DBRS has attained a market share of over 36% during the same time period.

The relative size of the U.S. conduit CMBS segment had been about half of the non-agency U.S. CMBS transactions in 2019 and 2020. In the first half of 2021, the U.S. conduit segment accounted for about a third of all non-agency U.S. CMBS transactions.[56] Fitch has continued to maintain market share in the U.S. conduit CMBS segment.

As illustrated in Chart 16, Fitch had the highest market share, measured by dollar value of issuance, in this segment during 2019, 2020, and the first half of 2021, rating all of the transactions over that period. KBRA had the third-highest market share, measured by dollar value of issuance, in the U.S. conduit CMBS segment in 2019, and the second-highest ranking in 2020 and the first half of 2021. In each of 2017, 2018, 2019, 2020, and the first half of 2021, KBRA has rated more than half of these transactions.

The relative size of the U.S. single-borrower segment was over 40% of the non-agency U.S. CMBS transactions in 2019 and 2020. In the first half of 2021, the U.S. single-borrower segment accounted for about two-thirds of all non-agency U.S. CMBS transactions.[57] DBRS gained market share in this segment, achieving the second highest market share in the first half of 2021, rating twenty-one of the forty-three transactions in the segment.

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55 Non-agency U.S. CMBS issuance came to a near halt in March 2020 because of COVID-19. Issuance began to pick-up in the third and fourth quarters of 2020, but overall issuance in 2020 was down nearly 40% from 2019 due to COVID-19 and the resulting economic impact. *See* S&P Loses to Moody's, *Commercial Mortgage Alert*, Jan. 22, 2021; CMBS Issuance Off 27% Year-Over-Year, *Commercial Mortgage Alert*, Oct. 2, 2020. Non-agency U.S. CMBS issuance continued to grow in the first half of 2021, with U.S. conduit CMBS transactions accounting for approximately 33% and U.S. single-borrower transactions accounting for 67%. *See* CMBS, CLO Issuers Prep for Busier 2nd Half, *Commercial Mortgage Alert*, July 9, 2021.

56 U.S. conduit CMBS issuance has resumed, albeit more slowly than other non-agency U.S. CMBS segments, because it takes more time and effort than it did before COVID-19 to aggregate enough collateral for a transaction—investors continue to shy away from offerings that are backed by more than minimal amounts of loans on hotel and retail properties, which have suffered as a result of COVID-19. *See* CMBS, CLO Issuers Prep for Busier 2nd Half, *Commercial Mortgage Alert*, July 9, 2021; Election Day Looms Large for CMBS Issuers, *Commercial Mortgage Alert*, Oct. 2, 2020.

57 U.S. single-borrower sector issuance resumed in the third quarter of 2020 and continued to grow in the first half of 2021 as lenders and investors have been attracted to securitizations of large loans tied to prominent borrowers and/or significant properties and portfolios during COVID-19. *See* CMBS, CLO Issuers Prep for Busier 2nd Half, *Commercial Mortgage Alert*, July 9, 2021; Election Day Looms Large for CMBS Issuers, *Commercial Mortgage Alert*, Oct. 2, 2020.

As illustrated in Chart 18, Fitch has continued to improve its market share in the agency CMBS segment. Fitch had the highest market share in this segment during 2019, 2020, and the first half of 2021. Over the same period, DBRS and KBRA had the second and third-highest market shares, respectively, in the agency CMBS segment.

ii. ABS/MBS/CLO

Charts 19 through 21 provide information concerning U.S. ABS, U.S. MBS, and U.S. CLO ratings by NRSROs,[58] as reported in *Asset-Backed Alert*. The charts include reported market share information for these transactions for calendar years 2019, calendar year 2020, and the first half of calendar year 2021.

Chart 19. Rating Agency Market Shares for U.S. ABS Issued in 2019, 2020, and First Half of 2021

1H-2021 Rank	NRSRO	1H-2021 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2020 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2019 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)
1	S&P	92,741	148	49.5/45.7	159,396	239	58.3/47.9	193,378	317	57.6/53.9
2	MIS	88,584	97	47.3/29.9	114,383	157	41.8/31.5	143,742	203	42.8/34.5
3	Fitch	63,954	85	34.1/26.2	109,286	151	40.0/30.3	151,090	192	45.0/32.7
4	DBRS	61,933	111	33.1/34.3	76,121	168	27.8/33.7	107,086	201	31.9/34.2
5	KBRA	40,538	108	21.6/33.3	50,228	137	18.4/27.5	64,909	177	19.3/30.1
	Total Rated Market	**187,300**	**324**		**273,360**	**499**		**335,931**	**588**	

Chart 19 reflects market share percentages based on dollar amounts of issuance and number of deals rated. The sum of the market share percentages exceeds 100% because more than one NRSRO may rate a particular transaction. Likewise, the aggregate issuance volume and number of deals represented above exceed the Total Rated Market values for each time period.

Source: Based on information from the *Asset-Backed Alert*'s ABS database as of July 26, 2021, available at https://www.greenstreet.com/news/library/asset-backed-alert. For calendar year 2019, the Staff has adjusted the presentation of the information by aggregating individual pre-integration DBRS and MCR information to present the information consistently as a combined entity, DBRS. *See* note 51.

58 For purposes of Charts 19 through 21, all rating activity for pre-integration DBRS, MCR, and DBRS has been aggregated and presented for DBRS for calendar year 2019. Please refer to the December 2020, January 2020, and December 2018 Annual Reports for information for pre-integration DBRS and MCR, which can be found under "Annual Reports to Congress" in the "Reports and Studies" section of the OCR webpage, available at https://www.sec.gov/ocr/ocr-reports-and-studies.html.

Chart 20. Rating Agency Market Shares for U.S. MBS Issued in 2019, 2020, and First Half of 2021

1H-2021 Rank	NRSRO	1H-2021 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2020 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2019 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)
1	Fitch	21,920	48	68.1/66.7	14,755	46	48.9/57.5	8,664	29	31.0/38.2
2	MIS	21,861	39	67.9/54.2	14,642	31	48.6/38.8	19,074	44	68.3/57.9
3	KBRA	9,051	22	28.1/30.6	10,576	25	35.1/31.3	13,126	33	47.0/43.4
4	DBRS	3,092	7	9.6/9.7	10,810	24	35.9/30.0	11,679	26	41.8/34.2
5	S&P	2,306	6	7.2/8.3	2,756	8	9.1/10.0	2,433	5	8.7/6.6
	Total Rated Market	**32,203**	**72**		**30,148**	**80**		**27,941**	**76**	

Chart 20 reflects market share percentages based on dollar amounts of issuance and number of deals rated. The sum of the market share percentages exceeds 100% because more than one NRSRO may rate a particular transaction. Likewise, the aggregate issuance volume and number of deals represented above exceed the Total Rated Market values for each time period.

Source: Based on information from the *Asset-Backed Alert*'s ABS database as of July 26, 2021, available at https://www.greenstreet.com/news/library/asset-backed-alert. For calendar year 2019, the Staff has adjusted the presentation of the information by aggregating individual pre-integration DBRS and MCR information to present the information consistently as a combined entity, DBRS. *See* note 51.

Chart 21. Rating Agency Market Shares for U.S. CLO Issued in First Half of 2019, 2020, and First Half of 2021

1H-2021 Rank	NRSRO	1H-2021 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2020 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)	2019 Issuance ($Mil.)	No. of deals	Market Share % ($)/(#)
1	S&P	56,824	119	66.9/68.0	81,589	193	87.0/86.2	73,791	152	60.1/58.5
2	MIS	31,746	65	37.4/37.1	18,890	45	20.1/20.1	73,538	155	59.9/59.6
3	Fitch	16,878	34	19.9/19.4	32,815	72	35.0/32.1	79,889	166	65.1/63.8
4	KBRA	6,066	12	7.1/609	3,541	10	3.8/4.5	5,678	13	4.6/5.0
5	DBRS	2,588	3	3.0/1.7	330	1	0.4/0.4	3,424	8	2.8/3.1
	Total Rated Market	**84,983**	**175**		**93,785**	**224**		**122,716**	**260**	

Chart 21 reflects market share percentages based on dollar amounts of issuance and number of deals rated. The sum of the market share percentages exceeds 100% because more than one NRSRO may rate a particular transaction. Likewise, the aggregate issuance volume and number of deals represented above exceed the Total Rated Market values for each time period.

Source: Based on information from the *Asset-Backed Alert*'s ABS database as of July 26, 2021, available at https://www.greenstreet.com/news/library/asset-backed-alert. For calendar year 2019, the Staff has adjusted the presentation of the information by aggregating individual pre-integration DBRS and MCR information to present the information consistently as a combined entity, DBRS. *See* note 51.

Chart 19 shows that DBRS and KBRA have built and maintained significant U.S. ABS rating market shares.[59] DBRS has consistently attained a market share of over 27% in each of 2019, 2020, and the first half of 2021, and KBRA has attained a market share of over 18% during the same time period.[60] For example, DBRS has been able to gain market share in rating more traditional types of asset-backed securities (aside from the MBS and CMBS categories). As another example, DBRS rated 95.1% of the transactions backed by student loans that priced during the first half of 2021.[61] DBRS also rated 34.1% of the transactions backed by credit card transactions (one of the larger classes of asset-backed securities) that priced during the first half of 2021.[62] DBRS has also been able to gain market share in auto-related asset-backed securities, rating 55.7% of the auto-fleet lease transactions, 22.2% of the subprime auto loan transactions, 5.6% of the prime auto loan transactions, and 19.0% of the auto lease transactions that priced during the first half of 2021.[63] KBRA has also established a market share in some of these auto-related asset-backed security categories, rating 32% of the subprime auto loan transactions and 3% of the prime auto loan transactions that priced during the first half of 2021.[64] Chart 20 shows that the highest market shares for the U.S. MBS segment have been achieved by two of the large NRSROs. KBRA and DBRS had achieved market shares of over 40% in this segment in 2019, but have since seen their market share decrease in 2020 and the first half of 2021. DBRS and KBRA have, however, achieved notable market share in certain types of residential mortgage-backed securities not included in Chart 20. For example, DBRS rated 69% of the

59 *See also* Section IV.A.2 of this Report for a discussion of additional ABS asset classes where these two NRSROs have reported success in gaining market share.

60 There was a significant reduction in U.S. ABS issuance volume in the second quarter of 2020 as COVID-19 caused vast financial market disruptions. Issuance began to resume in the third quarter of 2020, but overall U.S. ABS issuance in 2020 was down nearly 19% from 2019 due to COVID-19. *See* After Bleak Year, Pros Eye Issuance Rebound, *Asset-Backed Alert*, Jan. 8, 2021; Worldwide Issuance Rebound Falling Flat, Asset-Backed Alert, Oct. 2, 2020. U.S. ABS issuance has been strong in the first half of 2021, with issuance up 52% from a year ago. *See* Second Half Kicking Off on $1 Trillion Tempo, *Asset-Backed Alert*, July 9, 2021; Worldwide Issuance On Pace for Banner Year, *Asset-Backed Alert*, Apr. 9, 2021.

61 *See Asset-Backed Alert*'s ABS database indicates that twenty-three student loan transactions totaling $17.6 billion priced during the first half of 2021.

62 The *Asset-Backed Alert* database lists 12 credit card transactions totaling $5.5 billion that priced during the first half of 2021.

63 *See Asset-Backed Alert*'s ABS database, which indicates that the following transactions were priced during the first half of 2021: 10 auto-fleet lease transactions totaling $8.9 billion, 32 subprime auto loan transactions totaling $20.7 billion, 48 prime auto loan transactions totaling $44.3 billion, and 28 auto lease transactions totaling $25.7 billion.

64 *See id.*

re-performing mortgage transactions that priced in the first half of 2021.[65] Additionally, DBRS and KBRA were active rating securities backed by subprime mortgages and risk transfer securities during the first half of 2021. For securities backed by subprime mortgages, DBRS rated 32% and KBRA rated 28% that priced during the first half of 2021;[66] for risk transfer securities, DBRS rated 50% and KBRA rated 14% that priced during the first half of 2021.[67]

Chart 21 shows that the large NRSROs have the highest, second highest, and third highest market shares in the U.S. CLO segment. However, DBRS and KBRA have attained some market share in the U.S. CLO segment.

b. Market Share Observations in Other Asset-Backed Securities Classes

While the large NRSROs maintain a large market share in some newer or more esoteric asset-backed securities asset classes, DBRS and KBRA have gained significant market share in these areas, as well.

For instance, DBRS and KBRA are significant raters of securities backed by unsecured consumer loans, including consumer loans originated through marketplace lending platforms. DBRS and KBRA had the two highest market shares in this category in the first half of 2021, both rating over 53% of the transactions priced during such period.[68] Comparatively, MIS and S&P each rated less than 30% of these transactions for the same time period.[69]

Another example of market share gains achieved by a medium NRSRO in a discrete asset class is KBRA's rating of securitizations backed by aircraft-lease receivables. KBRA rated 85.0% of the aircraft-lease receivables transactions that priced during the first half of 2021, while MIS and S&P rated 63.4% and 29.1%, respectively, of these transactions for the same time period.[70] KBRA has rated sixty-four of the sixty-six, or 97.0%, of the aircraft-lease receivables transactions issued from December 2015 through the end of the second quarter of 2021.[71]

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65 *See Asset-Backed Alert*'s ABS database, which indicates that fourteen re-performing mortgage-backed securities transactions totaling $8.5 billion priced during the first half of 2021.

66 *See Asset-Backed Alert*'s ABS database, which indicates that forty-two subprime mortgage-backed securities transactions totaling $11.6 billion priced during the first half of 2021.

67 *See Asset-Backed Alert*'s ABS database, which indicates that twenty-one risk transfer transactions totaling $13.0 billion priced during the first half of 2021.

68 *See Asset-Backed Alert*'s ABS database, which indicates that thirty unsecured consumer loan transactions totaling $10.4 billion priced during the first half of 2021.

69 *See id.*

70 *See Asset-Backed Alert*'s ABS database, which indicates that eight aircraft-lease receivables transactions totaling $4.1 billion priced during the first half of 2021.

71 *See id.*

KBRA was also active rating whole-business securitizations during the first half of 2021, rating 45.5% of the issuance amount of such transactions.[72] While MIS had a greater market share for this time period (rating 65% of the transactions), KBRA's gain in the whole-business category is further demonstrated when measured by the number of transactions rather than dollar amounts of issuance; KBRA rated six of the nine transactions priced during the first half of 2021.[73]

3. Barriers to Entry

Barriers to entry continue to exist in the credit ratings industry, presenting competitive challenges for the small and medium NRSROs.

One such potential barrier that has been raised by certain small and medium NRSROs are the investment management contracts of some institutional fund managers and the investment guidelines of some fixed income mutual fund managers, pension plan sponsors, and endowment fund managers, which require the use of ratings of specified rating agencies.[74] The effect of these requirements can be to increase the demand for and liquidity of securities bearing the ratings of specified rating agencies. Historically, many of these guidelines refer to the ratings from the large NRSROs by name (i.e., Fitch, MIS, and S&P). Despite reports in recent years that investors are increasingly changing their guidelines to allow for investments in securities rated by a wider group of NRSROs,[75] investment guidelines continue to be identified as a factor impacting the selection of NRSROs to rate certain transactions.[76]

A related barrier to entry is the inclusion requirements of some fixed income indices. To be included in certain of these indices, securities must be rated by specified NRSROs. Certain investment companies try to closely track the performance of the indices by purchasing the securities included in them, and can thus increase the demand for securities bearing the ratings of particular

72 *See Asset-Backed Alert*'s ABS database, which indicates that nine whole-business securitization transactions totaling $6.1 billion priced during the first half of 2021. DBRS rated one whole-business securitization transaction representing 7.0% of the issuance amount of such transactions priced during the first half of 2021. Fitch rated 5.9% of the issuance amount of the whole-business transactions during the same time period.

73 *See id*.

74 *See* Statement of Jim Nadler, President and CEO, Kroll Bond Rating Agency, *Bond Rating Agencies: Examining the "Nationally Recognized" Statistical Rating Organizations Hearing Before the Subcommittee on Investor Protection, Entrepreneurship and Capital Markets of the House Committee on Financial Services*, 117th Congress (July 21, 2021), available at https://democrats-financialservices.house.gov/UploadedFiles/HHRG-117-BA16-Wstate-NadlerJ-20210721.pdf; *see also* Letter from KBRA to the Commission (Aug. 19, 2014), available at https://www.sec.gov/comments/s7-18-11/s71811-88.pdf. This barrier to entry was also mentioned during the SEC's Credit Ratings Roundtable held on May 14, 2013. At the roundtable, a representative of a former NRSRO mentioned that, according to a study conducted by the former NRSRO, approximately 42% of open-end fixed income funds with investment guidelines that reference ratings specifically refer to S&P, MIS, or a "major NRSRO." *See* Credit Rating Roundtable, May 14, 2013, available at https://www.sec.gov/spotlight/credit-ratings-roundtable.shtml.

75 *See, e.g.*, Big Investors Accept More Rating Agencies, *Asset-Backed Alert*, May 19, 2017.

76 *See* S&P Vaults Past Moody's in Conduit Sector, *Commercial Mortgage Alert*, Jan. 24, 2020; S&P, Moody's Duke It Out in Fitch's Shadow, *Commercial Mortgage Alert*, Jan. 25, 2019.

NRSROs.[77] For instance, Fitch announced that its ratings had been added to the J.P. Morgan High-Yield Bond Indices, noting that investors rely on such indices to determine which bonds suit their level of credit risk.[78]

Market participants and academics have identified various other barriers to entry in the credit rating industry, including economic and regulatory barriers.[79] Among the regulatory barriers to entry for NRSROs are the potential challenges associated with complying with the statutory provisions included in the Rating Agency Act, such as the requirement in Section 15E(a)(1)(C) to furnish written certifications from qualified institutional buyers, and the costs associated with the Dodd-Frank Act and the related rules and rule amendments adopted by the Commission (the NRSRO Amendments).[80] When the Commission issued the proposed NRSRO Amendments, commenters expressed concerns that certain of the proposed requirements would be burdensome for small NRSROs to implement and could raise barriers to entry for credit rating agencies to seek to register as NRSROs.[81] In connection with the adoption of the NRSRO Amendments, the Commission acknowledged that, despite efforts to limit the impact on small entities, the Dodd-Frank Act contained requirements, including those implemented by the NRSRO Amendments, which impose costs on NRSROs and may consequently create barriers to entry and have negative impacts on competition.[82] The NRSRO Amendments as adopted by the Commission include various changes from the proposed amendments intended to address concerns regarding barriers to entry, including standards allowing NRSROs to tailor particular requirements to their business models, size, and rating methodologies.[83]

77 *See, e.g.*, Rating Firms Seek Changes to Index, *Asset-Backed Alert*, May 26, 2017.

78 *See* Fitch Ratings Joins J.P. Morgan High Yield Bond Indices, Fitch Ratings, June 28, 2017. In a related example, DBRS announced that its ratings would be included in the determination of index credit quality classifications for CAD-denominated securities in the Bloomberg Barclays Canada Aggregate Index and the Global Aggregate Index, resulting in approximately 49 securities being added to the Canadian Aggregate Index. *See* DBRS Bond Ratings to Be Included in the Bloomberg Barclays Canada Aggregate Index, DBRS, Inc., Apr. 19, 2018.

79 *See, e.g.*, Section IV.C of the March 2012 Annual Report, available at https://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf; Fitch Assigns 'A-' Rating to S&P's Senior Unsecured Notes Offering, Outlook Stable, Fitch Ratings, Aug. 10, 2020; Fitch Assigns 'BBB+' Rating to Moody's Senior Unsecured Notes Offering, Outlook Stable, Fitch Ratings, Aug. 4, 2020.

80 *See* 2014 Adopting Release, 79 FR 55078 (Sept. 15, 2014), available at https://www.govinfo.gov/content/pkg/FR-2014-09-15/pdf/2014-20890.pdf.

81 *See* 2014 Adopting Release, 79 FR at 55090, 55154, 55161, and 55254-55. *See also* comment letters received with respect to the NRSRO Amendments as proposed, available at https://www.sec.gov/comments/s7-18-11/s71811.shtml.

82 *See* 2014 Adopting Release, 79 FR at 55254.

83 *See* Section IV.C of the December 2015 Annual Report, available at https://www.sec.gov/ocr/reportspubs/annual-reports/2015-annual-report-on-nrsros.pdf.

Additionally, there are provisions for exemptions built into several rules and statutes that relate to small and medium NRSROs, if the Commission deems that these requirements may impose an unreasonable burden on the NRSRO. NRSROs may also request exemptions under Section 36 to other rules and statutes that do not have exemptions built into them.[84]

B. TRANSPARENCY

Congress described the Rating Agency Act as an act to improve ratings quality for the protection of investors and in the public interest "by fostering accountability, transparency, and competition in the credit rating agency industry."[85] Section 932 of the Dodd-Frank Act is entitled "Enhanced regulation, accountability, and transparency of NRSROs." Both acts contain various provisions designed to increase the transparency—through clear disclosure open to public scrutiny—of, among other things, NRSROs' credit rating procedures and methodologies, business practices, and credit ratings performance. Under Exchange Act rules, NRSROs are required to disclose:

- Standardized performance statistics;[86]
- Consolidated information about credit rating histories;[87]
- Information about material changes and significant errors in the procedures and methodologies used to determine credit ratings;[88]
- Information about specific rating actions;[89] and
- Clear definitions of each symbol, number, or score in the rating scale used by the NRSRO.[90]

NRSROs must also disclose certain information in connection with each rating action.[91] Such information includes, among other things, the version of the procedure or methodology used to determine the credit rating, a description of the types of data

84 For example, KBRA was granted a temporary conditional exemption from Rule 17g-5(c)(1), which prohibits an NRSRO from issuing or maintaining a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equaling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year. In another example, the Commission granted JCR a temporary conditional exemption from certain requirements of Section 15E(t), which include provisions regarding the composition and duties of the supervisory board of an NRSRO. The Commission's orders granting exemption requests can be found under "Exemption Orders" in the "Commission Orders" section of the OCR webpage, available at https://www.sec.gov/ocr/ocr-commission-orders.html.

85 *See* the preamble to the Rating Agency Act.

86 *See* Instructions for Exhibit 1 to Form NRSRO.

87 *See* Rule 17g-7(b).

88 *See* Rule 17g-8(a)(4).

89 *See* Rule 17g-7(a).

90 *See* Rule 17g-8(b)(2).

91 *See* Rule 17g-7(a).

that were relied upon for purposes of determining the credit rating, an assessment of the quality of information available and considered in determining the credit rating, and information on the sensitivity of the credit ratings to assumptions made by the NRSRO.[92]

In addition to or in connection with required disclosures, NRSROs often issue press releases and reports at the time of a rating action to describe the rationale behind such rating action, and make versions of methodologies for determining credit ratings available on their websites.[93] The availability of underlying methodologies, together with a report discussing the analysis supporting the rating action, may provide additional transparency into an NRSRO's credit analysis and credit rating process.

From time-to-time, NRSROs also publish revisions and updates to their methodologies. They may also at times publish revisions to the assumptions that are inputs to their methodologies and rating approaches, including changes to their economic outlooks or default rate assumptions. Revised methodologies and related assumptions may provide additional transparency into changes in the NRSROs' credit views and analyses.

NRSROs may also provide transparency to the extent they publish commentaries or research. NRSROs publish commentaries and research that generally include data, analyses, or projections on market sectors and economic outlooks.[94] These publications may be helpful to investors to understand industry trends and the NRSROs' credit views.

For example, following the emergence of COVID-19 in early 2020, NRSROs began publishing commentaries and research that provide their perspectives on the potential credit and rating impacts of COVID-19 on issuers and debt obligations in different market sectors. They also began publishing COVID-19-related commentaries on economic and market trends. KBRA published research discussing valuation declines in distressed commercial real estate properties in CMBS transactions during COVID-19.[95] A DBRS report examining how the self-storage industry has fared during COVID-19 describes how the self-storage industry had been growing steadily prior to COVID-19 and remained resilient as pandemic related restrictions persisted, in contrast to certain other types of commercial real estate properties, including those in the hotel and non-essential retail sectors.[96]

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92 *See* Rule 17g-7(a)(1)(ii).

93 The reports accompanying a rating action are frequently available on a paid subscription basis, although some NRSROs provide access to such reports for free.

94 NRSROs may also make market and economic data separately available.

95 *See* KBRA, *Appraisals for Distressed CRE Continue to Trend Lower in COVID's Wake* (May 18, 2021), available at https://www.kbra.com/documents/report/48884/appraisals-for-distressed-cre-continue-to-trend-lower-in-covid-s-wake.

96 *See* DBRS, *Self-Storage in the Pandemic: People Need Their Space* (Aug. 23, 2021), available at https://www.dbrsmorningstar.com/research/383322/self-storage-in-the-pandemic-people-need-their-space.

NRSROs have also produced research in recent years regarding their views on ESG matters and how they incorporate ESG considerations in their credit rating actions. For example, DBRS published research discussing the potential impact of climate change on portfolios of renewable and gas-based power plants and how, in some power markets, increases in green power generation entails risks, such as power supply volatility due to more frequent weather-related outages caused by climate change.[97] KBRA also published research regarding how it views the consideration of ESG issues in credit analysis and why it does not deploy subjective value-based ESG scoring rubrics. KBRA indicated that it believes that ESG factors that impact credit risk need better disclosure and are best examined through the lens of risk management analysis for corporate, financial institution, and government debt issues and issuers.[98]

Between 2016 and 2021, several of the Section 15E Review Areas discussed in Section III above, including adherence to policies, procedures, and methodologies, conflicts of interest, internal supervisory controls, DCO activities, and post-employment activities, included examination findings that addressed transparency-related issues. In total, there were 172 transparency-related findings, accounting for approximately 39% of all essential findings, in the Section 15E examinations conducted from 2016 to 2021. On average, each Section 15E examination cycle from 2016 to 2021 included 29 transparency-related essential findings. For the 2020 and 2021 examinations specifically, transparency-related essential findings accounted for 16 and 18 essential findings, respectively.

C. CONFLICTS OF INTEREST

NRSROs operate under one or more business models, each having potential conflicts of interest. Most of the NRSROs primarily operate under the "issuer-pay" model, which is subject to a potential conflict in that the credit rating agency may be influenced to determine more favorable (i.e., higher) ratings than warranted in order to retain the obligors or issuers as clients. Another business model is the "subscriber-pay" model, under which investors pay a subscription fee to access

97 *See* DBRS, *Impact of Climate Change on Renewable and Natural Gas-Fired Power Generation Assets* (Oct. 4, 2021), available at https://www.dbrsmorningstar.com/research/385386/impact-of-climate-change-on-renewable-and-natural-gas-fired-power-generation-assets.

98 *See* KBRA, *Credit Ratings Deserve ESG Risk Analysis, Not ESG Scores* (Feb. 3, 2021), available at https://www.kbra.com/documents/report/44260/credit-ratings-deserve-esg-risk-analysis-not-esg-scores.

an NRSRO's ratings. This model is also subject to potential conflicts of interests. For example, an NRSRO may be aware that an influential subscriber holds a securities position (long or short) that could be advantaged if a credit rating upgrade or downgrade causes the market value of the security to increase or decrease or that a subscriber invests in newly issued bonds and would obtain higher yields if the bonds were to have lower ratings.

Section 15E and the related Commission rules address conflicts of interest.[99] For example, Rule 17g-5 identifies certain conflicts of interest that are prohibited under all circumstances[100] and other conflicts of interest that are prohibited unless an NRSRO has publicly disclosed the existence of the conflict and has implemented policies and procedures reasonably designed to address and manage such conflict.[101]

Among the conflicts of interest identified in Rule 17g-5 are conflicts involving individual credit analysts or other employees of an NRSRO. For example, an NRSRO is prohibited from issuing or maintaining a credit rating for a person where an employee of the NRSRO that participated in determining, or is responsible for approving, the credit rating directly owns securities of, or is an officer or director of, the person that would be subject to the credit rating.[102]

Rule 17g-5(c)(8) is another example of a prohibited conflict of interest involving persons within an NRSRO. Under the Rule, an NRSRO is prohibited from issuing or maintaining a credit rating where a person within the NRSRO who participates in determining or monitoring the rating, or developing or approving procedures or methodologies used for determining the rating, also (i) participates in sales or marketing activities of the NRSRO or its affiliate, or (ii) is influenced by sales or marketing considerations.[103] In May 2020, the Commission instituted settled administrative proceedings against MCR for issuing or maintaining credit ratings where MCR employees who participated in determining or monitoring the credit ratings also participated in the sales or marketing of a product or service of MCR, in violation of Rule 17g-5(c)(8)(i).[104]

Other statutory provisions and Commission rules address potential conflicts of interest that may arise when a credit analyst seeks employment outside the NRSRO. Section 15E requires each NRSRO to have policies and procedures in place to provide for an internal "look-back" review process in order to determine whether any conflict of interest of a former employee influenced a credit rating in certain instances.[105] Rule 17g-8(c) requires an NRSRO's policies and procedures to address instances in which a "look-back" review determined that a conflict of interest influenced a credit

99 *See, e.g.*, Section 15E(h) and Rule 17g-5.
100 *See* Rule 17g-5(c).
101 *See* Rule 17g-5(a)(1)-(2) and Rule 17g-5(b); Instructions for Exhibits 6 and 7 to Form NRSRO. In addition, Section 15E(t)(3)(B) requires an NRSRO's board of directors to oversee the establishment, maintenance, and enforcement of policies and procedures to address, manage, and disclose any conflicts of interest.
102 *See* Rule 17g-5(c)(2) and Rule 17g-5(c)(4).
103 *See* Rule 17g-5(c)(8).
104 *See* In re Morningstar Credit Ratings, LLC, Exch. Act Rel. No. 88880 (May 15, 2020) (settled action), available at https://www.sec.gov/litigation/admin/2020/34-88880.pdf.
105 *See* Section 15E(h)(4)(A).

rating. Such policies and procedures are required to be reasonably designed to ensure that the NRSRO will promptly determine whether a credit rating must be revised and promptly publish a revised credit rating or an affirmation of the credit rating, along with certain disclosures about the existence of the conflict.[106]

One of the conflict of interest rules concerns the issuer-pay conflict of interest relating to structured finance products. The Commission adopted Rule 17g-5(a)(3) in 2009 to address this conflict of interest. An exemption was in effect for Rule 17g-5(a)(3) with regard to structured finance products issued by non-U.S. issuers in transactions outside the United States until the Commission codified the exemption in August 2019. In the adopting release, the Commission directed the Staff to further evaluate the effectiveness of Rule 17g-5(a)(3) with respect to ratings of structured finance products that are not eligible for relief under the adopted exemption.[107] Towards this end, in a February 2020 speech, then OCR Director Jessica Kane welcomed input and engagement from all interested parties on the effectiveness of Rule 17g-5(a)(3).[108] In the May 26, 2021 hearing before the House Appropriations Subcommittee on Financial Services and General Government, SEC Chair Gary Gensler testified that he has asked the Staff to take a fresh look at the Staff's prior work on the issuer-pay conflict to assess if there are further modifications to be done.[109]

As discussed in Section III.C.5 of this Report, conflicts of interest accounted for 11.5% of all essential findings from the Section 15E examinations conducted from 2016 to 2021. As Chart 3 shows, conflicts of interest accounted for 19 of the essential findings from the 2016 to 2021 examinations.[110] Conflicts of interest have accounted for approximately seven essential findings for each examination, on average, from 2017 to 2021. For the 2020 and 2021 examinations, conflicts of interest accounted for five and four essential findings, respectively.

106 *See* Rule 17g-8(c).

107 *See Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, Release No. 34-86590 (Aug. 7, 2019), 84 FR 40247, 40250 (Aug. 14, 2019) ("2019 Adopting Release"), available at https://www.govinfo.gov/content/pkg/FR-2019-08-14/pdf/2019-17218.pdf.

108 *See* Jessica Kane, Speech, *The SEC's Office of Credit Ratings and NRSRO Regulation: Past, Present, and Future* (Feb. 24, 2020), available at https://www.sec.gov/news/speech/speech-jessica-kane-2020-02-24. OCR then-Director Jessica Kane delivered a speech describing the NRSRO regulatory framework and certain regulatory requirements; OCR's responsibility for administering this regulatory framework; and observed trends in NRSRO compliance. The speech referenced the Commission's 2019 Adopting Release and invited interested parties to provide input on the effectiveness of Rule 17g-5(a)(3).

109 *See Securities and Exchange Commission Oversight Hearing Before the Subcommittee on Financial Services and General Government of the House Committee on Appropriations*, 117th Congress (May 26, 2021), available at https://appropriations.house.gov/events/hearings/securities-and-exchange-commission-oversight-hearing.

110 This was likely related to the new and amended rules that became effective in 2015. *See* note 21.

V. ACTIVITIES RELATING TO NRSROs

A. COMMISSION ORDERS AND RELEASES

The Commission issued the following orders and releases relating to NRSROs or credit ratings in general during the Report Period:

- *In re DBRS, Inc., Exch. Act Rel. No. 92952 (Sept. 13, 2021) (settled action)*.[111] The Commission instituted settled administrative proceedings against DBRS concerning violations of Rule 17g-8(b)(1) in connection with rating CLO Combo Notes.[112] The SEC's order finds that DBRS's policies and procedures were not reasonably designed to ensure that it rated CLO Combo Notes in accordance with the terms of those securities.
- *Continuance of Exemption Pursuant to Order Granting Temporary Conditional Exemption for Japan Credit Rating Agency, Ltd. from Certain Requirements of Section 15E(t) of the Securities Exchange Act of 1934*.[113] On August 17, 2018, the Commission granted JCR a temporary, conditional exemption from certain corporate governance requirements under Section 15E(t). On August 20, 2021, the exemption automatically renewed until August 20, 2023.[114]
- *SEC v. Morningstar Credit Ratings, LLC, No. 1:21-cv-1359 (S.D.N.Y. filed Feb. 16, 2021)*.[115] The Commission filed a civil action alleging that former credit rating agency Morningstar Credit Ratings, LLC, violated disclosure and internal controls provisions of Section 15E and the rules promulgated thereunder in rating CMBS.[116]

111 Available at https://www.sec.gov/litigation/admin/2021/34-92952.pdf.
112 *See* https://www.sec.gov/enforce/34-92952-s.
113 Release No. 34-83884 (Aug. 17, 2018), available at https://www.sec.gov/rules/exorders/2018/34-83884.pdf.
114 *See id*.
115 Available at https://www.sec.gov/litigation/complaints/2021/comp-pr2021-29.pdf.
116 *See* https://www.sec.gov/news/press-release/2021-29.

B. STAFF PUBLICATIONS

The Staff issued the following publications relating to NRSROs or credit ratings in general during the Report Period:

- *2020 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization*, dated December 2020 (December 2020 Exam Report), as required under Section 15E(p)(3)(C).[117] The December 2020 Exam Report summarizes the essential findings of the examinations conducted by the Staff under Section 15E(p)(3)(C) for the period January 1, 2019 through December 31, 2019.
- *Annual Report on Nationally Recognized Statistical Rating Organizations*, dated December 2020 (December 2020 Annual Report), as required by Section 6 of the Rating Agency Act.[118] The December 2020 Annual Report addresses the matters described in the second paragraph under Section II of this Report for the period June 26, 2019 to June 25, 2020.

C. ADVISORY COMMITTEES

The SEC's Investor Advisory Committee (IAC)[119] has considered the SEC's approach to regulation of the credit rating agency industry. The IAC met five times during the Report Period. At the IAC meeting on March 11, 2021,[120] the IAC approved, for the Commission's consideration, the Market Structure Subcommittee's recommendation for increasing transparency in OCR Staff's annual examination reports of NRSROs.[121]

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117 Available at https://www.sec.gov/files/nrsro-summary-report-2020.pdf.

118 Available at https://www.sec.gov/files/2020-annual-report-on-nrsros.pdf.

119 Section 911 of the Dodd-Frank Act established the IAC to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and on initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the IAC to submit findings and recommendations for review and consideration by the Commission. *See* https://www.sec.gov/spotlight/investor-advisory-committee.shtml; https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-charter.pdf.

120 *See* Webcast of IAC Meeting, SEC (Mar. 11, 2021), available at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac031121. The IAC's Market Structure Subcommittee circulated its draft recommendation ahead of this IAC meeting. *See* https://www.sec.gov/spotlight/investor-advisory-committee-2012/credit-rating-agencies-recommendation-03112021.pdf.

121 *See* Recommendation of the Market Structure Subcommittee of the SEC Investor Advisory Committee Regarding Credit Rating Agencies (Mar. 11, 2021), available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/20210311-credit-rating-agencies-recommendation.pdf.

VI. APPENDIX: SUMMARY OF STATUTORY FRAMEWORK AND RULES

Section 15E and Rules 17g-1 through 17g-10 govern the registration and oversight program for credit rating agencies that are registered with the Commission as NRSROs. This regulatory regime was established by the Rating Agency Act[122] and amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[123]

The Dodd-Frank Act mandated the creation of the Office of Credit Ratings (OCR), which is responsible for oversight of credit rating agencies registered with the Commission as NRSROs. OCR's Staff includes professionals with expertise in a variety of areas that relate to its regulatory mission, such as corporate, municipal, and structured debt finance.[124]

Pursuant to the Commission's regulatory regime for NRSROs, an NRSRO is required to, among other things:

- File with the Commission an annual certification of its Form NRSRO registration,[125] promptly update its filing in certain circumstances,[126] and make its current Form NRSRO filing and most of its current Form NRSRO Exhibits available on its public website.[127]
- Disclose certain information, including information concerning the NRSRO's performance measurement statistics and its procedures and methodologies to determine ratings.[128]
- Establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings,[129] and retain records of its internal control structure.[130]
- Consider certain factors with respect to its establishment, maintenance, enforcement, and documentation of an effective internal control structure.[131]

122 Pub. L. No. 109-291, 120 Stat. 1327 (2006).
123 Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1872-83 (2010).
124 *See* Section 15E(p)(2) for a description of OCR staffing requirements.
125 Section 15E(b)(2) and Rule 17g-1(f).
126 Section 15E(b)(1) and Rule 17g-1(e).
127 Section 15E(a)(3) and Rule 17g-1(i).
128 Section 15E(a)(1)(B)(i) and Section 15E(a)(1)(B)(ii).
129 Section 15E(c)(3)(A).
130 Rule 17g-2(b)(12).
131 *See, e.g.*, Rule 17g-8(d)(1)–(4).

- Establish, maintain, enforce, and document policies and procedures reasonably designed to: achieve certain objectives concerning its development and application of, and disclosures related to, methodologies and models.[132]
- File an unaudited report containing an assessment by management of the effectiveness during the fiscal year of the NRSRO's internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings.[133] The report must be accompanied by a signed statement by the NRSRO's chief executive officer or an individual performing similar functions.[134]
- Establish, maintain, enforce, and document policies and procedures that are reasonably designed to: assess the probability that an issuer of a security or money market instrument will default or fail to make required payments to investors,[135] and ensure that it applies any rating symbol, number, or score in a manner that is consistent for all types of obligors, securities, and money market instruments for which the symbol, number, or score is used.[136]
- Publish an information disclosure form when taking a rating action with respect to a rating assigned to an obligor, security, or money-market instrument in a class for which it is registered as an NRSRO.[137] The information form must disclose certain information with respect to the particular rating action.[138] In addition, the NRSRO must attach to the information disclosure form a signed statement by a person within the NRSRO with responsibility for the rating action.[139]

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132 *See, e.g.*, Rule 17g-8(a)(2)–(5).
133 Rule 17g-3(a)(7)(i).
134 Rule 17g-3(b)(2).
135 Rule 17g-8(b)(1).
136 Rule 17g-8(b)(3).
137 Rule 17g-7(a). Rule 17g-7(a) defines rating action to include an expected or preliminary rating, an initial rating, an upgrade or downgrade of an existing rating (including a downgrade to, or assignment of, default), and an affirmation or withdrawal of an existing rating if the affirmation or withdrawal is the result of the NRSRO's review of the rating using applicable procedures and methodologies for determining credit ratings. Pursuant to Rule 17g-7(a)(3), an NRSRO is exempt from publishing an information disclosure form for a particular rating if: (i) the rated obligor or issuer of the rated security or money market instrument is not a U.S. person; and (ii) the NRSRO has a reasonable basis to conclude that: (A) with respect to any security or money market instrument issued by a rated obligor, all offers and sales by any issuer, sponsor, or underwriter linked to the security or money market instrument will occur outside the United States; or (B) with respect to a rated security or money market instrument, all offers and sales by any issuer, sponsor, or underwriter linked to a security or money market instrument will occur outside the United States.
138 Rule 17g-7(a)(1)(ii)(A)-(N) specifies the information that must be disclosed in the information disclosure form. These required disclosures include: the version of the procedure or methodology used to determine the credit rating; disclosures concerning the uncertainty of the rating, including regarding the reliability, accuracy, quality, and accessibility of data related to the rating; a statement containing an overall assessment of the quality of information available and considered in determining the credit rating for the obligor, security, or money market instrument; and information on the sensitivity of the rating to assumptions made by the NRSRO. In addition, an NRSRO must attach to the information disclosure form any executed Form ABS Due Diligence-15E containing information about the security or money market instrument subject to the rating action that is received by the NRSRO or obtained by the NRSRO through a Rule 17g-5(a)(3) website.
139 Rule 17g-7(a)(1)(iii).

- Make and retain, or retain, certain records, including a record documenting its established procedures and methodologies used to determine credit ratings[140] and records related to its ratings.[141] An NRSRO must promptly furnish to the Commission or its representatives copies of required records, including English translations of those records, upon request.[142]
- Establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information (MNPI), including the inappropriate dissemination of MNPI both within and outside the NRSRO, the inappropriate trading of securities using MNPI by a person within the NRSRO, and the inappropriate dissemination of pending credit rating actions within and outside the NRSRO before issuing the rating on the Internet or through another readily accessible means.[143]
- Establish, maintain, and enforce written policies and procedures reasonably designed to address and manage conflicts of interest.[144] Certain conflicts of interest are expressly prohibited,[145] and for other types of conflicts of interest, the NRSRO must disclose the conflicts and have policies and procedures in place to manage them.[146]
- Refrain from engaging in specified unfair, coercive, or abusive practices.[147]
- Provide information on whether it has in effect a code of ethics, and if not, the reasons it does not have a code of ethics.[148]
- Establish procedures for the receipt, retention, and treatment of complaints regarding credit ratings, models, methodologies, and compliance with the securities laws and its policies and procedures developed under this regulatory regime, and of confidential, anonymous complaints.[149]

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140 Rule 17g-2(a)(6).

141 The records that an NRSRO must make and retain, or retain, with respect to its ratings include the identity of certain persons who participated in determining or approving the rating, records used to form the basis of a rating, external and internal communications received or sent by the NRSRO and its employees related to a rating, and for ABS ratings, a record of the rationale for any material difference between the final rating assigned and the rating implied by a quantitative model that was a substantial component in determining the rating. Rule 17g-2(a)(2)(i), (ii), and (iii); Rule 17g-2(b)(2) and (b)(7).

142 Section 15E(a) and (b) and Rule 17g-2(f).

143 Section 15E(g) and Rule 17g-4.

144 Section 15E(h) and Rule 17g-5. *See also* Section IV.C of this Report.

145 Rule 17g-5(c). *See also* Section IV.C of this Report.

146 Rule 17g-5(a)(1) and (a)(2); Rule 17g-5(b). Moreover, Rule 17g-5(a)(3) prohibits an NRSRO from having a conflict of interest related to a rating for a security or money market instrument issued by an asset pool or as part of any ABS transaction unless the NRSRO, among other things, maintains and provides access to a password-protected Internet Web site containing a list of each such security or money market instrument for which it is currently in the process of determining an initial credit rating, and obtains certain written representations from the issuer, sponsor, or underwriter of each such security or money market instrument.

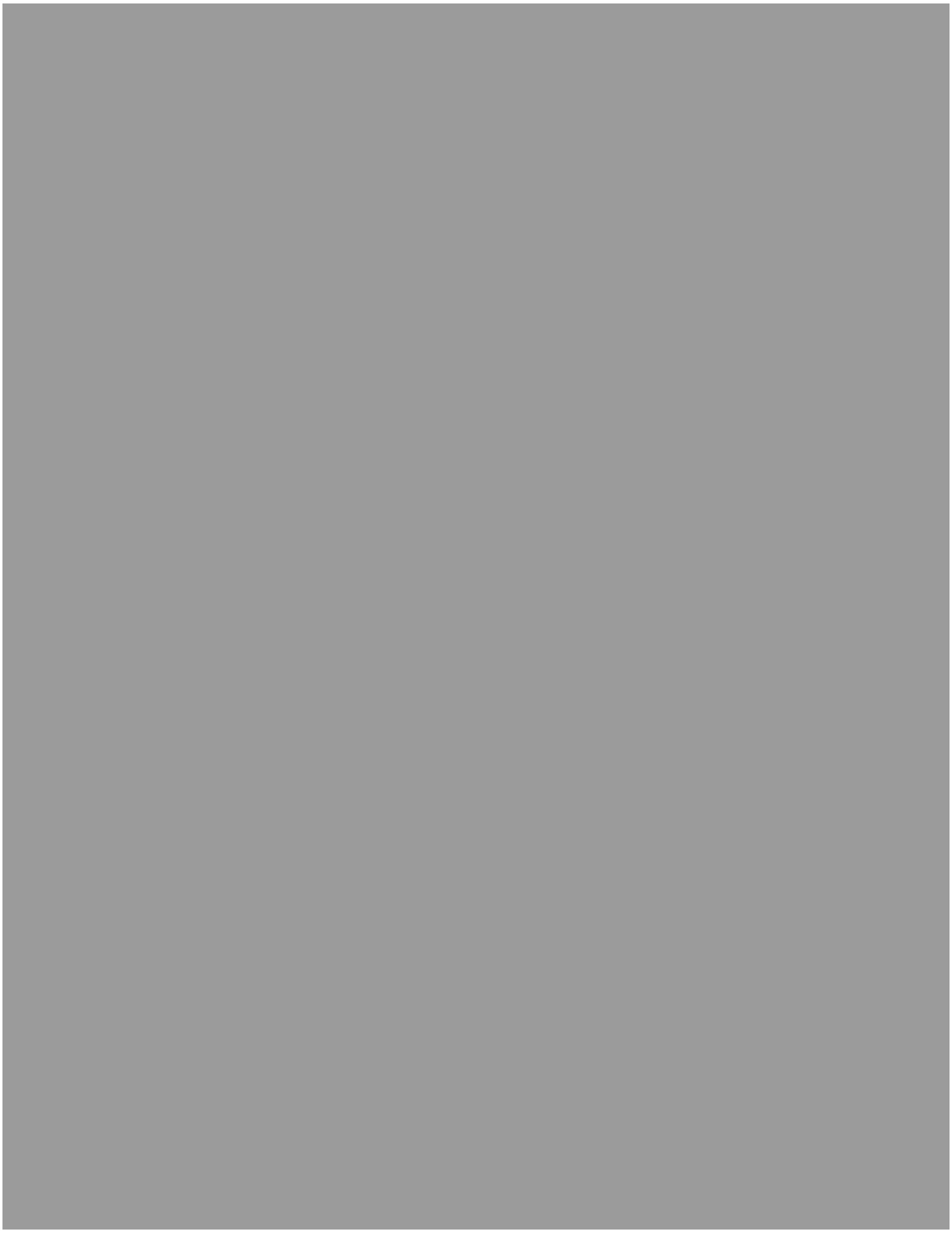
147 Rule 17g-6.

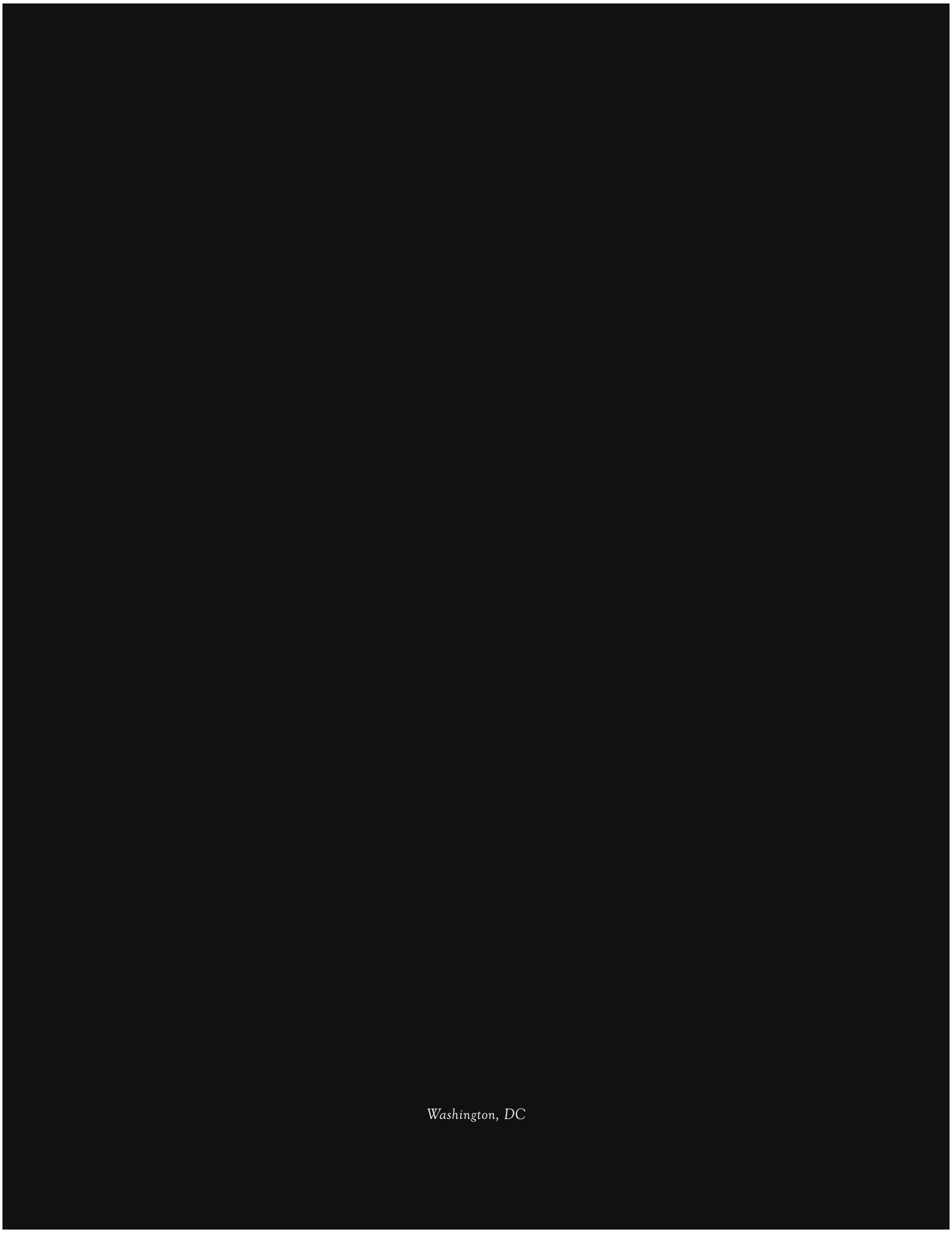
148 Section 15E(a)(1)(B)(v).

149 Section 15E(j)(3).

- Designate a compliance officer (the DCO) responsible for administering policies and procedures related to MNPI and conflicts of interest, ensuring compliance with the securities laws and regulations, and establishing procedures for handling complaints by employees or users of credit ratings.[150] The DCO must submit an annual report to the NRSRO on the compliance of the NRSRO with the securities laws and the NRSRO's policies and procedures, and the NRSRO must file the report with the Commission.[151]
- Have a board of directors or similar governing body (collectively, the Board), certain of whose members must be independent from the NRSRO.[152] An NRSRO's Board, or members thereof, are responsible for exercising oversight of specified subjects related to the NRSRO's rating business and for approving the procedures and methodologies, including qualitative and quantitative data and models that the NRSRO uses to determine ratings.[153]
- Establish, maintain, enforce, and document standards of training, experience, and competence for the individuals it employs to participate in the determination of credit ratings that are reasonably designed to achieve the objective that the NRSRO produces accurate credit ratings, and retain a record of these standards.[154]
- Establish policies and procedures regarding post-employment activities of certain former personnel.[155]

150 Section 15E(j)(1) and (3).
151 Section 15E(j)(5).
152 Section 15E(t)(2).
153 Section 15E(t)(3) and Rule 17g-8(a)(1).
154 Rule 17g-9.
155 Section 15E(h)(4) and (5); Rule 17g-8(c).





Washington, DC

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