SULLIVAN & WORCESTER

Investment Management

Client Alert

2025 Form ADV Annual Amendment Season

Lessons and Suggestions from the 2024 Enforcement Frenzy

March 11, 2025
By Stephanie Monaco
Partner, Sullivan & Worcester

The Gary Gensler age of regulation by enforcement is finally over! While the total number of enforcement actions brought and settled in FY 2024 was not as high as previous years (and in fact more than 50% of the combined penalties came from one case, *SEC v. Terraform*), the total amount of imposed penalties and disgorgement certainly was unprecedented – nearly doubling the totals of each of the prior three fiscal years of the Gensler-led SEC. Included in the eye-popping $8.2 billion collected in penalties and disgorgement were fines and penalties stemming from proceedings brought and settled by 74 firms for off-channel communications infractions, totaling $600 million in FY2024, with a total of $2 billion from those cases alone since 2021. And, for many, it is hard to forget the dread associated with receiving a notice that a routine examination was about to commence, with many of those examinations feeling more like hunting expeditions for enforcement referrals, no matter how small the infraction. The last four years have been frightening times to be in this regulated industry.

The industry is about to receive a new SEC Chairman who is likely to peddle back on the enforcement approach of his predecessor and, hopefully, usher in a time where examinations become opportunities to improve compliance. Likely, a new SEC Chairman will not take the approach of “broken windows” on Steroids to the lengths that Chairman Gensler’s enforcement regime did. Not to get giddy or over our skis, any new Chairman confirmed by a Republican-led Congress will continue to pursue fraudsters, manipulators and those who take advantage of investors and clients to their financial harm.

It is therefore a valuable exercise to go mining through some of the 2024 enforcement actions, Examination Priorities and Risk Alerts, for lessons to apply to disclosure and compliance programs now, in advance of the time that calendar year end advisers prepare their annual updating amendments to Form ADV and typically revise their compliance policies and procedures. The following summarizes certain instructive lessons to consider from the end of the Gensler SEC:

- Insider Trading (MNPI)
- Conflicts of Interest
- Outsourcing

- Off Channel Communications
- Model Management/Artificial Intelligence
- Timely Filings
- Marketing
- Expectations of Future Enforcement Interest under new Leadership

A. Insider Trading (MNPI) Policies and Procedures

1. Shadow Trading.

SEC v. Panuwat (citations omitted for ease of reading but available upon request)

This case established a novel theory, "shadow trading," as grounds for imposing insider trading liability. In essence, the case stands for the notion that insider trading occurs when an employee, in the course of his/her employment, learns of confidential information about one company and then trades the stock of another company that is in a similar line of business as the company about which the confidential information relates.

Scholars will probably write for years about the three alternative theories of liability for shadow trading but they are:

a. If an employee signs a confidentiality agreement with his/her employer, that employee cannot use confidential information obtained through his/her job and trade in the stock of another company that bears a "market connection" or "close economic correlation" to the company about which the confidential information relates.
b. Even if no confidentiality agreement is signed, if the employee is subject to a code of business conduct/ethics policy that states that no employee can use the company's property, information or position for personal gain, the employee cannot take confidential information obtained in his/her employment and trade the stock of another company that, again, bears a connection or correlation to the employing company.
c. Even if no confidentiality agreement exists, and there is no policy that states an employee cannot use company property for personal gain, the *Panuwat* court concluded that Agency Law establishes a duty to refrain from profiting from material non-public information obtained while employed.

An appeal has been filed in this case.

It is unclear what direction the SEC might go regarding future enforcement actions premised on shadow trading. Under new leadership, the SEC could view shadow trading as too attenuated from well-established insider trading concepts and abandon pursuing cases on that theory. Alternatively, a new SEC could take the view that *Panuwat* established a path for shadow trading liability grounded in established Agency Law and continue to pursue them. Given the lack of clarity concerning what the future of shadow trading holds, compliance personnel are left with a Hobson's Choice:

- Don't enhance policies and procedures to cover shadow trading. If an adviser does nothing to reflect the *Panuwat* holding and does not describe what shadow trading is, the adviser runs the risk of receiving a deficiency comment to its Insider Trading Policy. This risk could be exacerbated if the investment adviser has employees sign confidentiality agreements or has a Code of Ethics that states clearly that confidential information obtained during employment cannot be used for personal gain. If either exists, an insider trading policy that does not cover shadow trading could be viewed as stale and deficient; or
- Alternatively, change insider trading policies and procedures to cover the concept of shadow trading. Any change can be as simple as mentioning that confidential information obtained during employment may not be used for personal gain and that this prohibition includes trading in securities of which the

adviser has material non-public information or of another company that bears a market connection or close economic correlation to that securities issuer. A word of caution, however. If an adviser includes shadow trading in its policies and procedures, and describes it in training sessions, it is arguable that the adviser has assumed some responsibility to engage in a level of personal trading surveillance for shadow trading. Critiques of the holding in *Panuwat* have pointed out how difficult it is for anyone to determine what companies bear “market connections” to others, and what a “close economic correlation” between companies might be. By including a description of shadow trading in policies and procedures, an investment adviser might be asking for more trouble than it is worth at this stage of the development of shadow trading theory.

2. Participation on Creditors’ Committees. Two cases, Sound Point Capital and Marathon Asset Management, clarified that if investment advisory personnel participate on a creditor’s committee of an investee company, and learns confidential information, the investment adviser cannot trade in the stock of that company while in possession of that information. While that seems obvious, the nuance of these cases highlights the risk and danger of permitting trading in that issuer’s securities based on a judgment call that the information, while non-public, is not material. Judgment calls like that risk evaluation by the SEC with the benefit of 20/20 hindsight.

If advisory personnel participate on these kinds of committees or in other ways with investee companies that expose personnel to receiving confidential information, consideration should be given to putting the name of that company on a restricted list for the duration of personnel involvement or the information is made public, whichever occurs first. Whether to do so or not would depend upon what access that person would have to what kind of confidential information.

At this time, materiality should continue to be part of the analysis of whether information received constitutes *material* non-public information. Obviously, materiality is not a factor if the firm has signed a non-disclosure agreement with an investee company. In that situation, that company and its stock should go on the restricted list. As to other arrangements where advisory personnel receive non-public information, consider the extent to which materiality should play a role in current insider trading policies. Consider clarifying the description of a materiality assessment to include evaluating a variety of factors, e.g., evaluate a security’s position or potential transaction in isolation but also consider its placement in, and leveraged impact on, a total portfolio.

B. Identification and Disclosure or Mitigation of Conflicts of Interest

The fiduciary duty imposed on investment advisers seems well-settled: as a fiduciary, an investment adviser must (1) identify material conflicts of interest that impact its business, (2) disclose those conflicts of interest to clients and prospective clients, or (3) avoid or mitigate conflicts of interest if possible, and (4) in certain cases, obtain informed client consent to move forward with a disclosed conflict of interest. SEC Enforcement priorities will always include cases involving conflicts of interest, primarily because when investment advisers succumb to conflicts of interest and put their interests ahead of clients/investors, it is usually to the clients/investors’ economic disadvantage and harm. In fact, harm is not a requirement for enforcement interest – the previous SEC chair and other chairs in the past brought cases involving conflicts of interest even when there was no client/investor harm.

Consistent with this perennial Enforcement interest, the list of 2025 Examination Priorities includes a priority to examine the impact of investment adviser financial conflicts of interest associated with providing impartial investment advice. It seems fair to assume conflict of interest cases will continue. As a result, investment advisers are challenged to first identify which conflicts of interest exist in their organization and then determine how to disclose, avoid or mitigate those conflicts.

1. The following kinds of conflicts of interest were found to have existed at investment advisory firms, without sufficient disclosure, avoidance or mitigation in some of last year's enforcement cases:

- failure to disclose receipt of payments by an affiliate from a company involved with an investee firm;
- failure to disclose that a senior official of the adviser sat on the board of a financial institution that also loaned money to a fund managed by the investment adviser;
- failure to adequately disclose that investment adviser and affiliate of the adviser made short-term loans to fund clients of the adviser, even though no interest was charged on the loans;
- failure to disclose to investors of a region-specific fund that one of the adviser's founders operated a separate fund in the same region (with no findings of mis-allocated limited investment opportunities);
- failure to disclose conflict of interest in paying incentive compensation to investment advisory representatives who refer, or successfully cause, a retirement plan participant to roll over his/her 401k account into an individual retirement account (IRA) managed by an affiliate of the investment adviser; and
- failure to disclose conflict of interest in outsourcing financial and accounting services and causing clients to pay for those services when they had originally been provided by the investment adviser, through its CFO, without charge.

2. Steps to take going forward include:

- Prepare a list of conflicts of interest if not already on a conflict of interest inventory or in matrix (still best practice);
- Provide an annual questionnaire to, at least, all senior staff, portfolio managers and senior traders for information about outside affiliations and activities that could present a conflict of interest;
- Give examples in an annual questionnaire such as "your neighbor is a senior official at a bank that is used for fund-level subscription facilities or loans," "you have been asked to sit on the board of that bank," "you receive compensation from other sources than the investment adviser, specifically…;"
- TRAIN, TRAIN, TRAIN all employees how to spot a conflict of interest, give examples by making the presentation interactive, and explain where to go with newly identified conflicts, whether actual or apparent;
- Check and double-check that new conflicts, and those already identified, are covered adequately in Form ADV (all Parts), investment advisory contracts, private and public fund offering and related documents – make sure written descriptions of conflicts of interest cover all known conflicts of interest and that those descriptions include how conflicts are addressed;
- No matter how many times you read the Form ADV, read it again, cover to cover;
- Be ready to draft disclosure of conflicts not previously identified;
- When identifying a new conflict of interest, evaluate if disclosure can cure or properly mitigate that conflict or if some other approach is necessary or advisable; and,
- Be aware that not all conflicts of interest can be identified in advance and, similarly, not all conflict resolution paths can be pre-determined.

    - Some conflicts, such as new ones identified, can be disclosed in Form ADV or in notifications to clients (including to appropriate fund committees, like advisory committees or LPACs).
    - Others may need remediation first (usually a payment of some kind for financial losses associated with undisclosed conflicts of interest that were borne by clients), and informed client consent to continue going forward.
    - It is typical to question if the identification of an undisclosed conflict of interest (remediated or not) should be reported to the SEC. There is no universal answer -- this is where advice of counsel is very important.

It is impossible to predict with any degree of certainty if the SEC under new leadership will continue to bring enforcement actions for undisclosed conflicts of interest that did not result in harm to investors or clients. It is reasonable to assume that the SEC will bring these actions – for undisclosed and inadequately disclosed conflicts of interest – if in Enforcement's judgement there is resulting harm.

C. Outsourcing

It seems fair to assume that the SEC's proposed Outsourcing Rule will be put on the back-burner, perhaps indefinitely. While that puts off compulsory Form ADV revisions, changes to existing contracts, and other requirements that would have been imposed had that rule been adopted, the focus on outsourced services will remain a priority, particularly when outsourced services are provided by affiliates of the investment adviser. Based on examinations since the rule was proposed, apparently the staff does not believe that a rule is necessary to examine outsourced services, relationships and processes. It appears to be their view that outsourcing as a general matter falls within an investment adviser's fiduciary duty and no express rule needs to be adopted.

The continued importance of reviewing the process around selecting, maintaining and terminating outsourced vendors stems from examinations during the year, and the Division of Examination's 2025 Examination Priorities. Among its priorities, the staff emphasized the importance of:

- An adviser's fiduciary duty when outsourcing the investment selection and portfolio management functions; and
- Oversight of affiliated and third-party service providers to registered investment companies and private funds.

Areas to consider strengthening include:

- Review disclosures in Form ADV, prospectuses/statements of additional information, and private placement memoranda about what services the adviser can outsource and delegate;
- Make sure that disclosure and current practices are in sync;
- Pay careful attention to services outsourced to affiliates – to an Examination team, affiliated outsourcing relationships are inherently suspect and warrant scrutiny;
    - To the extent affiliates are performing services for the adviser, evaluate the quality of those services as best as possible to reach a level of confidence, and can produce a record of that evaluation, that the affiliate's services are as good as a third-party would provide. Also, focus on the cost of services provided by an affiliate to determine that the cost is comparable to what an unaffiliated, qualified service provider would charge; and
    - Build a record of the foregoing evaluations, particularly as to competitive costs (surveys of service providers in some businesses, and their costs, are available for comparison purposes [e.g., real estate management and leasing]);
- Review existing contracts with service providers and focus on what happens to books and records maintained by the service provider on the adviser's behalf if the relationship terminates. For essential services, it can be very difficult to get those records once the relationship ends, particularly if the contract is silent on post-termination cooperation. An adviser can be put into a vulnerable position if that level of cooperation is not forthcoming, particularly if a regulatory exam should occur and a document request compels delivery of those records. If the contract is silent, consider discussing a change to the contract while relations are good with outsourced vendors; and,
- For outsourced vendors performing "mission critical" services and are in possession of investor/client information, a good practice would be to perform annual due diligence of the vendor's cyber (including AML to the extent applicable) and information security practices. Cyber and information security remains a very high priority for the SEC and should be a priority for advisers who have retained vendors that receive and maintain investor and client information (and for advisers themselves who perform this work in-house).

D. Off Channel Communications

Much has been made of the many cases the SEC has brought concerning off channel communications. Anyone who does not know of this enforcement focus has not been paying attention. Fundamentally these cases were really books and records violations. An important lesson from these cases lies in the differences between the books and records broker-dealers are required to keep under the Securities Exchange Act of 1934 versus those investment advisers are required to keep under the Investment Advisers Act of 1940 as they are different. For investment advisers, there are only four specific book and record requirements that might be violated if covered in social media, text messages, WhatsApp, etc.:

1. Any recommendation made or proposed to be made, and any advice given or proposed to be given;
2. Any receipt, disbursement, or delivery of funds or securities;
3. The placing or execution of any order to purchase or sell any security; and,
4. Predecessor performance and the performance or rate of return of all managed accounts.

Accordingly, investment advisers should examine their policies and procedures relating to use of social media and personal devices, and their policies and procedures describing the Advisers Act's required books and records and scale back to only require maintenance of records relating to these four specific provisions. In other words, an investment adviser that has a broader books and records retention policy, such as a policy that requires maintenance of all books and records relating to the business of providing investment advice, is running the risk of an action for violation of the firm's own books and records retention policies and procedures rather than a violation of the rule itself – a self-inflicted wound to be avoided.

E. Model Management – Artificial Intelligence and "AI Washing"

There was a fair amount of sizzle last year, continuing into this year, involving faulty or fraudulent uses and marketing of technology in making investment decisions or making tools available to assist in that respect. While "AI Washing" might be the new label placed on these uses and faults, enforcement actions in this respect are not new. Going back to 1997 and the LBS enforcement matter, cases in which advisers have claimed technology that either existed or did not exist to inform or drive investment decisions have been brought. The AXA Rosenberg and Transamerica/Aegon cases spring to mind as major cases involving the use and marketing of artificial intelligence in investment decision-making. The cases in 2024 (Delphia and Global Predictions), and the one so far in 2025 (Two Sigma), are more recent cases to learn from when using AI in advisory activities.

Whether the use of algorithms drives or informs the investment decision-making process, these cases demonstrate the need to build a good process around the development, application and implementation of artificial intelligence/algorithms. Specifically,

- Determine if algorithms will inform investment decisions or drive them;
- Once that is determined, make sure that drafters of marketing and offering materials understands those intended uses so that descriptions of the uses of algorithms in social media, websites, brochures, marketing materials and offering materials do not exaggerate those uses;
- Depending upon how significantly algorithms will be used, determine if a model risk management committee should be created to oversee the process;
- That committee, or compliance if no committee is assembled for this process, should develop a model life cycle procedure with checks and balances built in at every stage (development, testing, changes, validation, identification of gaps, releases into production, retirement) with appropriate checks and balances (e.g., engineers of algorithms should not be able to change models without supervision and approval); and,
- Promptly deal with vulnerabilities that arise in an algorithm once identified – notes to self to correct some problem in an algorithm cannot be put off to a later date.

As a general matter, compliance officers are not qualified to understand the details of an algorithm. It is therefore important to employ experts to advise on the life cycles of artificial intelligence/algorithms and assist in developing a robust process around their uses.

Related to AI Washing, the SEC proposed a rule that would sweep into Advisers Act and Exchange Act regulations so-called Predictive Data Analytics in March of 2024. Perhaps predictive on her part, Commissioner Peirce was vocal in her criticism of the broad expanse that rule would have on the industry. Given her objections to this rule, it seems unlikely that the SEC under new leadership will pursue its adoption. That should not be interpreted as a prediction that the SEC would not support enforcement actions involving fraud in this space, particularly if investors or clients were misled or harmed.

F. Timely Filings

The SEC brought a variety of cases (at least 23) involving failures to file, or unacceptable delays in filing, Forms 13Ds, 13Fs, 13Gs, 13H, and related schedules. Whether the SEC under new leadership will continue to bring cases like this is unclear. Suffice it to say, it behooves compliance to create timelines and calendar reminders for any of these filings that have to be made and stick to it. Importantly, compliance needs to build into those timelines sufficient time to gather the information and prepare those filings so they can be made on time.

G. Marketing Rule

Compliance with the Marketing Rule is very difficult to navigate, both prior to and in advance of the new administration. That Rule is extraordinarily bulky, vague, unclear…what more can be said about it other than it is on the books and the industry is stuck with it for the time being. If the SEC staff would get back to writing FAQs, providing some guidance, offering compliance solutions, bona fide efforts could be made to comply with a rule that is primarily principles-based. A few lessons can be learned from the enforcement actions brought in 2024, although the facts in some of those cases were relatively egregious:

- Substantiate all claims made (e.g., of ratings, membership in organizations, awards, endorsements versus testimonials);
- Don’t modify or manipulate actual data to enhance performance (or for any reason, frankly);
- Try to define what performance is (it is not defined in the Rule) and apply the specifics in the Rule to whatever performance is defined to be (e.g., always show net performance with equal prominence to gross performance, determine if yield is performance or not); in other words, evaluate statistics as a whole and don’t present any of them in a misleading manner;
- Consider never showing hypothetical performance (i.e., performance that was not actually achieved) to a retail audience (and never include on a public website); and,
- Maximize disclosure of what is being shown, even in gray areas (e.g., predecessor performance), don’t place at the end of a long pitch book, and don’t use tiny font sizes.

As if compliance departments aren’t burdened already, compliance needs to put eyes on all forms of marketing, from the public website to investor communications to offering materials to pitch books and responses to requests for proposals. Many advisers develop templates to be used for these materials which can reduce the amount of time compliance needs for review. In addition, compliance needs to train those who prepare and manage these materials. The gap formed by the natural tension between compliance and marketing has to be bridged or, at least, narrowed. Sharing knowledge through examples from enforcement actions can all go a long way to complying with this challenging rule; for example, try short lunch and learn sessions, compliance corner notices, and one-on-one sessions with key marketers.

H. Expectations of areas that will Continue to draw Enforcement Interest:

Before a new SEC is assembled it is valuable to read the tea leaves and identify practices that are likely to attract enforcement interest. They would likely be the following:

- When an investment adviser leans into its own interest resulting in financial harm to clients and investors;
- When an investment adviser has promised to correct practices but hasn't done so;
- When an investment adviser has been the subject of an enforcement action (even one brought by the Gensler regime) and repeats the same violative conduct; and,
- When Form ADV says one thing, and policies and procedures say something else.

What can you do to have a good examination and avoid Enforcement:

- By listening, observing and asking the right questions, become a student of the firm and learn where conflicts exist;
- Train, train, train employees, particularly senior personnel and owners engaged in the business, on the firm's policies and procedures;
- Make sure Form ADV disclosures of policies and procedures sync up to actual policies and procedures and, more importantly to actual practices;
- Make sure policies and procedures have been written to reflect actual practice of stakeholders (e.g., when reviewing Marketing Rule policies and procedures, have marketers review them and advise what is accurate, what is different, and then revise); and,
- Test policies and procedures to make sure they are capturing errors and exposing patterns of non-compliance (intentional and inadvertent).

****

We are living in "interesting times," which, unfortunately, is reputed to be a curse rather than a blessing. Sullivan & Worcester and I are here to help navigate through the many changes and challenges that are about to occur in our industry. Please reach out if you would like a deeper dive into any of the foregoing subjects or others that you are facing.

Stephanie Monaco
Sullivan & Worcester
smonaco@sullivanlaw.com
(202) 775-1202