STRADLEY RONON

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Client Alert | Investment Management and Securities Litigation & Enforcement

SEC Settles Enforcement Actions with JPMorganChase Affiliates for $151M

The U.S. Securities and Exchange Commission (SEC) has settled five administrative actions against J.P. Morgan Securities LLC (JPMS) and J.P. Morgan Investment Management Inc. (JPMIM), affiliates of JPMorgan Chase & Co. (JPMorganChase), for alleged failures including misleading disclosures to investors, product fee-based best interest violations, prohibited joint transactions and improperly managed principal trades. Without admitting or denying the findings in the SEC's October 31 orders, JPMS and JPMIM agreed to pay more than $151 million in combined civil penalties and voluntary payments to investors to resolve the actions. Despite the magnitude of the combined monetary remedies, all five actions were based on non-scienter violations, and those remedies ranged from as low as $1 million to as high as $100 million.

Portfolio Management Program Action[1]

JPMS, a dually registered investment adviser and broker-dealer, offers discretionary wrap fee programs to its clients. These programs are advisory programs in which clients pay JPMS an asset-based fee for asset management, and JPMS agrees not to charge clients any transaction-based fees for the purchase or sale of securities in client accounts. JPMS offered both discretionary wrap fee programs through its own strategies (PM Program) and through strategies offered by other third-party investment advisers (TPM Program).

While overall fees in the PM Program were typically lower than the TPM Program because clients were not charged a third-party fee, the financial advisers managing the PM Program typically charged a higher wrap fee to those accounts. The wrap fees collected for the PM Program were shared between JPMS and the financial advisers. However, the wrap fees collected for the TPM Program were retained solely by JPMS.

Further, JPMS only approved financial advisers to participate in the PM Program if the financial adviser maintained at least $20 million in assets under management (AUM) in the PM Program after two years. The SEC stated that the higher wrap fee created a financial incentive for financial advisers to recommend that clients put and keep their assets in the PM Program rather than the TPM Program, despite that such recommendations likely benefited the PM Program investors as they had direct access to the person selecting individual securities and were able to request portfolio modifications based on their individual circumstances (e.g., tax considerations).

[1] See *In the Matter of J.P. Morgan Securities*, Release No. IA-6759 (October 31, 2024).

The SEC instituted settled charges against JPMS pursuant to Section 206(2) of the Investment Advisers Act of 1940 (IAA) [2] for not fully and fairly disclosing the conflict created by the differences in the fee structure of the PM Program and the TPM Program; specifically, that the financial advisers often negotiate a higher wrap fee when the clients participate in the PM Program, which has no separate portfolio manager fee, versus the TPM Program, which has a separate portfolio manager fee. Additionally, the SEC stated that JPMS did not make full and fair disclosure regarding the incentive for financial advisers to put and keep client assets in PM Program strategies created by the requirement that PM Program investors maintain $20 million in AUM after two years.

The SEC also charged JPMS with a violation of Section 206(4) of the IAA and Rule 206(4)-7 thereunder[3] for failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the IAA. The SEC stated that JPMS's policies and procedures contained generalized statements that conflicts of interest should be disclosed but did not have any specific guidance regarding those disclosures.

While the specific incentive was allegedly not explicitly disclosed, the order does not cite a failure to disclose the differing fee structures, the amount of such fees or the special AUM requirements of the PM Program, the underlying facts that constituted the alleged undisclosed incentive.

As a result of these violations, JPMS was fined $45 million. The order provides no explanation as to how the SEC determined that $45 million represents the legally appropriate amount for a non-scienter charge or if that figure represents some unidentified calculation of fees or investor losses.

Conduit Private Funds Action[4]

JPMS's conduit private funds program (Conduit Program) was a pooled vehicle that invested in private equity or hedge funds that periodically distributed shares of their portfolio private companies that went public to the pooled vehicle. The Conduit Program offered customers access to private investments that customers may not have been able to purchase given private investment restrictions. The program delegated all administrative and ministerial tasks to J.P. Morgan Private Investments Inc., a wholly owned subsidiary of JPMorganChase that exercised complete discretion over when to sell the shares and the number of shares sold. The affiliate, according to the SEC, took too long to sell the shares in some instances, and the shares declined in value.

The order claims that JPMS failed to inform brokerage customers that an affiliate would have complete discretion as to the sale of the shares. The order provides no detail regarding the materiality of such omissions nor explains how this omission is actionable.

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[2] Section 206(2) of the IAA prohibits an investment adviser, directly or indirectly, from engaging "in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client" (15 U.S.C. § 80b-6(2)).

[3] Section 206(4) of the IAA and Rule 206(4)-7 require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the IAA and the rules promulgated thereunder (15 U.S.C. § 80b-6(4); 17 C.F.R. § 275.206(4)-7).

[4] See *In the Matter of J.P. Morgan Securities*, Release No. IA-6760 (October 31, 2024).

While JPMS settled on non-scienter-based disclosure violations, it voluntarily repaid a total of $90 million to more than 1,500 investor accounts and the order imposed a $10 million civil penalty. The SEC notes the firm's remediation efforts but provides no explanation as to how such remediation impacted the penalty calculation.

Clone Mutual Funds Action[5]

JPMS settled charges that it violated Regulation Best Interest's care and compliance obligations when it offered and sold certain mutual fund products (clone mutual funds) to retail brokerage clients when lower-cost exchange-traded funds (clone ETFs) were available. Clone mutual funds and ETFs offer the same investment portfolio but different structures, as mutual funds are priced once per day, and ETFs are priced throughout the day, reflecting the current market price of the shares. According to the order, the retail brokerage clients paid $14.03 million in additional fees, charges and expenses to purchase the clone mutual funds.

The SEC claims that JPMS failed to consider the difference in price and, therefore, did not have a reasonable basis to offer the higher-cost product. While the SEC has previously admitted that cost is only one important factor among many factors when making an investment recommendation, it does not appear that JPMS was able to point to any factors upon which it based its higher-cost recommendations. In any event, this matter demonstrates the importance of maintaining point-of-sale documentation to establish the consideration given to similar products and the basis for selling a higher-cost product.

JPMS self-reported the conduct to the SEC and voluntarily refunded $15.9 million, which included the extra fees paid by impacted customers. The SEC imposed a cease-and-desist order against JPMS but did not impose additional monetary sanctions, noting the firm's cooperation.

Joint Transactions Action[6]

JPMIM is a registered investment adviser that provides advisory services to registered investment companies, including those that operate as U.S. money market funds and foreign money market funds. In March 2020, the onset of the COVID-19 pandemic resulted in highly stressed market conditions for certain investments typically held by money market funds. As a result, the Federal Reserve created a liquidity facility (MMLF) to assist in providing liquidity to domestic money market funds. The MMLF permitted eligible borrowers to pledge certain assets purchased from domestic money market funds into the facility at the assets' amortized cost. In exchange, the MMLF would provide eligible borrowers with non-recourse cash advances equal to their amortized cost or fair value of the pledged assets provided to the MMLF.

JPMIM engaged in transactions in which its foreign money market fund sold assets that were ineligible for the MMLF to an unaffiliated investment bank. The investment bank then repackaged the assets as collateral for asset-backed commercial paper and immediately sold the entire issuance to the domestic money market funds through an unaffiliated broker-dealer. The domestic money market funds then sold these securities to a different, unaffiliated broker-dealer, which immediately pledged them to the MMLF.

As a result of the transactions, the foreign money market fund recognized a net realized gain of $1.5 million and received $4.3 billion in sales proceeds from the transactions, which enhanced

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[5] See *In the Matter of J.P. Morgan Securities*, Release No. IA-6758 (October 31, 2024).

[6] See *In the Matter of J.P. Morgan Investment Management*, Release No. IC-35373 (October 31, 2024).

its liquidity. The domestic money market fund earned one-tenth this amount and bore certain associated risks, including the chance that the Federal Reserve might reject the asset-backed commercial paper for placement in the MMLF due to the structure of the transactions and the risk that a regulator could determine that the transactions were joint transactions in violation of Section 17(d) of the Investment Company Act of 1940 (1940 Act) and Rule 17d-1 promulgated thereunder.

Section 17(d) of the 1940 Act prohibits any affiliated person of a registered investment company or any affiliated person of such affiliated person acting as principal, from effecting any transaction in which such registered investment company is a joint or a joint and several participant with an affiliated person in contravention of such rules and regulations the SEC may prescribe.[7] Further, Rule 17d-1 prohibits any affiliated person from participating in any joint enterprise, other joint arrangement or profit-sharing plan unless it obtains an order from the SEC permitting the joint arrangement.[8]

Although personnel at JPMS consulted the Federal Reserve, the institution charged with implementing the MMLF, and the Federal Reserve did not issue guidance to prevent the transactions, JPMIM did not seek nor obtain exemptive relief from the SEC to engage in the joint transactions as required pursuant to Section 17(d). As a result, the SEC charged JPMIM for violating Section 17(d) and Rule 17d-1 and fined JPMIM $5 million. While the fine was relatively small for an entity with the AUM of JPMIM, the action is the latest of three enforcement actions involving joint transactions brought during SEC Chair Gary Gensler's administration.[9]

Principal Trades Action[10]

Section 17(a)(1) of the 1940 Act generally prohibits any affiliated person of a registered investment company or any affiliated person of such affiliated person, acting as principal, from knowingly selling a security to the registered investment company (i.e., a principal trade) unless the person first obtains an exemptive order from the SEC under Section 17(b) of the 1940 Act.[11]

JPMIM obtained exemptive relief in 2002 pursuant to Sections 6(c) and 17(b) of the 1940 Act with respect to principal trades between JPMIM and JPMS that subjected JPMIM to the following conditions: (1) JPMIM must make a determination that the price available from JPMS is at least as favorable as that available from other sources; (2) JPMIM must prepare guidelines for personnel to follow the requirements of the exemptive order; (3) JPMIM must conduct periodic compliance monitoring of the principal trades; and (4) JPMIM must provide, at least on an annual basis, information to the registered investment company's board concerning such transactions.

With respect to JPMIM's registered investment company clients, JPMIM's Global Liquidity group purchased and sold various short-term fixed-income securities for various funds and clients from an approved list of broker-dealers. One such broker-dealer had direct access to JPMS's offers of commercial paper issuances. JPMIM traders purchased JPMS commercial paper from that

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[7] 15 U.S.C. § 80a-17(d).

[8] 17 C.F.R. § 270.17d-1.

[9] See *In the Matter of Catalyst Capital Advisors*, Release No. IA-6597 (April 29, 2024); and *In the Matter of Exchange Traded Managers Group*, Release No. 6362 (August 1, 2023).

[10] See *In the Matter of J.P. Morgan Investment Management*, Release No. IA-6761 (October 31, 2024).

[11] See 15 U.S.C. § 80a-17(a)(1).

broker-dealer on behalf of JPMIM funds, including the U.S. money market funds. However, the SEC stated that the interpositioning of a broker-dealer in a transaction that, in the absence of such party, would represent a principal trade does not remove the prohibition on the transaction under Section 17(a). Reliance on the exemptive order was therefore necessary, and the SEC stated that JPMIM did not comply with the conditions in its exemptive order because no favorable price determination was made concerning the transactions, and the transactions were not reported to the fund's board of trustees.

With respect to JPMIM's non-registered investment company clients, JPMIM engaged in similar principal trades. The SEC stated that JPMIM did not provide any prior written disclosure to, or receive consent from, its clients who were parties to any of these principal trades.

Additionally, the SEC stated that JPMIM failed to adopt and implement reasonably designed policies and procedures to prevent its personnel from conducting prohibited principal trades and did not provide adequate guidance and training to its investment professionals concerning such transactions. The order notes that JPMIM notified enforcement staff of the principal trades and provided documents and information on an ongoing basis. The SEC fined JPMIM $1 million.

Takeaways

- The Regulation Best Interest matter demonstrates the SEC's continued trend toward enforcing this rule and should cause firms to review and document sales involving similar funds with different fee structures as well as differing share classes. It appears that the lack of contemporaneous documentation regarding the sales may have hurt JPMS in defending against the charges.
- The SEC's headline $151 million payment was largely driven by the amounts collected in two of the five matters included in this packaged enforcement action. Combining the five enforcement actions under one headline also helped to enhance visibility for several of the SEC's current priorities in the waning days of the Gensler Commission while disguising that individually, none were particularly significant and all involved conduct that began no later than 2020.
- While the SEC, in three of the actions, touted the alleged cooperation by the firm, the result of such cooperation seems obscured and therefore minimized by the packaging of the enforcement action to highlight the $151 million fine paid by a well-known and significant market registrant.

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