THE NATIONAL LAW REVIEW

January 2016: Compilation of Enforcement and Non-Enforcement Actions

Monday, February 1, 2016

Article By Stuart E. Fross
Peter D. Fetzer Terry D. Nelson
Foley & Lardner LLP Legal News Alert

Financial Institutions & Banking
Securities & SEC
All Federal

Non-Enforcement

- FINRA's Proposed Pay-to-Play Rule Will Impact Investment Advisers
- Fair Warning — SEC’s 2016 Examination Priorities

Enforcement

- Recommendations of 12b-1 Funds to Clients Results in Enforcement Action
- Fund Manager Sanctioned for Misleading and Overcharging Fund Investors
- SEC Charges Lobbyist and Bank Pays $12 Million to Settle Pay-to-Play Claim
- Why Transparency is Essential for Investment Advisers and Funds

Non-Enforcement

FINRA’s Proposed Pay-to-Play Rule Will Impact Investment Advisers

Late last year (December 24, 2015), the ***Financial Industry Regulatory Authority (FINRA)*** submitted a proposed rule to the ***U.S. Securities and Exchange Commission (SEC)*** for adoption. If adopted in its final form, FINRA Rule 2030(a) will restrict the ability of FINRA member firms to provide client solicitation activities on behalf of registered investment advisers that provide (or seek to provide) investment management services to governmental entities.

The proposed FINRA rule is modeled after SEC Rule 206(4)-5 under the Investment Advisers Act of 1940, a pay-to-play rule that covers investment advisers and certain of their employees. The proposed FINRA rule would also impose a two-year “time out” on the earning of compensation for solicitation engagements in connection with a governmental entity on behalf of an investment adviser when the FINRA member firm or one of its “covered” associates makes a disqualifying contribution to an official of that governmental entity. In order for the FINRA rule to come into play, the political contribution must be more than $30 in an election year or more than $150 in a non-election year. If the political contribution was inadvertent or made by mistake, the rule allows the broker-dealer to cure the violation without penalty if a refund of the donation is received within a four month period of the initial contribution that caused the violation.

Provided the SEC does not seek to deny or require revisions to the proposed FINRA rule after the end of the comment period, which closed on January 20, 2016, the rule would likely be in place prior to the 2016 election cycle.

As a result, broker-dealer FINRA member firms will need to monitor employees who are included under the coverage of the rule to ensure that their compliance and recordkeeping systems are up-to-task in order to avoid violations of the rule.

In addition, registered investment advisers, while engaging broker-dealers and their representatives to solicit prospective government clients on their behalf, should include appropriate representations with any engagement letter to solicit such clients. This would ensure that they are aware that the broker-dealer and its representatives are in compliance with the rule.

Fair Warning — SEC's 2016 Examination Priorities

The SEC's Office of Compliance Inspections and Examinations (OCIE) recently announced its priorities for examinations to be conducted during 2016. OCIE examines, on a regular and routine basis, registered investment advisers and investment companies.

Over the last four years, the OCIE has announced, in advance, its examination priorities to allow the industry to gear up for such examinations. OCIE believes that providing this information in advance has been helpful in preparing for the examinations and for the staff to prioritize while conducting the examinations.

The OCIE generally determines the annual examination priorities by observing market conditions and industry developments, and by risk assessments.

The 2016 examination priorities include:

- **Protecting retail investors, primarily retirement investors**: OCIE will assess risks to such investors, including disclosure information available for investment products geared to seniors
- **Cyber security compliance and controls**: OCIE will continue to test and assess the registrants' compliance and controls
- **Use of data analytics**: The OCIE will continue to collect, review and use large amounts of data collected from the industry in order to detect unusual and possible fraudulent activity

Of particular interest to our clients will be OICE's focus on Public Pension Advisers, a close examination of exchange traded fund operations and risks, with an ongoing focus on cybersecurity and liquidity controls for funds that hold fixed income securities. Of note, the SEC also called out EB-5 programs for special attention, with respect to due diligence, disclosure and suitability.

Of particular interest to private fund advisers, OICE will maintain its focus on fees and expenses, as well as evaluation of the controls and disclosure of side by side management of performance fee and purely asset based fee accounts.

New target areas for the OCIE 2016 examinations include public pension advisers, product promotion, and investment products such as exchange-traded funds and variable annuities.

Other initiatives within the OCIE 2016 examinations will include municipal advisors and their compliance with the many regulatory requirements established by the MSRB; and private placements, with an emphasis in the areas of due diligence, disclosure, and suitability.

Enforcement

Recommendations of 12b-1 Funds to Clients Results in Enforcement Action.

In a recent enforcement action by the SEC, an Ohio-based registered investment adviser and its principals (In the matter of Everhart Financial Group, Inc., Richard Scott Everhart, and Matthew James Romeo, Release No. IA 4314, January 14, 2016) were found by the SEC to have violated the "anti-fraud" provisions under the Investment Advisers Act of 1940 for recommending investments to clients in a mutual fund that paid 12b-1 fees over funds that did not pay such fees. It was advantageous for the investment adviser to recommend the fund that paid 12b-1 fees because such fees were paid to the adviser's principals, who were registered representatives of a broker-dealer.

During 2010-2015, when the adviser's clients were placed in the fund with the 12b-1 payments, the adviser failed to disclose that payments were made to the fund's principals, and the conflict of interest that accompanied the receipt of such payments.

In addition, the SEC found that the adviser failed to perform annual compliance reviews during six of the previous seven years.

In order to resolve the matter, the adviser agreed to:

1. Engage an independent compliance consultant to conduct compliance reviews during each of the next two years and provide the SEC with the consultant's findings
2. Designate a non-principal as the firm's chief compliance officer to hold such position for a period of at least five years
3. Require the firm's compliance officer to complete 30 hours of compliance training
4. Provide to each of its current and prospective clients a copy of the SEC order for a period of one year
5. Issue a cease and desist order and order of censure
6. Pay total disgorgement and interest of more than $225,000
7. Pay civil penalty payments collectively of $140,000.

Fund Manager Sanctioned for Misleading and Overcharging Fund Investors

In a recent enforcement action (In the matter of Equinox Fund Management, LLC, Release No. IA 4315, January 19, 2016), the SEC imposed sanctions against a Denver-based registered investment adviser for overcharging management fees and misleading investors about how it valued certain assets in a registered fund.

In order to settle the matter, the adviser agreed to refund investors $5.4 million in excessive management fees plus $600,000 in prejudgment interest. In addition, the adviser agreed to pay to the SEC a $400,000 penalty.

The series fund managed by the adviser is registered under the Securities Act of 1933, and as such, is filed as public registration statements with the SEC disclosing, among other things, that management fees were based upon the net asset value of each series of the fund. However, the SEC found that the adviser instead used the notional trading value of the assets (i.e., the total amount of assets invested including leverage). That method of calculation resulted in the adviser overcharging the fund $5.4 million in management fees over a seven year period. In addition, various periodic public reports filed with the SEC and provided to investors continued to disclose during this period that the method for valuating certain assets was checked by third party valuations. However, the third party valuations indicated that the adviser had valued such assets substantially higher than the third party valuations for the same assets.

The adviser faced violations of the anti-fraud provisions under the Securities Act of 1933 as a result of overcharging management fees and providing misleading material information to fund investors.

In addition to the monetary penalties agreed to by the adviser, the adviser also agreed to be censured.

SEC Charges Lobbyist and Bank Pays $12 Million to Settle Pay-to-Play Claim

A failure to abide by state pay-to-play legislation has led to SEC enforcement under the Exchange Act. The SEC has settled the matter brought against a former bank senior vice president and head of public funds, who was alleged to have entered into an agreement with a deputy treasurer of the State of Ohio and a purported lobbyist. As part of this agreement, fees were allegedly paid by the bank to the lobbyist, and actually operated as kickbacks to the deputy treasurer and campaign contributions his treasurer's campaign. This arrangement was purportedly an inducement to the award of international sub-custodial business awarded by the state to the bank. It is alleged that the lobbyist was not actually a lobbyist, and had no prior experience, and that the bank's payments to the lobbyist were intended by the bank's senior vice president to be payments to the state treasurer.

In addition, the senior vice president arranged for political contributions to the campaign of the same official through a second lobbyist. The actions of the bank senior vice president violated the bank's Standard of Conduct, and the use of the second lobbyist to funnel contributions to the state official's campaign circumvented direct instructions of the bank's compliance department.

Once the bank won the international sub-custody business, the senior vice president signed an agreement making representations of compliance with state pay-to-play laws — representations he knew to be false. The SEC charged the senior vice president with violation of Rule 10b-5 under the Securities Exchange Act. The SEC brought related charges against the bank, which demonstrated cooperation with the SEC by conducting an internal investigation, and appointing an independent law firm to conduct an investigation and share its findings with the staff of the Commission's Division of Enforcement. The bank's employees cooperated fully. In the matter of Vincent J. DeBaggis,; in re State Street Bank and Trust Company.

Why Transparency is Essential for Investment Advisers and Funds

The Securities and Exchange Commission (SEC) recently announced that a Manhattan-based investment advisory firm and its Toronto-based hedge fund manager agreed to settle charges that they misled investors about a fund's investment strategy and historical performance. They will reimburse investors $2.877 million in losses. The manager agreed to pay a $75,000 penalty and is barred from the securities industry.

Key Takeaways

While the investment adviser and the manager appear to have engaged in some egregious behavior, there are some key takeaways for all investment advisers and funds. Failure to adhere to these takeaways may result in investment advisers and funds facing lawsuits, enforcement actions, and significant monetary penalties:

- **A fund's disclosure about its investment strategy must be accurate, and it must be followed.**

  The investment adviser and the manager claimed that the fund followed a "five categories" strategy focusing on 285 varying metrics within the categories of momentum, growth, value, risk, and estimates They also stated that no more than 20 percent of the fund's assets could be invested in any single security, and that no more than 5 percent of the fund's assets could be invested in an illiquid security. Deviation from this investment strategy led to poor performance and a further bad decision to misrepresent fund performance.

- **Historical performance must be accurate.**

  The manager provided investors with documents that reported purported historical results that were significantly higher than the fund's actual results. In order to show these misleadingly positive returns, the manager excluded the disastrous returns he actually achieved, replacing them with the hypothetical returns that his model purportedly would have achieved if he had applied it correctly and consistently during the periods reported.

- **Do not engage in conflict of interest transactions without making full disclosure to investors.**

  The manager did not disclose to the investors that a significant investment had been made in return for the promoters agreeing to help the adviser and the manager find clients.

Summary

The investment advisory firm and manager acted as advisers to a private investment company or fund. They marketed the fund based on promises to follow a scientific stock selection strategy but, in practice, they repeatedly deviated from that strategy. When an early deviation led to heavy losses, the manager marketed the fund based on a misleading mixture of actual and hypothetical returns. When the investment advisory firm and manager later deviated from the strategy again, by investing most of the fund's assets in a single penny stock, the manager failed to disclose the investment to the fund's investors. The manager also failed to disclose that when he made the investment in the penny stock, he had a conflict of interest.

The manager subsequently used unsupported valuations of the penny stock to make the fund appear more successful than it was, thereby inducing additional investments and delaying investor redemption attempts. He also lied to investors about the fund's liquidity when they began requesting redemptions in 2013. Through these deceptions, the manager delayed the discovery of his fraud and prolonged his ability to earn management and performance fees.