THE NATIONAL LAW REVIEW

Voluntary Remediation and the SEC: Six Key Elements and Three Potential Pitfalls

Thursday, May 3, 2018

Article By Laura Stafford
Samuel J. WaldonProskauer Rose LLP
The Capital Commitment

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A recent settled SEC order, *In re Arlington Capital Management, Inc. and Joseph F. LoPresti*, highlights the potential benefits of voluntarily taking steps to remediate conduct or practices that could run afoul of the SEC's rules and standards. If done correctly, voluntary remediation can result in meaningful reductions in the sanctions sought by the SEC. But if done incorrectly, remediation can result in wasted time and money – and possibly make matters worse. This post will explore the elements of an effective voluntary remediation plan, as shown by the remediation in *Arlington*, as well as some of the potential pitfalls of ineffective remediation.

In *Arlington*, the SEC found that the firm, an investment adviser, and LoPresti, the firm's owner and CCO, fraudulently advertised the firm's performance by using inflated, hypothetical, back-tested results and creating the false impression that those results were the firm's actual performance results. As part of the settlement, Arlington and LoPresti each agreed to the entry of a cease and desist order and a censure, as well as the payment of civil penalties – $125,000 by Arlington and $75,000 by LoPresti. Most notably, however, LoPresti was not barred or suspended from being associated with an investment adviser, a sanction the SEC could have pursued.

In accepting the settlements with Arlington and LoPresti, the SEC specifically emphasized the respondents' remedial efforts. The *Arlington* Order suggests that an effective remediation plan should focus on the following:

1. **Timing**. The firm began its remediation during the SEC investigation – demonstrating that remediation is typically better late than never. However, the SEC will almost always give greater credit to a firm that begins remediation before becoming aware of an SEC investigation.

2. **Outside compliance consultant**. The firm retained an outside firm to review and revise the firm's compliance policies and procedures. The SEC will almost always have greater confidence in remedial efforts recommended or implemented by an outside firm, rather than the firm itself. It is common for the SEC to require, as part of a settlement, that a firm retain an independent compliance consultant.

3. **Compliance policies and procedures related to the misconduct**. The firm revised its policies and procedures relating to advertising, permitting the firm to argue to the SEC that it is unlikely that similar misconduct will occur in the future.

4. **Compliance policies and procedures more broadly**. The consultant undertook a comprehensive review of Arlington's entire compliance program, rather than limiting its review to the firm's policies and procedures regarding advertising. The SEC often views isolated misconduct as potentially evidencing broader legal or compliance failures at a firm. By reviewing and revising its overall compliance program, Arlington was able to demonstrate its commitment to establishing a "culture of compliance " at the firm.

5. **Compliance functions**. The firm agreed to separate the CCO function from the management function. LoPresti previously held both functions, but as part of the settlement, the firm agreed to hire a new CCO to replace LoPresti. Also, the firm upgraded its compliance software.

6. **Training**. LoPresti and the new CCO both received additional training provided by the consultant.

Although not part of the remediation in *Arlington*, where there are identifiable client losses, an effective remediation plan could also include reimbursement – or at least segregation – of the losses by the adviser. In appropriate cases, disclosure to clients and investors of the underlying misconduct or the remediation may be important. Moreover, it may be appropriate in some cases to discipline or terminate employees involved in the wrongful conduct.

While effective voluntary remediation, as in *Arlington*, can offer significant benefits, implementing a plan is not without risks. Most notably, a firm engaging in remediation should be mindful that:

- The remedial efforts could be viewed as insufficient. If, in evaluating a proposed settlement, the SEC takes this view, the remediation will have accomplished little more than wasting time and money. As a result, a firm should carefully design its remediation plan with an eye towards anticipating and meeting the SEC's expectations.
- The remedial efforts could attract attention to an area of concern. The SEC staff (Enforcement staff in an investigation or OCIE staff in an exam) could view the remediation as an acknowledgement by the firm that the conduct at issue was unlawful (or at least problematic) or that its prior policies and procedures were deficient. In developing a remediation plan – especially where the underlying conduct is not definitively violative – a firm should take steps to ensure that the remedial efforts do not have the unintended effect of helping to establish culpability.
- The remedial efforts themselves could create additional disclosure obligations, which could raise concerns with clients. A firm considering a particular remediation effort should carefully consider whether and how to disclose the remedial changes to clients or investors. Failure to accurately do so may be an additional violation of the securities laws, which the SEC may view as more serious than the underlying compliance matter being remediated.

As Arlington's efforts demonstrate, voluntary remediation can offer significant benefits if done correctly – particularly in mitigating the sanctions sought by the SEC in an enforcement action. However, voluntary remediation is not without risk, and therefore any remediation plan should be carefully developed and implemented with those risks in mind.

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