

From SEC Examinations to Enforcement Actions

Ascendant Compliance Management Conference
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By: Eva Carman, David Luis, and Steve Stone

Speakers



**Eva Ciko
Carman**

Partner
Ropes & Gray LLP

Eva Carman is the Co-head of the Ropes & Gray Securities Enforcement Group and a member of the firm's Government Enforcement and Securities Litigation Groups. She has over two decades of experience counseling investment managers on the securities industry's most pressing issues, including those relating to insider trading, custody, money market rules, supervisory liability and anti-corruption. As a regulatory lawyer and a litigator, Ms. Carman both counsels managers in advance of inspections, and also conducts internal investigations and represents managers in actions by the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Department of Justice. She is regularly invited to speak to securities industry groups on developments in securities enforcement and hot topics related to effective defense of regulatory actions.



**David
Luis**

Chief Compliance
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David Luis is the Chief Compliance Officer at Gaillard. Prior to joining Gaillard, David was the Chief Compliance Officer of FAF Advisors and First American Funds, the asset management arm of U.S. Bancorp. Previously, David was Chief Compliance Officer of Franklin Advisers and Chief Compliance Counsel for Charles Schwab in San Francisco. David earned his B.A. in history from Brown University in Providence, Rhode Island, and a J.D. from the University of California, Hastings College of Law, in San Francisco. He has been admitted to practice law in both California and Minnesota. He is a past Chairman of the Board of Directors of the National Society of Compliance Professionals and is a nationally recognized speaker in compliance issues. David has more than 20 years of experience in compliance and investment company law.



**Steve
Stone**

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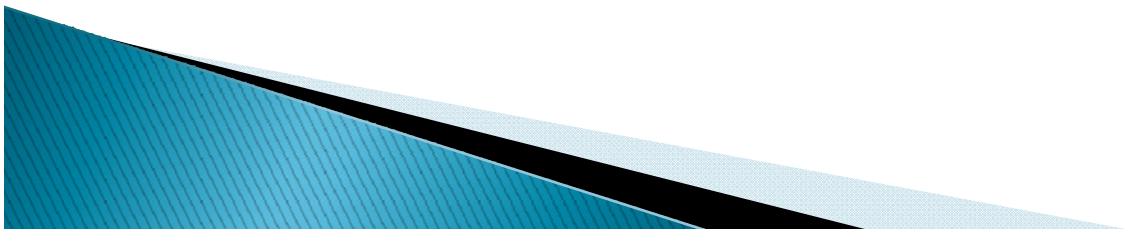
Steve Stone is the leader of Morgan Lewis's Investment Management Practice Group, and has formerly served as a member of the firm's Advisory Board and as the Managing Partner of the firm's Washington, D.C. office. Mr. Stone's practice focuses on broker-dealer and investment manager regulation and enforcement defense and regulation of the capital markets. Mr. Stone counsels clients on a wide variety of regulatory and transactional matters, including development of innovative products and services; regulation and operation of separately managed account (or wrap fee) programs and hedge funds; trading issues affecting both broker-dealers and investment advisers; soft dollar arrangements; SEC, FINRA and state investigations, and enforcement actions; mergers and acquisitions and joint ventures involving broker-dealers and investment advisers; interpretive and "no-action" letter requests; insider trading issues; and related matters.

Agenda

- ▶ The New Dynamic of SEC Inspections
- ▶ Preventing Inspections from Becoming Enforcement Actions
- ▶ Anatomy of an Enforcement Action
- ▶ Current Trends in Enforcement
- ▶ Questions & Answers

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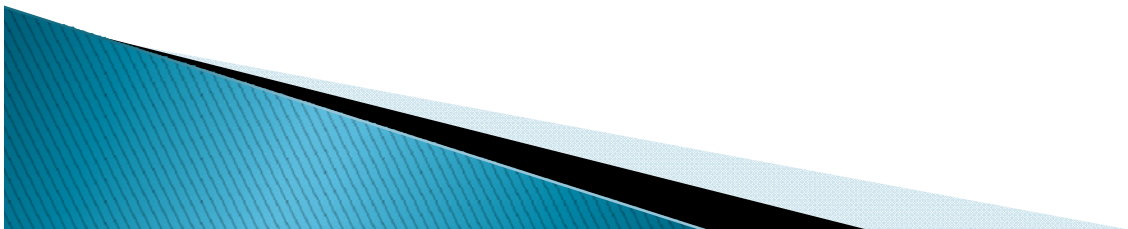


The New Dynamic of SEC Inspections

- ▶ National Exam Program and Priorities
 - “National” Exam Manual
- ▶ OCIE / Enforcement Coordination
 - Impact of Delegated Authority to Initiate Investigations
- ▶ National Examination Risk Alerts
- ▶ Emerging Questions & Areas of Focus for Advisers
 - Risk Analytics and “Aberrational Performance”
 - Backgrounds and Qualification of Managers
 - Systems Related Issues
 - Disclosure & Conflicts
 - Testing

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Preventing Inspections from Becoming Enforcement Actions

▶ Prepare for Inspections:

- Conduct a Risk Assessment
 - Identify all possible events that could pose risks
 - Allocate resources accordingly
- Demonstrate a “Culture of Compliance”
 - Establish a tone at the top
 - Ensure the qualifications of your Chief Compliance Officer
 - Observe the record-keeping requirements
 - Conduct periodic internal compliance reviews
- Implement Testing
 - Implement transactional, periodic, and forensic and record all findings and corrective measures taken

Preventing Inspections from Becoming Enforcement Actions

▶ Manage the Process:

- Designate an Exam Coordinator
 - Inform the examiners that all information requests should be directed to this person
- Inquire about the Focus of the Examination
 - Fully understand the areas that the examiners will cover and clarify all requests as necessary
 - Discuss time frames and duration
- Promptly Respond to all Requests
 - Review all documents before production
- Arrange and Prepare for Interviews
 - Prior to any interview, the coordinator should meet with the employee to explain the interview process, and offer guidance on what to expect and how to respond

Preventing Inspections from Becoming Enforcement Actions

▶ Advocate Your Case:

- Never refuse to produce records that are subject to the SEC's inspection powers
- Avoid confrontations with the SEC, but stick to the ground rules you have agreed upon
- Confront the examiners' concerns directly and undertake an effort to persuade the staff not to make a referral
- Make factual and legal arguments and address potential remediation you have undertaken or are willing to undertake to address the SEC's concerns

Preventing Inspections from Becoming Enforcement Actions

▶ End the Inspection Quickly:

- Produce all information promptly and efficiently
- Give the SEC staff proper facilities
- Expedite pre-production review of requested records
- Be scrupulously honest
 - A serious regulator problem will only become more serious if personnel of the registrant lie to or mislead the SEC
- Keep all promises made to the SEC

Preventing Inspections from Becoming Enforcement Actions

▶ Preserve Confidentiality:

- Information produced to the SEC frequently contains extremely sensitive business information and, once this information is placed in the SEC's files, it may be subject to disclosure to numerous sources
- To preserve confidentiality:
 - First, request confidential treatment under the FOIA
 - Second, request, in writing, the return of documents

Preventing Inspections from Becoming Enforcement Actions

▶ Possible Outcomes of Inspections:

- Letter Closing the Examination
 - A letter indicating that the examination has concluded without findings
- Deficiency Letter
 - A summary of examination findings requiring the firm to respond within 30 days, documenting the steps it intends to take to correct deficiencies
- Enforcement Referral
 - When examiners find a violation, they must determine whether it should be referred to the Enforcement staff for further investigation and possible enforcement action

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Anatomy of an Enforcement Action

- ▶ What First Gets the SEC's Attention?
 - Inspection issues
 - Public disclosure by the company itself about compliance problems
 - Whistleblower tips, including anonymous tips
 - Lawsuits and negative market buzz about a company

Anatomy of an Enforcement Action

- ▶ The SEC's investigative structure and tools
 - Specialized units
 - Asset Management and Market Manipulation Units (mutual funds, private funds and investment advisors)
 - Cooperation agreements
 - Defining cooperation and its rewards
 - Whistleblower provisions – New developments
 - The impact Cooperation Agreements and the Whistleblower Program on enforcement defense
 - Coordination with the criminal authorities

Anatomy of an Enforcement Action

▶ The SEC's Broken Window Approach

- Traditionally, the SEC would file an enforcement action only when the violations were significant. Now, minor mistakes may subject the firm to an SEC Enforcement action.
- *"It's like the crime-fighting approach championed by Rudy Giuliani in 1990s New York - if you stop people when they commit small infractions, they are less likely to graduate to bigger ones. . . . For Rudy it was a focus on subway turnstile-jumpers and squeegee-men. For us it is the advisers who lie about graduating Phi Beta Kappa, conceal their association in a past failed business venture, or inflate their assets under management who might well be the same persons who outright steal your money when the markets turn against them."* (Robert Hisami, Dec. 2011)

Anatomy of an Enforcement Action

▶ What are the Stages of an Investigation?

◦ Informal Investigation

- “Informal” refers to lack of Formal Order of Investigation, not level of interest
- Requires voluntary cooperation or regulatory authority

◦ Formal Investigation

- Formal Order of Investigation
- Authority to subpoena documents and testimony
- Non-public

Anatomy of an Enforcement Action

▶ How Does the Wells Process Work?

- Wells Notice
 - The right to notice
 - The nature of the notice – phone call, then letter
 - Official notice of target
 - Pre-Wells advocacy
- The Wells Submission
 - Goes to the Staff
 - Seeks to have the Staff not pursue an Action
- Action Memo
 - After investigation, if Staff thinks enforcement action is warranted, it provides “Action Memorandum” to Commission
 - Action Memorandum not given to our clients

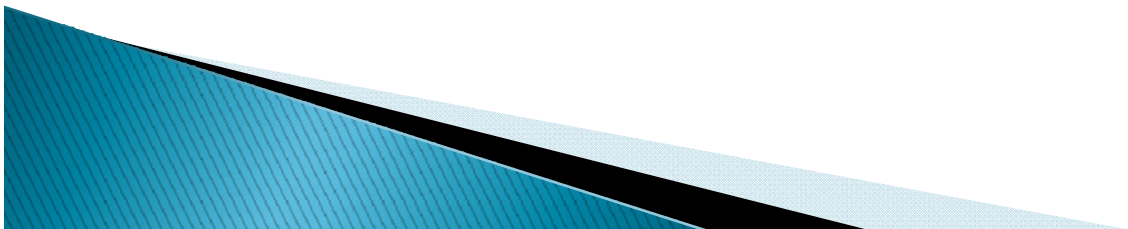
Anatomy of an Enforcement Action

▶ How Do Cases Get Resolved?

- Once a case goes to the Wells Process, it can be resolved in several ways
 - *Option 1:* The 5 Commissioners can vote not to sue, in which case the matter is concluded
 - *Option 2:* The 5 Commissioners can vote to sue, in which case, the matter will be litigated in either Federal Court or in an Administrative Proceeding
 - *Option 3:* The parties may settle the case, either before or after the Commissioners authorize suit (most cases are resolved before the Commissioners authorize suit)

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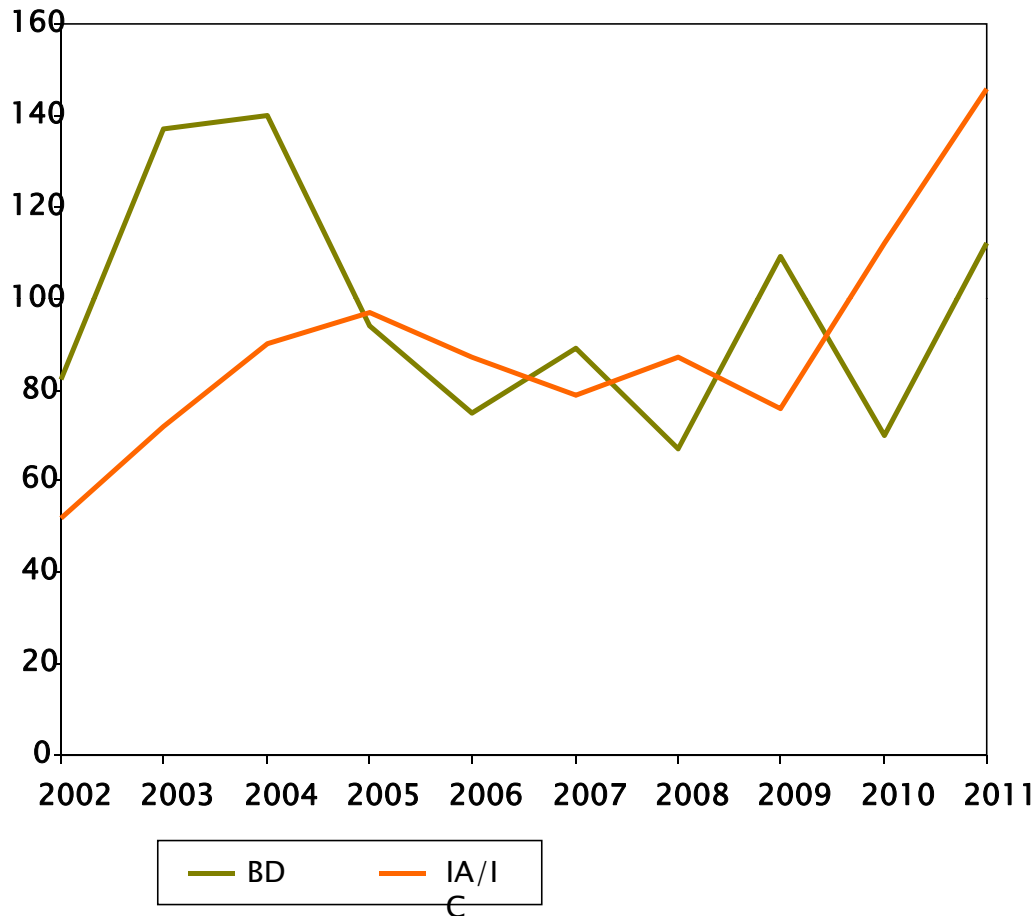
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Current Trends in Enforcement

- ▶ Broad Based Changes in Enforcement Program
 - Cooperation Initiatives
 - Dodd–Frank Act Whistleblower Provisions
 - Asset Management Unit’s 2nd Year
 - Specialized Personnel in OCIE and Enforcement
 - Technology Resources and Analytical Tools

2011 Highlights: SEC Statistics



- **146** cases against investment advisers and investment companies
- **30%** increase over FY 2010
- **92%** increase from FY 2009
- 112 cases against broker-dealers (70 in FY 2010)
- Cases against investment advisers, investment companies and broker-dealers represent 35% of SEC's total enforcement docket

Current Trends in Enforcement

- ▶ Compliance programs and supervisory structure
 - Felt & Company, Inc. (Nov. 28, 2011)
 - OMNI Investment Advisors Inc. and Gary R. Beyond (Nov. 28, 2011)
 - Asset Advisors, LLC (Nov. 28, 2011)
- ▶ Mutual fund fee arrangements, including board oversight and the 15(c) contract renewal process
 - Morgan Stanley Investment Management, Inc. (Nov. 16, 2011)
 - AMMO Consultant Stentorian Berthed (June 27, 2012)
- ▶ Turn key mutual fund solutions and inexperienced advisers

Current Trends in Enforcement

- ▶ Failure to disclose errors & focus on code
 - AXA Rosenberg Group LLC (Feb. 3, 2011)
- ▶ Performance and background claims
 - Cretan Kapoor; Think Strategy Capital Management, LLC (Nov. 10, 2011)
 - Georgia Elias and International Consultants & Investment Group Ltd. Corp. (Apr. 6, 2012)
 - GM Capital Management LLC, GM Capital Partners LLC, Gabriel Bertan and Marco Bertan (Apr. 20, 2012)
 - Jason A. D'Amato (Aug. 31, 2012)
 - Raymond J. Lucia Companies, Inc. (Sept. 5, 2012)

Current Trends in Enforcement

- ▶ Claims about investment process and “skin in the game” investments
 - Quanta Asset Management LLC; Bull tick Capital Markets Holdings, LP; Javier Guerra; Ralph Patina (May 29, 2012)
- ▶ Misrepresentations on sufficiency of due diligence procedures
 - Cretan Kapoor (Nov. 30, 2011)
- ▶ Marking the Close
 - Eric David Wagner; Wagner Investment Management, Inc. (Dec. 23, 2011)

Current Trends in Enforcement

- ▶ **Fraudulent use of Social Media**
 - Anthony Fields, CPA d/b/a Anthony Fields & Associates and d/b/a Platinum Securities Brokers (Jan. 4, 2012)
- ▶ **Use of one client's assets to benefit another**
 - Martin Currie Inc. and Martin Currie Investment Management Ltd. (May 10, 2012)
- ▶ **Advising clients to invest in proprietary companies or vehicles**
 - Mark F. Spangler and the Spangler Group, Inc. (May 18, 2012)
 - Oxford Investment Partners, LLC; Walter J. Clarke (May 30, 2012)

Current Trends in Enforcement

- ▶ Misappropriation of client funds
 - Harbinger Capital Partners, LLC (June 27, 2012)
- ▶ Revenue Sharing
 - Focus Point Solutions, Inc. (Sept. 6, 2012)
- ▶ Insider Trading, including Expert Networks, Info Barriers & Front Running
- ▶ Private Equity Funds and related Conflicts, including
 - Use of placement agents and other gatekeepers
 - Preferential terms in side letters and co-investing
 - Relationships with portfolio companies
 - Investing at different levels in the capital structure

Current Trends in Enforcement

- ▶ Valuation of illiquid, hard-to-value assets and derivatives and related disclosures
 - Morgan Asset Management, Inc. and Morgan Keegan & Company, Inc. (June 22, 2011)
 - UBS Global Asset Management (Americas) Inc. (Jan. 17, 2012)
 - OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc. (June 6, 2012)

Current Trends in Enforcement

- ▶ PE Focused SEC Enforcement Priorities
 - (1) Valuation as a means to misrepresent performance
 - Are two PE funds valuing the same portfolio company differently?
 - Are valuations consistent, robust and documented?
 - Did valuations increase prior to a capital raise?
 - (2) Undisclosed conflicts changing perspectives on business as usual
 - Selectively reporting only the most successful investments?
 - Claiming inability to divest to earn more management fees?
 - Were preferential terms for certain investors disclosed?
 - (3) Insider trading based on data from post-registration inspections
 - Advance knowledge of going-private transactions?
 - Advance knowledge of fund investments in public companies?
 - Non-public data obtained by PE firm from board membership?

Current Trends in Enforcement

- ▶ Market manipulation through high frequency trading
 - Pattern of order cancellations / “layering”
 - “Bad” e-mails/IMs at time of trading
 - Financial motivation unrelated to the transaction at issue
 - Attempt to dominate market (especially at close)
 - Trades not economically reasonable on their own terms

Current Trends in Enforcement

- ▶ Legal and compliance officers subject to liability for “failure to supervise” despite not serving as a direct supervisor
 - *Geutfreund* (1992) & *Urban* (2012) – liability for General Counsel
- ▶ Legal and compliance officers can thus be held responsible for:
 - Duty to investigate alleged misconduct
 - Duty to take effective action
- ▶ SEC recognizes the dilemma for legal and compliance officers:
 - The more engaged and therefore effective they are in their job, the more they risk incurring liability
- ▶ No official resolution of dilemma

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