PODCAST: Investment Management Update – Regulatory and Enforcement

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Categories: Financial, Funds, Litigation, White Collar

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[Brian Dolan]
Hi, this is Brian Dolan with the law firm of Pepper Hamilton. Each month, Pepper partner Greg Nowak hosts a webinar for West LegalEdcenter which focuses on issues that are affecting private funds and their managers. You can download a copy of the PowerPoint slides that the presenters went through by visiting Pepper's Insight Center at www.pepperlaw.com where this podcast is posted. Thank you.

[Gregory J. Nowak]
This is Greg Nowak. I am a partner in the Financial Services Group at Pepper Hamilton in the New York and Philadelphia offices, and to all of you, first of all, happy thanksgiving. I hope you had a very nice holiday with your family or whomever you happen to spend that with and we are here today – bright-eyed and bushy-tailed as they say – to focus on our favorite topic as lawyers – compliance and enforcement. Our industry, the financial services industry is, of course, always concerned about the assets that we manage, the trust that our investors and clients place in the industry and making sure that it is a level playing field for investors as well as for the market participants. With me today, I have two of my partners, Jay Dubow and Rich Zack. Jay – do you want to introduce yourself?

[Jay A. Dubow]
Good afternoon or good morning depending on what time zone you are in. Jay Dubow – partner, as Greg said, a partner at Pepper Hamilton. I began my legal career at the SEC in division enforcement in Washington and left there as a branch chief a number of years ago and have been general counsel at a public company and I have been at Pepper for a number of years. I am in the White Collar Enforcement Investigations Practice Group and I represent companies involved in SEC investigations, other regulatory investigations, internal investigations and defend class actions, derivative suits, and other securities litigation. Rich?

[Richard J. Zack]
I am Rich Zack. I am a partner at Pepper also in both the White Collar Group, as well as the Financial Services Group. I started out my legal career at the United States Attorney's Office in Philadelphia and when I left there I was the chief of the Securities Section and the Fraud Section and prosecuted securities cases, as well as all different types of fraud cases. I have been at Pepper for about eight years now and represent companies that either are facing regulatory or enforcement issues or are the victim of frauds, and I also give advice to companies about how to set up compliance systems and provide advice about how to operate effective compliance systems in the securities industry and other industries.

[Gregory J. Nowak]
Not just securities – also banking and –

[Richard J. Zack]
Banking, education, in any company that is highly regulated that would have regular interface with regulators.

[Gregory J. Nowak]
And certainly – last but not least – we have our associate, Cassandre Juste. Cass, do you want to tell us a little bit about yourself?

[Cassandre L. Juste]
Sure. I have started my career here at Pepper in the Financial Services Group. I work primarily in the investment management subgroup and most of my work is with registered, open-end and closed-end funds, and I dabble a bit in private funds.

[Gregory J. Nowak]
Okay, well, without further ado, we are going to get to the topic of the day which is a regulatory round table discussion. Before we get into the meat of it, I just wanted to sort of set the table. The enforcement actions that we have seen out of the SEC and the CFTC, which are the primary regulators along with the states in certain instances, have run the gambit. They've run the gambit from going after a group of unregistered funds and their owner for allegedly defrauding thousands of retail investors to the typical Ponzi schemes that we see every year, to very large industry players and their prize financial services, Wells Fargo – even the pastor of one of the largest churches in the country and a self-described financial planner who allegedly defrauded elderly investors by selling them interest in worthless pre-revolutionary Chinese bonds. I mean you can't make some of this stuff up– it is so bizarre. And these are – I think – examples of the bad actors that the SEC has ferreted out and that the courts and the Department of Justice have dealt with – but we also have our traditional insider trading issues, issue of reporting and disclosure issues under the 34 Act as well as this year a lot of enforcement actions and legal cases in the cyber-related area – dealing with initial coin offerings and whether or not something is a security and whether or not it can be traded without registration. So there has been a whole array of enforcement activity by the regulators – a lot of it in traditional areas – some of it cutting edge. Cassie, why don't you tell us a little about the statistics we saw unfold in the last year?

[Cassandre L. Juste]
Sure. On slide three we have a chart that list out the enforcement statistics for the SEC for this most recent fiscal year, end of 2018. In the independent enforcement actions category, they had 490 actions, with follow-on administrative proceedings they had 210, delinquent filings was 121 and their total actions for the fiscal year was 821. There has been a bit of some peaks and valleys between 2016, 2017 and 2018. The numbers increased slightly from 2017, but are still a little bit lower than they were in 2016.

[Gregory J. Nowak]
Rich and Jay, any insights on what's happening on these peaks and valleys?

[Jay A. Dubow]
Yes, so last year, which was the first full year of the Trump administration, if you look at the number of cases, there was a big drop and people were claiming a closet effect, let's say, of the new administration. I just – It's important to note 2016 – the 548 independent enforcement

actions includes over 80 actions that were related to the Municipal Disclosure Initiative that the SEC had, whereby municipal issuers could self-report violations and many of them did and then those actions – there were some in 2015, most of them were 2016, so that skews the numbers. So if you back out, you know, 80 or 80 plus from those numbers and then you look at the trends, I think the trends are that there's relative similarity in terms of absolute numbers between '16, '17 and '18, as you can see there's even a little bump up.

[Gregory J. Nowak]
I was just going to say it seems like not an insignificant bump up – almost 20% from 2016 to 2018, if you back out those 80, which again was a 2015 initiative that just had its completion in 2016. Also, the other important point – the disgorgement and penalties order – this was not actually money that was collected, right? This was what was ordered by the SEC.

[Jay A. Dubow]
Correct. They don't always collect all of what is ordered. People are bankrupt. People don't have the ability to pay. People sometimes skip out on payments. So, it's an ordered numbering.

[Gregory J. Nowak]
But normally what happens, if you don't pay, if you've been banned for example from participating in the securities industry for a period of time, one of the conditions of reapplication generally is that you have paid all of the disgorgement and other penalties that have been ordered, right?

[Jay A. Dubow]
Oh, absolutely, but there's also a worse penalty. If you don't pay, the SEC certainly can go after you. It can get a court to hold you in civil or criminal contempt.

[Gregory J. Nowak]
So the trend line is slightly up. Disgorgement penalties relatively flat, and other penalties relatively flat. Follow on administrative proceedings. What exactly is that?

[Jay A. Dubow]
So a follow on administrative proceeding would be if, for example, there's – an insider trading case, or an accounting fraud case brought in the Federal Court. There's an injunction issued against the company and maybe some individuals, and then if – a follow on an administrative proceeding might be a proceeding to either bar or suspend someone from being associated as let's say an investment bank – that house or investment adviser, broker/dealer, registered person or it could be an accountant or a lawyer, barring someone from practice before the commission for a period of time. That's typically what a follow on administrative proceeding is.

[Richard J. Zack]
And it also could encompass a situation where, you know, if a broker/dealer or someone who's registered engages in some sort of fraudulent or criminal conduct unrelated to the securities industry, the SEC will often do a – if they're convicted or there's some other action taken against them by another agency – the SEC will do a suspension or debarment proceeding in their administrative system, you know, to bar that person from engaging in securities transactions or being associated with a registrant.

[Gregory J. Nowak]
So let's drill into these numbers a little bit, Cassie. If you go to the next slide, this breaks down the enforcement results by type. So what trends are we seeing here?

[Cassandre L. Juste]
Sure. So generally in almost all categories, we have an increase in the category of enforcement proceedings. For the securities offering category in 2018, we had 121 as compared to 94 in 2017. For investment adviser and investment company enforcement actions, this year we had 108 as compared to 82 in 2017. The issue of reporting an audit in accounting enforcement actions, that one actually had a decrease. We had 79 this past year as compared to 95 in 2017. Broker-dealer enforcement actions had a slight increase by ten cases – 63 this year as compared to 53 last year. Insider trading, the same thing – 51 this year as compared to 41 last year. In market manipulation cases, there was a slight decrease. We had 32 cases this year and 41 in 2017.

[Gregory J. Nowak]
So I would assume that the increase in securities offering actions probably relates to the coins. Initial coin offerings and determinations of the Howey Test that – you know, something that was purported not to be a security is in fact a security.

[Jay A. Dubow]
Yeah, I think that that's probably right. I mean – and it also is part of the main street focus of the enforcement division of offerings to individuals. It could be any other kind of private offering as well. And I note the decrease in the issue of reporting/audit in accounting number, those cases are the hardest for the SEC to bring. They are the most complicated. They need accountants, very document intensive to prove, so a decline in that, you know, is interesting because, you know, the other cases are much easier from an enforcement perspective to bring.

[Richard J. Zack]
And, on that note, I think one trend we might see in the coming months now that many of this administration's U.S. Attorneys are now in place and are looking to set their priorities, particularly in this area. One area, two areas, that criminal cases are focused on tend to be the insider trading type of case, and I think we'll see more of those cases brought now that the DOJ personnel are in place and cases involving misuse of investor fund, embezzlement type of cases. We have clear criminal conduct that not only violates the securities laws but may violate the mailer wire fraud statute. And, as Jay said, many of those cases are much easier for the SEC and the DOJ to bring because there tend to be lots of documents showing the misappropriation of funds, and in insider trading cases oftentimes you'll have communications between the participants in the scheme, you know, either emails or texts which make those cases easier to prove.

[Gregory J. Nowak]
So, in the United States, unlike in England and some other countries, we actually have a division between securities enforcement and regulation with the SEC and commodity futures trading enforcement with the CFTC under the Commodities Exchange Act. So, Cassie, tell us the trends we've seen in the CFTC enforcement actions in 2018.

[Cassandre L. Juste]
Sure. So, for 2018, we've had a bit of an uptick in enforcement actions for the CFTC as compared to the past four years, although it's a slight decrease as compared to 2011 and 2012, with 83 cases this year compared to less than 50 cases last year. With respect to their civil penalties, they issued about a little bit over $897 million in civil penalties, and, when you take restitution and discouragement into account there, the total monetary judgment is over $947 million for the year.

[Gregory J. Nowak]
Now, again, if you look at the biggest contributor probably to the spike in enforcement actions, the digital currencies, the SEC and CFTC have determined that Bitcoin, Ethereum and certain others are commodities and subject to the jurisdiction of the CFTC for any fraud purposes and, if there's a futures contract, obviously direct regulatory jurisdiction by the CFTC. The SEC, on the other hand, has jurisdiction over initial coin offerings that involve securities. So, again, run the transaction through the Howey Test and decide whether or not you have a security or something else. And, if you have that something else, that doesn't mean it's unregulated; it may mean that it's simply regulated by the CFTC. So we have a quote here on Slide 7. Jay?

[Jay A. Dubow]
Well, we have some quotes in this program and in the slides, and they're just to reflect what is the thinking of the government, and I think that these are from speeches and other statements from regulators, and, you know, I always take notice and advise, you know, my clients to take notice of what the regulators are saying. So, here, the Chairman of the SEC last August noted that "retail investors believe the right way to regulate investment professionals is to have the core obligations of investment professionals match reasonable investor expectations." And this just goes, chairman Clayton has made a number of speeches where the, you know, analysis of the SEC in its enforcement program is to protect the retail investors, what he calls "Main Street."

[Richard J. Zack]
And just to sort of add to, I think, what the implications of that are, cases that would resonate with retail investors like, you know, stock manipulation or market manipulation-type cases as well as insider trading and embezzlement cases, you know, those are the kinds of cases that, you have clear victims, and they're many times retail investors.

[Gregory J. Nowak]
But you have to unpack this a little bit more. I mean, he's saying the right way to regulate investment professionals – so that would be investment advisers and broker-dealers, presumably, financial advisers – is to have the core obligations of those professionals match reasonable investor expectations. Now, in law school, that would be called void for vagueness, right? Because we don't know what the reasonable investor on Main Street versus New York versus Pittsburgh would have as their reasonable expectation. However, here we have the chairman of the SEC saying, well, we have to essentially distill a standard that would be acceptable across the board and then judge our professionals by that standard.

[Jay A. Dubow]
Right. So professionals who are involved in embezzling client funds, that's an easy, you know, clear violation. And that usually involves a retail investor being evicted. As well as insider

trading where potentially sophisticated professionals are trading information that's not accessible to a retail investor. And same with, you know, more sophisticated market manipulation schemes that involve broker-dealers, but all those violations that are accessible to professionals at the same time that victimize directly retail investors, I think, will be a focus.

[Gregory J. Nowak]
Well, one of the things we saw in 2018 was the court decisions invalidating the Department of Labor's fiduciary rule, and the SEC immediately took up that mantle and said we need to focus on how to harmonize the standard by which broker-dealers and investment professionals are measured. Now, of course, traditionally, broker-dealers were firing for debt best execution and with the duty to the client other than best execution, whereas the investment management professional has always had the buy, sell and hold decision, so even the decision to hold is still an investment decision for which they're paid in assets of the management fee, right? So, melding those two seems almost impossible to me, and we haven't yet seem a proposal from the SEC, have we, that attempts to draw that line, and we know the DOL's decision has been to wait and see. I don't think they're going to take on that project again after having had their fingers slapped by the court. So we're sort of back to where we were, back to the future, I guess?

[Jay A. Dubow]
Well, I think we're back to the SEC. The SEC often regulates through its enforcement and through its cases and enforcement actions, so we're going to take some of them, and we're going to talk about them today.

[Richard J. Zack]
Including, you know, cases that they settle where they ensure release, you'll hear SEC lawyers, you know, saying that's our official position, that that conduct is a violation, even though it wasn't. That was not litigated, decided by a third party. You know, that's the SEC's position. You need to take note of it.

[Gregory J. Nowak]
All right, so let's get into those cases. Cassie, tell us what happened in Investment Advisers Release No. 4985, which came out in August of this year.

[Cassandre L. Juste]
Sure. So, in this particular case, there were registered representative of a dual registered investment adviser and broker-dealer. This firm had automated systems in place that were intended to detect misappropriation of client funds. So certain types of transactions would kind of kick off a red flag that would indicate there might be misappropriation going on, then someone can check it out and take action at that point. There were two particular systems that either failed completely to function as they were intended to or had limitations in place that prevented the system from detecting the misappropriation as it was designed to do so. So one of the systems was intended to flag any instance where a representative changed a client's address to one of their own personal or business addresses. That would indicate misappropriation of funds, and then action could be taken at that point. That system failed to catch several instances where a representative misappropriated about $1 million from two of her clients.

[Gregory J. Nowak]
All right, so let's make sure our audience understands exactly what happened here. We had presumably a brokerage firm with custody, or an adviser with access to custody accounts, who went into the client management system and changed the client's address.

[Cassandre L. Juste]
Correct.

[Gregory J. Nowak]
And, as a result, with that address change, correspondence and other documentation which would be used normally by an investor to track what's happening in their account, at least on a monthly or quarterly basis, they would no longer be getting the statements. So that enabled the person to perpetrate the fraud, and then because they had access to the client accounts and other identifying information – the passwords, if you will – they were able to actually move the money. So, in order for this to work, you needed custody. And, once you have custody, then you could see how this type of system would unfold. So, Jay, what kind of policies and procedures should a chief compliance officer have in place? What kind of testing should they do to make sure that this doesn't happen?

[Jay A. Dubow]
Well, yeah, again, you know, I think it varies. It has to be something in place that works for your firm. I mean, you know, a three-person shop might be very different from a hundred-person or a thousand-person shop. So I think that's the first thing. You can't have an off-the-shelf policy. But, you know, if you think about, just, you know, thinking about here, what would have worked? Well, if you go into your smartphone and you changed your password, you'd get an email. Is this you? Did you change your password? So there might have been in place, in this situation, some way for a compliance person or someone else to (1) be notified of this change and (2) to check with the client, did you in fact authorize this change?

[Richard J. Zack]
And this is, Greg and Jay and Cassie – this is a prototypical criminal case that you see the DOJ bringing, that it's a clear, easily provable case against the brokers, and it's such a basic scheme that, really, you know, the critical question is, how did the system miss this. Any regulator is going to expect a brokerage to be able to guard against this type of very simple investment. That's not a criminal case against the brokerage, but, you know, this is a case that the SEC will bring, you know, every day, which sort of raises a question about making sure that you are doing periodic testing of your compliance system. Your system has to evolve to address concerns that come up.

[Gregory J. Nowak]
Let's unpack that a little bit. Let's talk about what it actually means to have the system work. I mean, Jay suggested that you've changed the password, changed the address, and then all of a sudden on your smartphone, after the fact, you get a notice, did you make this change, right? Is that enough? Should there be a system in place that says, before the change becomes effective, we're going to send a notice to your smartphone and say, are you authorizing this change?

[Jay A. Dubow]
Some of the systems do that. Actually some of the smartphone apps do that. You're locked out until you authorize it. Yeah.

[Richard J. Zack]
The other thing that should have been in place or trick that should have been in place is, when you're having a number of address changes that would appear suspicious, that should also trip a red flag in your system. So the head of your compliance department has to be able to sort of predict that, and that means making sure that person is up on the trends, up on the latest technology to prevent this, and is also seeing what type of schemes people are getting in trouble for so they can come back and then modify your system.

[Jay A. Dubow]
With respect again, if the testing point which is listed there is just, do you have the right policies and procedures, and then are they being followed? Because you could have the best policies and procedures in place, but if they're not being followed by your personnel then they're not going to work.

[Richard J. Zack]
And is your compliance chief regularly talking to the people that have the client contact and the people supervising them about making sure that they are, you know, seeing trends like this with respect to compliance.

[Gregory J. Nowak]
That works for a relatively small organization, but you get above 30 or 40 people, and the chief compliance officer is already running around like a, you know.

[Richard J. Zack]
You know, that is a key question in that Jay and I do a lot of cases where we see companies growing significantly.

[Gregory J. Nowak]
Exactly. And they're not keeping pace.

[Richard J. Zack]
Yep. You grow from the ten-representative firm to the hundred-representative firm, and you still have the same two compliance employees in place. They haven't increased the resources. They haven't hired someone who has the experience and the stature within the company to run a compliance department to supervise a hundred or a hundred and fifty, you know, brokers or whatever it is that – the number of people that have the client contacts. You have to have that evolution.

[Jay A. Dubow]
And they sometimes don't even change the policies. Again, as I said earlier, a policy that works for three, ten, whatever brokers or advisers may not work for a much larger group.

[Richard J. Zack]
And this case would be defensible if there was embezzlement by, you know, an individual.

[Gregory J. Nowak]
An individual.

[Richard J. Zack]
Or group of individuals –

[Gregory J. Nowak]
Right.

[Richard J. Zack]
If your system was in place, that it was, you know, properly constituted, that your compliance chief was checking on it and was doing what he or she was supposed to do, these things happen, but the way the company can prove that this is a rogue employee rather than a system failure is by having the systems in place and those constantly being updated and checked.

[Gregory J. Nowak]
Now, what we've seen are several clients with very large workforces in this space do is they deputize. Basically, you know, you'll have middle-level managers, and then one out of five is deputized essentially as a compliance person who has a direct reporting line to the compliance department. They still have their day job, but they now have an extra duty or responsibility, as part of the compliance reporting structure, to report horizontally and then vertically. You know, look horizontally and report vertically, because in those circumstances the organization realizes they need to have more compliance resources, but it takes time to staff that up. And so what better way than to start with the people who are in those positions and, you know, give them an additional responsibility back to the organization?

[Richard J. Zack]
And those systems create some challenges. Greg, as you said, resources. You know, are you, as you grow, you need to invest more resources. And are you supporting that person who you've now given additional job duties to? And then also being aware of the conflicts that that person may have as a result of serving in those two functions, being a supervisor and also being a compliance person.

[Jay A. Dubow]
Another thing is also training. You should be training all of your employees, and you should have a tone on top of compliance so that employees who, if they notice something that might be awry, then they can report, and then it can be looked at.

[Gregory J. Nowak]
So, Cassie, tell us about the Office of Compliance, Inspection and Enforcement Risk Alert from July of this year on best execution.

[Cassandre L. Juste]
Sure. So OC identified some of the most common issues with respect to best execution. They kind of run the gamut, but there are certainly a few themes here. So one of the things that they had noticed was firms not seeking comparisons from other broker-dealers, utilizing only one broker-dealer consistently without seeking comparisons from competing broker-dealers, either initially or on some type of an ongoing basis. There's also an issue they noted that was one the

larger ones of not performing best execution reviews, and the issue there is not necessarily that the adviser didn't conduct them at all but that the advisers couldn't demonstrate that they periodically and systematically evaluated best execution throughout, the documentation didn't show anything.

[Gregory J. Nowak]
So the trading consultants tell you that, to get best execution, you may not have to go to the national market; you have to go to a dark pool. You have to go to an alternative training system. So how does that get measured, you know, when you're looking at best execution? I'm not necessarily getting the best commissions, but presumably I'm going to an ATS, getting the best possible price for the actual instrument. So, you know, trading, it's not as simple as it used to be, with, you know, beating down the commissions to so many, you know, basis points per share, it's now a much more complex analysis, and should I be trading this on the national market system, or is there an available ATS, alternative trading system, licensed and regulated, of course, that would give my large-block trades a better price than I would get if I went directly to the floor. So, testing points here. Jay?

[Jay A. Dubow]
Yeah, so, you know, this, again – I first note this came from OC as something that may, you know, that they felt important to issue this, this past July, as a result of what they're seeing when they're doing their exams. So they're running into a number of firms that are, in their eyes, deficient in this area. So, in terms of sort of preparing for next year what you should be doing, a number of things that we listed, of points, were, you know, doing execution reviews, in terms of testing, you know, again, how often one does it would depend in part on, you know, the volume of trading, the size of the firm. You should also consider all materially relevant factors in terms of selecting of BD for your execution, what's the capacity? Getting input from portfolio managers is important. We're on the point, it's comparing with broker-dealers, not just going to one place even though you think that's the best price or best execution, and then soft dollars. Is there a soft dollar policy in place; is it being followed? And these are all related because I'm sure from the commission standpoint they're looking at, is there some kind of quid pro quo from a broker-dealer to, you know, get that business.

[Richard J. Zack]
And this is also another instance where, you know, an alert's issued with very specific points and issues to address. That's something that should be – you should consider folding that into your compliance system. So meaning, as Jay said, training of employees, educating of your compliance staff, and, again, you know, addressing the fact that this has been made a priority by regulators.

[Gregory J. Nowak]
Now, the interesting thing here, soft dollars. This was all the rage and a huge issue ten years ago, five years ago. Don't really hear much about soft dollars because I think the industry has been so beaten up about it, and pretty much the institutional investors have required their advisers to use 28E, say Parker Policies, that essentially say soft dollars will only be used for investment research and related activities. So, for all intents and purposes, the soft dollars are not the issues that they used to be with people paying for vacations, etc., obviously illegally, but, you know, they were trying to do that. However, I think your point, Rich, is an important one,

which is soft dollars can raise their ugly head in ways that people don't realize, especially if there's some form of order flow arrangement or otherwise that you need to be aware of, and you need to ferret that out. So it might not be called soft dollars, but if it's a payment to the entity for commissions, etc., that's got to fit within the safe harbor; otherwise, you could potentially have an issue. Okay, Cassie, SEC Release 2018-195. Defrauding advisory clients. What happened here?

[Cassandre L. Juste]
Here we have an Indianapolis-based investment advisory firm that was charged with selling approximately $13 million worth of hybrid securities to a little over one hundred and twenty clients, most of whom were current or former teachers or some type of worker in public education, without disclosing that the firm would receive an 18% commission on each of those sales that totaled about $2.5 million. They also created false invoices and took other steps to conceal their involvement in selling the securities.

[Gregory J. Nowak]
Well, if you're creating a false invoice –

(Laughter)

[Gregory J. Nowak]
Right there.

(Laughter)

[Gregory J. Nowak]
There's something going on.

(Laughter)

[Gregory J. Nowak]
So, if somebody says, oh, well, I just need you to create this invoice, that's where you want to say, time out, stop, let's talk to compliance, because that doesn't make any sense. But, you know, an 18% commission, certain insurance policies and others, that's not a beyond-the-pale type of commission. I don't think the commission itself is something that's inimical. It's really the high-risk element and whether or not there was full disclosure of that commission.

[Jay A. Dubow]
Disclosure. Exactly.

[Gregory J. Nowak]
Yeah. So, if you disclose, yeah, I'm getting 20% on this, that in and of itself is not illegal. It may cause the investor to say, I'm not going to pay it. A lot of people do not want to disclose it because they're afraid they're going to be embarrassed by the high commission rates, right?

[Richard J. Zack]
This is a violation committed by the firm owner, so this is the person at the top. And this raises, I think, an important issue, that, I think, despite what we've heard from the Department of Justice

and some others about corporate liability and the Yates Memo and– this is a situation where you're going to see individuals being held responsible, and you're going to see not only the SEC and the Department of Justice looking to charge more individuals, whether it's civilly or criminally, but you're going to see this as a trend, you know, by other agencies. You're going to see state attorneys general, to the extent that they're bringing charges, or even commissioners of banking and securities looking for more cases where they hold individuals liable. There's lots of criticisms of deals that the department as well as the SEC have made where they haven't charged individuals, and there's a question, I think, in judges' minds and in the public's mind of, is that an adequate deterrent if an individual got held accountable.

[Gregory J. Nowak]
So, you mentioned the Yates Memo. So, for our listeners, refresh everybody's recollection. What exactly is the Yates Memo, and how does it apply in this context?

[Richard J. Zack]
The Yates Memo was a memo issued by then Deputy AG Sally Yates, Deputy Attorney General, regarding principles that prosecutors are supposed to consider in making charging decisions about whether or not you charge a corporation or whether or not you seek charges against an individual. And interesting thing, just an aside comment about memos like these that are issued. We've had a number of memos that the DOJ has issued. There's the Philip Memo, there's the Yates Memo, there is the Comey Memo, there's all sorts of different memos that purport to detail DOJ policy. And the Yates, in particular, policy is important because it dealt with individual and corporate liability. But those memos are very difficult to enforce when it comes to individual U.S. Attorney's offices, and it creates a level of unpredictability about how cases will be treated depending on which U.S. Attorney's office is –

[Gregory J. Nowak]
Wait a minute, it's not a top-down hierarchy. The Attorney General of the United States doesn't tell the Attorney General for the District of whatever, this is how you're supposed to manage your office and cases you should take.

[Richard J. Zack]
So the way the system works is, you have a Senate-confirmed Attorney General, and then you have Senate-confirmed U.S. Attorneys in each one of the jurisdictions, each one of the 94 districts that exist in the country. And –

[Gregory J. Nowak]
But they all serve at the pleasure of the President, do they not?

[Richard J. Zack]
They do.

[Gregory J. Nowak]
I mean, usually when there's a turnover in administration, it causes a lot of brouhaha, but generally they change the U.S. Attorney in those districts.

[Richard J. Zack]
Yeah, almost always, they do.

[Gregory J. Nowak]
Yeah.

[Richard J. Zack]
But the discretion that an individual U.S. Attorney has in setting priorities is extensive. You know, there may be Department priorities like, you know, we've heard a lot about a new emphasis on immigration and drug crimes. But each individual U.S. Attorney is going to set his own priorities, and a number have come out and publicly said that they are going to focus more on white collar crime and securities crime despite the business-friendly language that we've heard from some in the Trump administration. There will be a focus on white collar crime by individual U.S. Attorneys, including many that have said, we'd like to bring more securities cases; we'd like to work more closely with the SEC in bringing criminal cases when the SEC is investigating. I know Jay has come across that in his practice and can comment on sort of how that impacts an SEC investigation, but you'll see more activity by the Department of Justice working with the SEC and the CFTC and even state securities regulators.

[Jay A. Dubow]
Yeah, in my practice, when I first left the SEC in '89 and you were involved in a case, for the most part, if the SEC was investigating, it was state, civil, unless there was perjury or something very unusual. But over the years it's evolved, and today there's more now a presumption if you're going to have an SEC investigation that there could be, you know, criminal, you know, U.S. Attorney's Office involved in thinking about looking at the cases left.

[Gregory J. Nowak]
Now, there's a statement here in the third bullet point that says "acting as an unregistered broker-dealer." Now, this is one of those that a drum, whip and banging for many years, that, if you're a placement agent and you're unlicensed, you cannot receive a commission. It's black and white; it's Section 15, Section 29 of the '34 Act; and it is a criminal statute. So, if you're doing this, you're violating criminal law. Similarly, in these investment advisory arrangements, you always have to ask yourself, is the transaction bleeding from investment advice into execution of a transaction on behalf of the client, we are acting as agency capacity. That's where the unlicensed broker-dealer issue comes in, and, you know, a lot of people used to think that was just a throwaway allegation to up the ante, if you will, to force settlement on the other issues. But it's become an independent violation, and we see enforcement actions all over the place now, especially in the initial coin offering and exchange phase. So I'm going to move ahead a little bit and go to the Barn Share Handling Release, SEC, Securities Act Release 10,560. Cassie, what happened there?

[Cassandre L. Juste]
Here we have a broker-dealer that had issued thousands of American deposit receipts or ADRs that weren't backed by the appropriate number of underlying shares. In this case, it was the fifth enforcement action that was taken against a depository bank or a broker-dealer for abusive practices involving ADRs and resulted in an ongoing SEC investigation.

[Gregory J. Nowak]
So, again, in the same way that, if you're making up invoices, if you're making up ADRs that aren't backed by actual securities, you got a problem, right? And it's not something you can let

work out in the wash or that it's ultimately going to converge and be okay. No. These are one of those boxes that has to be ticked before you move forward, and of course the big issue with ADRs, because they're foreign shares, is you have to worry about the tax issues, the disclosures associated with that. Do the foreign shares actually represent an ownership interest in something, or is it, like, you know, ephemeral? So, again, those BDs that are doing this, they need to be certain that they do have the policies and procedures and that they review the economic substance of the trade.

[Jay A. Dubow]
Yeah, I just know that the SEC made a point of knowing it was the fifth enforcement action involving ADRs, which I think was something you really didn't see much of going back a few years, suggesting to me that it might be more in the works.

[Gregory J. Nowak]
Yeah, and I think that's an important point. I mean, ADRs used to be a fairly complicated offering process, with state monies at our banks and custodians and law firms and broker-dealers involved in the process. It has become a much more mainstream, in quotes, type of activity, and as a result you don't have the same institutionalized protections with the big intermediaries making sure that those i's are dotted and t's are crossed. And so that's the concern when you start taking a sophisticated product like an ADR and moving it down market to something that potentially is not appropriate for that type of issuance. Fake Forex Trades. What happened there, Cassie?

[Cassandre L. Juste]
This would be the SEC enforcement action against a UK-based brokerage and U.S. affiliate. This took place between the years of 2008 and 2015, where this brokerage firm regularly placed fake bids and offers and fake trades in the foreign exchange options market to attract order flow. The SEC also had a separate action against the chairman of this particular firm for failure to provide, and that was settled as well.

[Gregory J. Nowak]
And it was investigated by both the CFTC and the New York Attorney General?

[Cassandre L. Juste]
Correct.

[Gregory J. Nowak]
So you have cooperation here between a federal and state agency. And, again, it's one of those things. If you're putting in a fake bid in order to reduce the price, come on.

[Richard J. Zack]
And this raises, I think – the more interesting issue that it raises, and I think that the regulators would focus on more, is that the fake trades were known to executives at the company. And so that is the kind of thing that will get the attention of the CFTC and some of, like, the New York AG people. You know, in every case where they're looking for reasons to charge individuals and hold individuals accountable. And, really, as the slide says, you know, they're going to be very, very critical of that there is not a culture of compliance and that the executives at the top

were not discharging their duty of making sure that their underlings knew that such conduct is not appropriate in that firm.

[Gregory J. Nowak]
So, did the executives know, or is this constructive knowledge? That they should have known because of their position, and, I mean, what is –

[Richard J. Zack]
That's a great question, and that is not – if you were an executive, that's not the position where you want to be.

[Gregory J. Nowak]
No. Let me here. If you're depending on that basis, you're dead.

[Richard J. Zack]
Right.

(Laughter)

[Richard J. Zack]
Really, the question that the government people raise is, why weren't you out looking for this? I mean, you know that this is an issue. Why weren't you modifying your compliance system, directing your compliance person to make sure that you were accounting for this type of activity? So it's the kind of thing, you have to seek it out, you have to find it, and, if you're at a point where you're saying, I didn't know it occurred, that's not the best position to be in.

[Gregory J. Nowak]
Yeah. It reminds me, I don't know if you guys knew this, but I do standup comedy. Trust me, I'd stay with my day job. But one of the parts of my routine is, I talk about management by PowerPoint, where you have senior executives and the way they manage their business, and they get PowerPoint reports from their underlings, and they never really leave their office or their computer screen to actually see what's going on. If that's the way you're managing your firm, you're managing by PowerPoint; you're not managing. And that's not the tone at the top that that the SEC is looking for.

[Richard J. Zack]
If you're a large firm with multiple offices and your chief compliance officer is not – you don't see travel requests or seeing that person traveling the country to other offices, that also is a system failure that you need to make sure that you correct.

[Gregory J. Nowak]
All right, so let's switch gears now to the ICO superstore. ICO Release No. 33221. Now, in the past two years or so, we have seen a significant surge in the creation of things called initial coin offerings, so-called digital assets that may or may not be tied to an ecosystem. Depending on what it's tied to, it may be a security because, you know, following the Howey Test, it's an investment of money in a common enterprise, with the expectation of profit, relying on the efforts of others. So, if you have those four elements, you have a security. If you then create a, quote, unquote, exchange platform or superstore to trade those evidences of whatever it is, then

you presumably need to be a broker-dealer, probably an alternative trading system, and you then need to worry about whether or not the instrument that you're trading has been properly registered under the '33 Act or whether an exception's available. So everything turns on the determination, is this thing a security? And this is where the industry and its advisors has gotten a lot of criticism from the SEC saying, come on, guys, take a good hard look at this, and don't kid yourselves. You know, rather than trying to find reasons why something is not a security, maybe you should be trying to, you know, start with the proposition that it is a security and see if there's an exception that's available. So what happened in this release?

[Cassandre L. Juste]
So here the owners of this self-described ICO superstore were found to have been acting as unregistered broker-dealers. They promoted this business as a means for digital – I'm sorry, to purchase digital tokens during ICOs. They specifically advertised the tokens in the ICO superstore's to investors of, quote, all experience levels unsolicited through social media post forums, newsletters and internet advertising. They received more than 6,000 retail investors and handled more than 200 different digital token-type transactions.

[Gregory J. Nowak]
So, if you start with the basics, these are securities, and if they are securities what's the exception that's available for you to offer? You could do a general solicitation under the Jobs Act, Article 6(c) of Reg Z. But then you need to verify that the investors are, in fact, accredited investors before you take their money. That wasn't happening. So that exception was not available to them. But then once you've issued the coins they cannot be traded until either the one-year restrictions have lapsed under the '33 Act, or there's an effective registration statement, or you get an exemptive order from the SEC. So just having a broker-dealer on the scene doesn't solve these other problems. You have '33 and '34 Act problems. You've got the failure to be a registered broker-dealer. You've got federal problems. All the way around, you know. Now, if these weren't securities, then it's like trading tickets to a baseball game, you know, on StubHub or whatever other secondary market exists. That's probably not going to implicate the federal securities laws. But here, unfortunately, when you go down the path, you say, oh, this is not a security; therefore, I can do anything I want. You have to constantly engage in ratiocination and say, wait a minute, is it now a security? Is it now a security? Do I need to look at this in a different way? And what we're seeing here is that, in this particular instance, the ICO superstore did not do that. So, digital asset fund registration. Cassie, September 11, 2018, IA Release 5004.

[Cassandre L. Juste]
Yes. So this was the SEC's first enforcement action that was related to an investment company registration violation by a digital asset hedge fund. So this particular fund operated as an unregistered investment company all the while marketing itself as the first ever regulated crypto asset fund in the United States. So the investors that they were reaching out to didn't have previous relationship with any of them and generally engaged in general solicitation through the company's website, social media, other media outlets and raised more than $3.6 million over a four-month period.

[Gregory J. Nowak]
So, again. So let's be clear for our audience. There's nothing wrong with a hedge fund doing a general solicitation under the Jobs Act, provided that the investors who come in can all verify and you have the documentation that verifies that they are accredited investors. So, if this fund had done that, then it could hold digital assets whether or not those digital assets are securities, and the investors, they would have ticked the box under 3(c)(1) or 3(c)(7) under the '40 Act, and everything would have been fine. So you can't ignore these rules, put your head in the sand and assume they don't apply to you just because you call it a token or a coin. Cybersecurity. You know, you see people saying that they're budgeting billions of dollars, large entities, with respect to cybersecurity. So what does this Investment Act Release say?

[Cassandre L. Juste]
So this was an issue where there were cyber intruders that basically impersonated contractors, called the help line or help desk and requested password resets to access thousands of clients' accounts. Where this firm went wrong is that they didn't terminate the intruders' access after they realized the issue, so they were still able to access the representatives' accounts and gained access to the personal identifying information for at least 5,600 of their customers.

[Gregory J. Nowak]
So, Jay, what's our testing point for this?

[Jay A. Dubow]
So, you know, I mean, it's just a straightforward one here, is what are your protocols for resetting a password. You know, it would just be a straightforward testing point. And then are they written down, and are they followed? So that's just a problem we have to hear, and there's lots of ways that intrusions can take place, and, you know, the hackers these days are getting more and more sophisticated, so I think it's an issue of having, here, again, good policies and procedures, a good, you know, IT department, someone who's keeping up on the latest trend, and also training so people are following, you know, and not just, you know, responding to someone calling up and asking for a password change. There should have been a protocol on it, how do you verify who that person is who's asking for it. You shouldn't be just giving, you know, password information to anyone who calls up. But there's other things, you know. So that's one problem. And, you know, it's like wack-a-mole. And there's another problem the next day. And all of that, again, comes down to training and policies and procedures. And this also applies not just to your internal people but also applies if you're responsible for third parties who are doing work for you as well, and their policies and procedures.

[Richard J. Zack]
And these schemes – and then we talk about how fraud schemes, you know, evolve very quickly out there and it's important that your clients' folks understand that – schemes involving cybersecurity evolve, you know, infinitely more quickly than just a garden-variety fraud scheme. And so it really pays to invest in resources and personnel that are going to take guarding your data seriously because there's a new scheme in this area every day, where people are – you know, the bad guys are figuring out how to figure out employees' mothers' maiden names so they can answer security questions, and there, where any other system we can set up, it's only good, you know, for a few months before the bad guy figures out how to defeat it. And so, therefore, making sure that your folks are up on the latest trends is critical.

[Gregory J. Nowak]
So, here's one. You get a phone call on your cell phone. You look at the number. You don't recognize it, right? And you figure it's probably a robocall of some sort. So now when I answer those I say nothing. I don't say hello, and I don't say yes, I don't say who this is. Because they use your voice as voice recognition to then power some other fraud, and until somebody else speaks they don't get a word from me, and then normally they hang up, and then I block the number.

[Richard J. Zack]
And sort of the way those schemes are working now, Greg, is the spoof number that they're using, they'll change that number by a few digits every time they call you.

[Gregory J. Nowak]
Yeah.

[Richard J. Zack]
So blocking that number, that's already obsolete because they're already assuming you're going to block the number, and they're going to call you on a different number and a different number and a different number. The key is, don't answer those. If you don't recognize a number and it looks vaguely similar to yours, don't answer it.

[Gregory J. Nowak]
So, municipal securities. This, again, is one of those sleepy areas. We haven't seen a lot of municipal bond issuances because interest rates have been so low and the tax advantage of the municipal issuances has not been as significant. Now, with interest rates creeping up, we start seeing more interest in municipal bonds. So what happened in Release 2018-153?

[Cassandre L. Juste]
Here we have two firms and at least 18 individuals that posed as retail investors to gain priority in bond allocations, then flipped the bonds to broker-dealers for a fee. This occurred between 2009 and 2016, and the SEC also charged the municipal underwriter for accepting kickbacks from one of the individuals that was flipping these.

[Gregory J. Nowak]
So the issue here is getting priority in the bond applications, and, if you want the bonds and then to be able to resell them, you need access to the flow. Procedures were in place with the underwriter to make sure that you didn't have concentrations going to certain brokers, and these individuals attempted to defeat that by using retail investors. So, again, if you're a party to a scheme, that should immediately raise a question in your mind. '34 Act, Rule 15c2-12?

[Cassandre L. Juste]
Yes. These were additional amendments to the Exchange Act. The amendments were in addition to existing disclosure obligations that currently exist in Rule 15c2-12. It requires disclosure of material financial obligations that could potentially impact an issuer's liquidity, their overall creditworthiness or rights of existing securityholders. On the materiality is exempt under the *TSC Industries* standard.

[Gregory J. Nowak]
So, again, this is getting at whether or not the municipality is truly capable of funding the bonds given how, you know, the spectacular municipal bankruptcy that we've had over the last couple of years.

[Richard J. Zack]
And just one quick comment, and it's in case that Jay and I have handled in this area. You know, in the muni area, you know, something may be called a municipal bond, but, you know, the number of entities that issue bonds through, you know, a sort of a nominal municipal issuer is, you know, significant – you know, colleges, universities. The diversity of, you know, the issuers is significant, and it's a very, very high-risk area, probably one of the highest risk areas that are out there as far as investing. And, you know, having an understanding of, you know, you are selling these securities, understanding of what you're selling and what you're putting your customers into is critical.

[Gregory J. Nowak]
So, I'm going to skip the Volcker Rule because that's one of those topics that could take easily an hour in and of itself. With the two or three minutes left, Jay, what's the significance of this Ninth Circuit opinion?

[Jay A. Dubow]
So, this is for private securities class actions and defending them. And typically when these cases get filed, the defendants file a motion to dismiss, and there's a lot of defenses that one can raise at the motion to dismiss stage. And, usually as part of a motion to dismiss, what you want to do is, say, give the full picture, because a plaintiff may take, like, a portion, let's say, of a 10-K and quote that in their complaint. And so what you want to do is, you know, get the context of the rest of the 10-K that the plaintiff did not include, which might in fact completely negate the corner language. So the 10-K isn't usually an exhibit to the complaint, so when you file a motion to dismiss there's certain documents you want to include and say that the court can take judicial notice of without converting the motion to dismiss into a motion for summary judgment, because the motion to dismiss was supposed to be based on the four corners of the complaint, but this whole concept of, again, judicial notice of things that are public filings and certain other documents and certain other public information has been the way the defendants have, you know, supported their motion to dismiss. This Ninth Circuit case reversed a lower court decision and in this case said that the lower court had taken too much liberty with the documents that had been proposed by the defendant as part of their motion to dismiss. And so you can't take judicial notice of all of those. So the net result is, at least certainly for now in the Ninth Circuit and other circuits, plaintiffs' lawyers are going to try to at least make the argument that the plaintiffs should be able to survive a motion to dismiss and try to argue against defendants' including these other clarifying types of documentation, which would then make it more difficult to get a motion to dismiss granted, and therefore result in cases settling more in favor of plaintiffs rather than being dismissed.

[Gregory J. Nowak]
So, again, I'm not a litigator, and going back to law school and my recollection of the Rules of Federal Civil Procedure, this would be a motion to dismiss on the pleadings for failure to state a claim on which relief can be granted.

[Jay A. Dubow]
Correct.

[Gregory J. Nowak]
Why wouldn't you simply then go to the summary judgment and, at that point, produce, you know, the rest of the 10-K or the other documents that you would need?

[Jay A. Dubow]
Because, when you file a motion for summary judgment, the easiest way to oppose that is to say, we need discovery to refute that, and therefore that gets into the expensive part of the case, is the discovery.

[Gregory J. Nowak]
Is the discovery.

[Jay A. Dubow]
Yes.

[Gregory J. Nowak]
So, basically, the plaintiffs are saying, spend the money to defend, or simply settle it out.

[Richard J. Zack]
The whole point is to get to discovery, where the plaintiff will have more leverage.

[Gregory J. Nowak]
Okay. Okay, we have a minute left. Lightning round. Tell us about the compliance cultures and investigations, Rich.

[Richard J. Zack]
And just a couple things to think about that we'd at least talk about intermittently here is compliance culture is critical. You have to have systems in place. Those systems will help you, if you're the firm, establish that the wrongdoer's a rogue employee and his conduct is not attributable to the firm. That's the reason why you have compliance culture, to make sure that the firm is protected. When it comes to internal investigations, that's one function that your compliance department will be – they'll be doing a lot of internal investigations and structuring those properly, making sure that the scope of the investigation is done, is properly described, who is the investigator reporting to. Dealing with all those issues is critical because, at the end of the day, you want the option of taking that internal investigation, if you need to, to the regulator, to the prosecutor, showing your findings and having them accept those findings as credible.

[Gregory J. Nowak]
So, if I do an internal investigation using outside counsel, so I have at least the argument that I have attorney-client privilege, and it uncovers wrongdoing, what's my duty? What's my obligation to the firm?

[Richard J. Zack]
So that, then, that's really when you get to the toughest decision to make, and that is do you disclose it, or do you have no obligation to disclose it in those circumstances?

[Gregory J. Nowak]
I can fix it.

[Richard J. Zack]
You can fix it.

[Gregory J. Nowak]
I could fire the people.

[Richard J. Zack]
You can take remedial action, and you can also – you know, one of the critical things that we advised clients is, if you're going to decide not to disclose it, you've got to be prepared for if someone does come knocking at your door. Whether a whistleblower calls the SEC or the SEC or department finds out about it anyway, you've got to have the story to tell them that shows that you're the good actor and that you investigated it, here's what you determined, here's how you fixed it, and here's why we didn't disclose it proactively.

[Gregory J. Nowak]
And I'm assuming if you're trying to do this DIY?

[Richard J. Zack]
There's significant pitfalls.

(Laughter)

[Richard J. Zack]
In that there are – as everyone knows, there are people that do this for a living. Jay and I, this is what we do every do, is do internal investigations. The structure, the scope, who you report to, what the product is that's at the end of the day, the decision about whether or not to report it to prosecutors or regulators, all those things, it pays to have someone with the depth of experience, who's been through this before, advising them what to do. You know, it pays to get that advice.

[Jay A. Dubow]
Well, in addition to all the advice and making sure it's done correctly, if you do report it, then you want to have someone like, you know, like, say, Rich and I who have credibility with the regulators, so they can be comfortable if the investigation was done properly and not skewed in some way.

[Richard J. Zack]
And that's critical, and Jay and I have done that a number of times, including recently, where we took a case down to the SEC and the DOJ, disclosed the report that we had written about the misconduct, and the investigation ended up not being of our client and the institution but being of the individuals that engaged in the wrongdoing, and the investigation, you know, the higher

power, the government's focused on them rather than the institution. That's where you want to get to.

[Gregory J. Nowak]
Well, thank you very much for your attention. Certainly, if you have any questions, feel free to reach out to Jay, Rich, Cassie or me, and until next month be well, and we'll talk to you soon. Thank you.
