DUFF & PHELPS

U.S. Regulatory Roundup

Fourth Quarter 2017

INSIDE

IN THIS ISSUE

In this issue of the U.S. Regulatory Roundup, we touch upon a number of regulatory events that have occurred over the last quarter, beginning with several pronouncements from the SEC and Chairman Jay Clayton. We then explore FINRA's newly released examination findings and the CFTC's annual enforcement results, as well as guidance from the NFA on the future of virtual currencies. Next, we provide a status update on new, forthcoming and proposed regulations which could impact the capital markets, including changes in investment adviser reporting obligations, margin requirements, FINRA registration, pay-to-play, and the oft-debated DOL uniform fiduciary rule. Lastly, we dive into a number of enforcement actions involving deficient compliance programs, insider trading, fraud, initial coin offerings, trading violations and fraud, and also address a handful of general industry developments.

— Sean Wilke, Director, U.S. CRC

SEC Updates

Statement by SEC Chairman

Summary of Statement by SEC Chairman Jay Clayton During 49th Annual PLI Seminar

On November 8, 2017, SEC Chairman Jay Clayton ("Clayton") spoke at the Practicing Law Institute's 49th Annual Securities Regulation seminar on governance and transparency within the SEC and securities markets.

Clayton first addressed the rules that the SEC must following when they are creating new rules for the securities markets. One such rule is the Regulatory Flexibility Act ("RFA"), which aims to structure regulatory requirements around the scope and scale of businesses. Clayton describes the idea of "regulatory proportionality" under the RFA whereby the SEC distinguishes its short-term and long-term rulemaking objectives and develops a plan for a phased implementation that would not pose an undue burden to member firms.

Clayton acknowledged that the SEC's focus over the past few years has been on short-term objectives. Citing limited resources and the time-intensive and resource intensive nature of enacting new rules, Clayton acknowledged that it would be nearly impossible to successfully everything of the SEC's near-term agenda. Due to the vast quantity of rule changes, the SEC approximates that is only able to implement 1/3rd of its agenda. The next near-term agenda is expected to be published shortly and is expected to be shorter than past agendas as a means of increasing transparency in the Commission's priorities. Clayton's did reiterate, however, that a shorter agenda does not mean that the SEC is slowing down.

In making the agenda, the Commission left space to add new agenda items in response to major developments in the overall regulatory environment. For instance, in October, the Commission issued three no-action letters to address questions regarding compliance with certain U.S. securities laws when doing business with European Union counterparts affected by MiFID II. Clayton anticipates that further guidance will need to be issued in the future as European counterparts restructure their operations to comply with MiFID II.

In early 2018, the Commission will issue its new strategic plan that spells out its vision for the next five years. While the 2018 strategic plan will likely contain less strategic initiatives and performance goals than the 2014 plan, the priorities that are included on the 2018 installment will address the challenges currently facing the overall regulatory climate, the SEC's most important priorities and the steps that it will take to attain those goals. SEC-registered firms can expect that this document will provide insight into Chairman Clayton's visions for the future of the Commission and how its role will continue to evolve in the coming years.

In addition to the short-term and next five years, Clayton is also mapping out the long-term future of the SEC. The following are priority areas that Clayton targeted during his November speech:

- **Governance.** Clayton believes that the SEC should be reexamining whether the needs of shareholders and companies are being addressed through the current system of proxy voting. Of particular concern to Clayton is whether shareholders are receiving all the information necessary to make an informed decision during the voting process. Even though the SEC made amendments to the proxy process in 2010, there are calls for continued reform to the process, particularly in the areas of retail shareholder participation and shareholder proposals.

- **Shareholder Participation.** Clayton stated that he believes retail investors are traditionally underrepresented in the realm of corporate governance. Based on SEC estimates, retail investors as a group own a majority stake in more than 66% of Russell 1000 stocks. Despite this comfortable majority, it is unclear if the current legislation gives serves the best interests of these retail shareholders. Clayton notes a power imbalance between retail investors and registered investment advisers where, even though it is the retail investors' money that is at risk, the registered investment adviser votes the proxies. For investors that are able to vote their own proxies, the SEC estimates that more than 71% fail to do so. This signals to the SEC that, for retail investors, the task of proxy voting is seen as either futile or unduly burdensome.

- **Shareholder Proposals.** Similarly, the set of rules that should govern shareholder proposals have been the subject of increasing disagreement among various groups of investors.

While shareholder proposals have the potential to bring about positive changes to a company that will benefit investors in the long-term, they can also bring about undue costs to the company. While a direct solution may appear to be unclear, the SEC, in its attempt to reconcile both positions, is considering the implementation of changes that are designed to serve the long-term interests of retail investors so ensure that their voices are heard during the proxy voting process.

- **Transparency.** Transitioning to the transparency segment of his speech, Clayton while emphasizing the importance of the Enforcement Division's work, also stressed that the SEC is continuing to look for ways to stop wrongdoing before it materializes. He notes that in most enforcement cases, an element of opacity has been present, which tends to abet misbehavior by firms and individuals alike. Accordingly, Clayton identifies several areas where he hopes that the Commission can take steps to increase transparency and protect investors.

- Disclosure of Fees. Clayton notes the proliferation of cases involving the improper disclosure of fees and expenses that are borne by the investor. Clayton states that while the SEC will continue to pursue cases against firms that charge hidden or unnecessary fees to investors, the Commission is also exploring ways to make fee disclosures more transparent to retail investors, as a preemptive measure to discourage future wrongdoing.

- **Penny Stocks.** Clayton also identifies penny stocks as an area that severely lacks transparency with regards to the financial stability of the issuer. Because many companies that trade on OTC exchanges are not required to make regulatory filings, including the provision of their audited financial statements, investors often buy these securities without doing adequate due diligence on their investment. Additionally, the due diligence performed by brokers on OTC securities is often copied verbatim by other brokers and not updated frequently, so as to cause the information to become inaccurate once a material change takes place.

- **Transaction Processing.** Another scenario that carries the potential to harm retail investors is the opacity surrounding the inner dealings of restricted securities. Clayton recognizes the power that transfer agents have in preventing this type of abusive behavior. Transfer agents remove the legends on restricted shares, so they can help thwart the illicit distribution. Because some transfer agents have blatantly disregarded red flags by relying on unsubstantiated opinion letters as justification for removing the restrictive legends on shares, the SEC will continue to monitor the actions of their actions to ensure that they are taking the necessary steps to protect investors.

- **Initial Coin Offerings.** An ever-popular way of raising money, initial coin offerings have become a breeding ground for fraud and exploitation. Because little information exists about platforms that offer tokens in an ICO, many investors are unaware that an ICO's insiders and large investors can liquidate their positions rather quickly, causing increased price volatility or even worse, manipulative trading practices.

The SEC recently issued guidance, stating that tokens acquired through an ICO are deemed to be securities and thus, fall under the purview of federal securities laws. As such, any entity facilitating an ICO must rely on an exemption or register as a national securities exchange. Finally, the Commission plans to increase transparency requirements for these national securities exchanges by providing guidance on how the tokens are valued and what measures are in place to protect investors and uphold market integrity.

- **Investor Education.** While fraud will, unfortunately, be an everlasting part of the securities marketplace, the SEC, in addition to targeting the fraudsters themselves, also aims to educate investors with the aim of protecting them from falling victim to a scam. Highlighting registered investment advisers and unregistered broker-dealers as particular risk areas, Clayton announced the creation of a website that contains a database of individuals that have been disciplined, due to a violation of federal securities laws. It is his hope that investors will utilize this resource to perform the requisite due diligence on their money managers, prior to making an investment.

SEC Cyber Breach

Statement by SEC Chairman Jay Clayton

On September 20, 2017, SEC Chairman Jay Clayton issued a statement highlighting the importance of cybersecurity to the agency and market participants, and detailing the agency's approach to cybersecurity as an organization and as a regulatory body.

The statement is part of an ongoing assessment of the SEC's cybersecurity risk profile that Chairman Clayton initiated upon taking office in May. Components of this initiative have included the creation of a senior-level cybersecurity working group to coordinate information sharing, risk monitoring, and incident response efforts throughout the agency. The statement provides an overview of the Commission's collection and use of data and discusses key cyber risks faced by the agency, including a 2016 intrusion of the Commission's EDGAR test filing system. In August 2017, the Commission learned that an incident previously detected in 2016 may have provided the basis for illicit gain through trading. Specifically, a software vulnerability in the test filing component of the Commission's EDGAR system, which was patched promptly after discovery, was exploited and resulted in access to nonpublic information. It is believed the intrusion did not result in unauthorized access to personally identifiable information, jeopardize the operations of the Commission, or result in systemic risk. An internal investigation was commenced immediately at the direction of the Chairman.

"Cybersecurity is critical to the operations of our markets and the risks are significant and, in many cases, systemic," said Chairman Clayton. "We must be vigilant. We also must recognize—in both the public and private sectors, including the SEC—that there will be intrusions, and that a key component of cyber risk management is resilience and recovery."

The statement also outlines the management of internal cybersecurity risks, including the incorporation of cybersecurity considerations in disclosure-based and supervisory efforts, coordination with other government entities, and the enforcement of the federal securities laws against cyber threat actors and market participants that do not meet their disclosure obligations.

Chairman Clayton writes, "By promoting effective cybersecurity practices in connection with both the Commission's internal operations and its external regulatory oversight efforts, it is our objective to contribute substantively to a financial market system that recognizes and addresses cybersecurity risks and, in circumstances in which these risks materialize, exhibits strong mitigation and resiliency."

SEC Announcements

Members Announced for SEC's Fixed Income Market Structure Advisory Committee

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Updates for FINRA, CFTC and NFA

FINRA 2017 Examination Findings

FINRA 2017 Examination Findings

On December 6, 2017, FINRA released its 2017 Report on FINRA Examination Findings, finding the below observations worth highlighting due to their potential impact on investors and markets or the frequency with which they occur.

CYBERSECURITY

FINRA has seen a significant increase in firms' attention to cybersecurity challenges over the past two years, including at the executive management level. Most firms FINRA examined have established, or were establishing, risk management practices, although the quality of those practices varied substantially both within and across firms. Common threats FINRA observed in 2016 and 2017 include phishing and spear-phishing attacks, ransomware attacks and fraudulent third-party wires that frequently involve use of email or stolen customer or financial advisor credentials.

FINRA observed a variety of areas where firms could improve their cybersecurity programs against these and other threats, including access management; establishing formal processes to conduct ongoing risk assessments; establishing formal processes to review a prospective or new vendor's cybersecurity preparedness; segregating the responsibilities for requesting, implementing and approving cybersecurity rules and system changes; and strengthening data loss implementation tools. FINRA also found that firms' branch offices typically faced greater cybersecurity challenges.

OUTSIDE BUSINESS ACTIVITIES (OBAS) AND PRIVATE SECURITIES TRANSACTIONS (PSTS)

FINRA observed firms that had effective programs to manage OBAs and PSTs typically implemented proactive compliance efforts, particularly at the branch level. FINRA found that firms used frequent training to make registered or associated persons aware of their responsibilities with respect to OBAs and PSTs and implemented various tools to identify undeclared OBAs and PSTs.

FINRA observed instances in which registered persons, other associated persons or firms failed to meet one or more of their obligations under the rules, including instances of some individuals failing to notify their firms of proposed OBAs or PSTs; weaknesses in OBA and PST reviews such as a lack of written supervisory procedures or poorly executed procedures; and problems regarding post-PST approval such as failing to supervise the activity effectively and failing to retain the necessary documentation.

ANTI-MONEY LAUNDERING (AML) COMPLIANCE PROGRAM

FINRA observed firms with effective AML programs actively tailor their risk-based AML program to the firm's business model and associated AML risks as opposed to simply implementing a more "generic" program. FINRA found these firms also conducted independent testing that included sampling customer accounts and found they designated training programs that were specific to the roles and responsibilities of the participating employees.

FINRA observed instances where firms failed to establish and implement an AML program reasonably designed to detect, and cause the reporting of, suspicious activity, including adequate policies and procedures for suspicious activity tailored to the firm; delegating responsibility for AML monitoring; deficiencies in data feeds used for AML monitoring; adequate resources provided to AML departments; and ensuring independent testing of the AML program was properly carried out.

PRODUCT SUITABILITY

FINRA's concerns with regard to the suitability of certain products and their supervision occurred more frequently in connection with certain product classes, specifically unit investment trusts (UITs) and certain multi-share class and complex products, such as leveraged and inverse exchange-traded funds (ETFs). FINRA observed firms that implemented a variety of effective practices in recommending the purchase or sale of these products, which included thoroughly training registered representatives on products' performance and risk characteristics, as well as establishing criteria to consider in determining whether a product was suitable for a specific customer.

FINRA observed instances where firms failed implement adequate internal controls with regard to UIT trading activity and failed to implement adequate supervisory systems and written supervisory procedures with regard to multi-share class and complex products. Some firms failed to provide adequate training for registered representatives with respect to suitability issues, particularly regarding the products described above.

BEST EXECUTION

FINRA observed firms that established, maintained, and enforced policy and supervisory procedures regarding regular and rigorous reviews for execution quality, including a description of the reviews performed and how the conduct and results of the reviews should be documented. Those firms documented their conduct of such reviews, the data and other information considered, order routing decisions and the rationale used.

FINRA had concerns regarding the duty of best execution at firms that receive, handle, route or execute customer orders in equities, options and fixed income securities. FINRA found that some firms failed to implement and conduct an adequate regular and rigorous review of the quality of the executions of their customers' orders. FINRA noted that conducting a regular and rigorous review of customer execution quality is critical to the supervision of best execution practices.

MARKET ACCESS CONTROLS

FINRA observed firms that provide market access implement a variety of effective controls to help satisfy the requirements of Securities Exchange Act Rule 15c3-5 (referred to as the SEC's "Market Access Rule"), such as maintaining reasonable documentation to support thresholds; conducting periodic reviews that assess the reasonableness of thresholds; aggregating capital or credit usage limits by assigning finely tuned or granular limits or by aggregating across applicable measures (e.g., accounts and systems) on a pre-trade basis; and establishing well-defined procedures that clearly describe the process to adjust a threshold both on an intra-day and permanent basis.

FINRA observed several areas where firms that provide market access fall short of their obligations under the Market Access Rule, particularly with respect to the establishment of pre-trade financial thresholds, implementing and monitoring aggregate capital or credit exposures, and tailoring erroneous trade controls. FINRA also found that some firms did not appropriately apply the Market Access Rule to some or all of their fixed income activities.

FINRA also observed additional areas where operational deficiencies challenged some firms' ability to meet their compliance obligations including, alternative investments held in individual retirement accounts; net capital and credit risk assessments; order capacity; Regulation SHO; and TRACE reporting.

CFTC Annual Enforcement Results

CFTC Releases Annual Enforcement Results for Fiscal Year 2017

On November 22, 2017, the agency's enforcement results for fiscal year 2017. In the fiscal year that ended September 30, 2017, the CFTC brought 49 enforcement-related actions, which included significant actions to root out manipulation and spoofing and to protect retail investors from fraud. The CFTC also pursued significant and complex litigation, including cases charging manipulation, spoofing, and unlawful use of customer funds. The CFTC obtained orders totaling $412,726,307 in restitution, disgorgement and penalties.

Specifically, in the fiscal year, the CFTC obtained $333,830,145 in civil monetary penalties and $78,896,162 million in restitution and disgorgement orders. Of the civil monetary penalties imposed, the CFTC collected and deposited at the U.S. Treasury more than $265 million.

In addition to its enforcement actions, the CFTC also implemented enhancements to increase the effectiveness and strength of the agency's enforcement program. New rules and procedures were put in place to better protect whistleblowers and to further incentivize whistleblowers to come forward. The CFTC also realigned the market surveillance unit under the Division of Enforcement (DOE). Under the new alignment, the market surveillance unit conducts market analysis to confirm market integrity and identifies areas that may warrant enforcement inquiry. DOE also issued new cooperation advisories, which brings DOE's cooperation program in line with other law enforcement agencies and will serve as a powerful enforcement tool going forward. Each of these developments will substantially strengthen the CFTC's enforcement program.

FINRA also observed additional areas where operational deficiencies challenged some firms' ability to meet their compliance obligations including, alternative investments held in individual retirement accounts; net capital and credit risk assessments; order capacity; Regulation SHO; and TRACE reporting.

NFA Advisory

The Future of Virtual Currencies

On December 1, 2017, the NFA released investor guidance regarding the investment in cryptocurrencies. The NFA reminds investors that, like all other investments, cryptocurrencies have certain associated risks and benefits, some of which may not be suitable for all investors. Accordingly, before investing, investors should educate themselves on these risks and conduct appropriate due diligence on their prospective investment.

Even though cryptocurrency futures, such as Bitcoin, are traded on regulated exchanges, the NFA emphasizes that this does not mean that the underlying currency's market is properly regulated. Similarly, the NFA warns investors to be on the look-out for sales pitches that promise high returns coupled with low risk, as con artists and fraudsters are exploiting the current focus on cryptocurrencies.

Once invested, investors are encouraged to monitor their investment frequently. Since the price of many cryptocurrencies is extremely volatile, the corresponding futures contract is likely to experience the same level of price instability, causing major price swings from the time a futures contract is purchased to when it is liquidated.

Rules

Approved Rules

Investment Adviser Reporting Requirements Rule

KEY TOPICS

Form ADV	Relying Advisers
Advisers Act	Books and Records
AUM	Transition Periods

IMPACTS

Primary – RIAs

The SEC adopted amendments to several rules under the Investment Advisers Act of 1940 (“Advisers Act”) to enhance the reporting and disclosure of information by investment advisers.

The major changes to Form ADV, which went into effect October 1, 2017, include:

- Additional information regarding separately managed accounts, such as the types of assets held and the use of derivatives and borrowings in such accounts.
- Additional information regarding a Firm’s investment advisory business such as:
  - Disclosure of social media pages;
  - Breakdown of assets under management by client; and
  - Identifying numbers (such as CIKs) for their financial service providers.
- Umbrella Registration so that advisers can register multiple entities that operate a single advisory business without relying on the “relying adviser” method of registration. The criteria for using umbrella registration are similar to those under the requirements of “relying adviser” registrations:
  - The filing adviser and the relying adviser must only advise private funds and separately managed accounts with qualified clients;
  - The filing adviser has its principal place of business in the U.S.;
  - The employees of each relying adviser are all subject to the supervision and control of the filing adviser;
  - The advisory activities of each relying adviser are subject to the Advisers Act; and
  - The filing adviser and each relying adviser operate under a single code of ethics.
- Miscellaneous changes to the Form ADV instructions and parts of the Form ADV to enhance clarity.

The major changes to the Advisers Act rules include:

- Changes to Rule 204-2 (the “Books and Records Rule”), which will require investment advisers to:
  - Maintain records supporting performance claims in communications that are distributed to any persons (previously 10 or more persons); and
  - Maintain originals of all written communications received and copies of written communications sent by an investment adviser relating to the performance or rate of return of any or all managed accounts or securities recommendations.
- Changes to Rule 203A-5, Rule 202 (a)(11)(G)-1(e), Rule 203-1(e), Rule 203-1(b), Rule 204-1(c) and Rule 204-3(g), which largely remove language related to “transition periods” for Rules.
  - For example, advisers that were relying on the rescinded “private adviser” exemption remained exempt from registration until March 30, 2012. Such language has been removed from the rule because the “transition for private advisers is now complete.”

Approved Rules

Margin Requirements Rule

KEY TOPICS

Covered Agency Transactions

Margin Requirements

IMPACTS

Primary – B/Ds

Secondary – RIAs

In the second quarter of 2017, the SEC approved proposed amendments to FINRA Rule 4210 to establish margin requirements for "To-Be-Announced" ("TBA") transactions, Specified Pool Transactions and certain forward transactions involving collateralized mortgage obligations (collectively, "Covered Agency Transactions").

Pursuant to the amended rule, FINRA members that engage in Covered Agency Transactions must establish risk limits for these transactions in accordance with the member's written risk policies and procedures. In addition, for transactions with non-exempt accounts, members must collect maintenance margin from counterparties in an amount equal to two (2) percent of the contract value of the counterparty's net long or net short position plus any net mark-to-market loss.

Any deficiency that is not satisfied by the close of business on the next business day must be deducted from the member's net capital until the deficiency is satisfied. If the deficiency is not satisfied within five (5) business days, the member must promptly liquidate positions to satisfy the deficiency unless FINRA has specifically granted the member additional time.

Maintenance margins will not be required for transactions where the original contractual settlement is in the same month as the trade date or in the following month if the customer regularly settles its Covered Agency Transactions on a delivery-versus-payment basis or for "cash"—provided, however, that such exception does not apply to customers that engage in dollar rolls, "round robin" trades, or that use other financing techniques for its Covered Agency Transactions.

No maintenance margins will be required to be collected for transactions with exempt accounts. However, those transactions must be marked to the market daily and the member must collect any net mark-to-market loss.

All requirements to collect any deficiency or mark to market loss from a single counterparty is subject to a $250,000 minimum transfer amount. The Rule will exempt from the foregoing margin requirements: (1) transactions with central banks and multilateral development banks; (2) transactions that are cleared through a registered clearing agency, and (3) subject to certain other requirements, short-dated transactions between a member and a counterparty where the dollar amount of the counterparty's gross open positions in Covered Agency Transactions with the member are equal to or less than $10 million.

It is worth noting that FINRA amended the proposed amendments three times prior to receiving SEC approval. Among other things, the last amendment clarified the written risk limit requirements that will become effective six (6) months after SEC approval.

The actual margin requirements imposed under Rule 4210 became effective on December 15, 2017. Since the approval of this Rule, the SEC released a proposed rule change to extend the implementation of Rule 4210. FINRA believes that extending the implementation of FINRA Rule 4210 for a limited period, to July 18, 2018, in light of the continuing development of the Credit Default Swap business within the framework of the Dodd-Frank Wall Street Reform and Consumer Protection Act and pending the final implementation of new CFTC and SEC rules pursuant to Title VII of that legislation, helps to promote stability in the financial markets and regulatory certainty for members.

Approved Rules

FINRA Registration Rules Consolidated

KEY TOPICS

B/D Rules

Registered Representatives

IMPACTS

Primary – B/Ds

On July 7, 2017, the SEC approved FINRA's proposed rule change to: (1) adopt consolidated FINRA registration rules; (2) restructure the representative-level qualification examinations by creating a general knowledge examination, the Securities Industry Essentials (SIE), and transforming the representative-level examinations into specialized knowledge examinations; and (3) amend the Continuing Education (CE) requirements.

FINRA consolidated the NASD and Incorporated NYSE registration rules as FINRA Rules 1210 (Registration Requirements), 1220 (Registration Categories), 1230 (Associated Persons Exempt from Registration), and 1240 (Continuing Education Requirements). The consolidated rules streamline, and bring consistency and uniformity to, the qualification and registration requirements. For the most part, the consolidated registration rules are substantially similar to the legacy NASD and Incorporated NYSE rules, but there are some significant differences between them, described below.

THE SIE

All new representative-level applicants will be required to pass the SIE and a revised representative-level qualification examination appropriate to their job functions before their registration can become effective. This requirement also applies to applicants who are seeking a representative-level registration as a prerequisite to a principal-level registration. Certain former and current registered representatives will be considered to have passed the SIE. Further, similar to the current waiver process, firms can request a waiver of the qualification requirements for applicants required to pass the SIE.

Individuals who are not associated persons of firms, such as members of the general public, are also eligible to take the SIE. The restructured program, among other things, eliminates duplicative testing of general securities knowledge on representative-level examinations and eliminates several representative-level registration categories that have become outdated or have limited utility.

FINANCIAL SERVICES AFFILIATE WAIVER PROGRAM

FINRA will implement a waiver program for individuals who terminate their registrations as representatives or principals to go to work for a foreign or domestic financial services industry affiliate of a member firm. Under the program, these individuals would terminate their registrations with the firm and would be granted a waiver of their requalification requirements, including the SIE, upon reapplying with FINRA for registration as a representative or principal, subject to applicable conditions. Individuals would be eligible for a single, fixed seven-year waiver period from the date of their initial designation.

PERMISSIVE REGISTRATIONS

Firms may permissively register or maintain the registration of any associated person, including individuals working solely in a clerical or ministerial capacity, expanding the current categories of permissive registrations.

PRINCIPAL FINANCIAL OFFICER AND PRINCIPAL OPERATIONS OFFICER

Firms will be required to designate: (1) a Principal Financial Officer with primary responsibility for financial filings and the related books and records; and (2) a Principal Operations Officer with primary responsibility for the day-to-day operations of the business.

NEW PRINCIPAL REGISTRATION CATEGORIES

FINRA established three new principal registration categories: Compliance Officer; Investment Banking Principal; and Private Securities Offerings Principal.

The rule changes will be effective on October 1, 2018.

Approved Rules

Capital Acquisition Broker Pay-to-Play Rule

KEY TOPICS

Capital Acquisition Broker
Pay-to-Play Rule

IMPACTS

Primary – B/Ds
Private Equity

On November 6, 2017, FINRA announced that the rule changes made to its Capital Acquisition Broker ("CAB") Rules set, specifically adding CAB Rule 203 (Engaging in Distribution and Solicitation Activities with Government Entities) and CAB Rule 458 (Books and Records Requirements for Government Distribution and Solicitation Activities), would become effective December 6, 2017. Such amendments to its existing pay-to-play rules cover CABs that solicit government entities on behalf of investment advisers. On September 29, 2017, the SEC approved the CAB rule changes made by FINRA.

SEC Rule 206(4)-5 adopted under the Advisers Act addressing pay-to-play practices (the "SEC Pay-to-Play Rule") prohibits, in part, an investment adviser and its covered associates from providing or agreeing to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of the investment adviser unless the person is a "regulated person." On August 25, 2016, the SEC approved FINRA pay-to-play rules, FINRA Rules 2030 and 4580, which are similar to the SEC pay-to-play rule and includes a recordkeeping component. The SEC Pay-to-Play Rule defines a "regulated person" to include a member firm subject to a FINRA pay-to-play rule.

On August 18, 2016, the SEC approved a set of FINRA rules for firms that meet the definition of a "capital acquisition broker" and that elect to be governed under this rule set. CABs are member firms that engage in a limited range of activities, essentially advising companies and private equity funds on capital raising and corporate restructuring, and acting as placement agents for sales of unregistered securities to institutional investors under limited conditions.

The CAB Rules set became effective on April 14, 2017. The CAB Rules subject CABs to a number of FINRA Rules, but do not expressly provide that FINRA Rules 2030 and 4580 apply to CABs. FINRA believes that the CAB Rules should be clarified to reflect that FINRA Rule 2030 and the related record-keeping requirements of FINRA Rule 4580 apply to CABs.

The rule changes make clear that CABs are subject to FINRA's pay-to-play rule and, therefore, that CABs, similarly to non-CAB member firms, are "regulated persons" that can engage in distribution and solicitation activities with government entities on behalf of investment advisers in accordance with the SEC Pay-to-Play Rule, while at the same time deterring CABs from engaging in pay-to-play practices.

To make this clarification, the SEC approved the addition of CAB Rule 203, which provides that all capital acquisition brokers are subject to FINRA Rule 2030, as well as CAB Rule 458, which provides that all capital acquisition brokers are subject to FINRA Rule 4580.

Approved Rules

Department of Labor Fiduciary Rule Transition Period

KEY TOPICS

Department of Labor
Fiduciary

IMPACTS

B/Ds
RIAs
Investment Companies

The U.S. Department of Labor ("DOL") has officially finalized the proposed delay that came to light in late August 2017. The proposed rule elaborates on the "investment advice fiduciary" definition under the Employee Retirement Income Security Act of 1974 ("ERISA"). On November 27, 2017, the DOL concluded that the exemptions pertaining to applicability dates would be delayed until July 1, 2019. However, the fiduciary rule's general definition of "fiduciary" and the "impartial conduct standards" remain in effect, albeit subject to a good faith compliance standard. Financial advisers and institutions continue to be required to (i) provide sensible advice that is in the retirement investor's best interest, (ii) charge no more than appropriate compensation, (iii) and abstain from misleading statements. Furthermore, due to the delay of the fiduciary rule exemptions, providing the written contract required by the Best Interest Contract Exemption ("BIC Exemption") and certain disclosure requirements are pending the DOL's review of the rule.

According to President Trump's memorandum from February 3, 2017, President Trump directed the DOL to reexamine the fiduciary rule and exemptions, which the DOL has stated as being the reason for the delay. The DOL has also stated that it plans to use the extension to further meet with regulators, including the National Association of Insurance Commissioners and the SEC. Although the DOL appears to be allowing the rule's core principles to develop, significant changes to the compliance details are in progress. The DOL has stated that it (i) anticipates proposing more efficient class exemption in the near future, (ii) and does not want stakeholders to be liable for additional costs to comply with conditions that the DOL may revise, repeal, or replace.

Enforcement & Judicial Actions

Supervision, Regulatory Filings & Recordkeeping

Green Tree Investment Group, Inc. Case

KEY TOPICS

Failure to Register as a Broker Dealer

Ill-Gotten Gains

Duff & Phelps has noticed an increased attention by regulators to the accuracy of regulatory filings and proper maintenance of advisers' books and records.

On November 17, 2017, the SEC charged Jeffrey B. Mallett and his company Green Tree Investment Group, Inc., for acting as unregistered brokers. According to the SEC's complaint, Mallett and Green Tree received compensation by marking up purchase prices for investments in wells and oilfield facilities in Texas. More specifically, in accordance with the SEC's complaint, while acting as brokers, Mallett and Green Tree failed to register as required under Section 15(b) of the Securities Exchange Act of 1934.

Mallett and Greentree agreed to settle the case with SEC and will pay combined disgorgement, interest, and penalties of over $777,000.

Hyaline Capital Management LLC Case

KEY TOPICS

B/Ds

Regulatory Examination

Supervisory Systems

Internal Controls

On November 22, 2017, Judge William Pauley of the United States District Court for the Southern District of New York entered a judgment against Justin Meadlin and Hyaline Capital Management, LLC ("Hyaline") for providing false and misleading information to prospective investors. Without admitting or denying the allegations, Meadlin was ordered to pay $150,645.66 in disgorgement; $12,771.39 in prejudgment interest and an additional civil monetary penalty of $150,000. Additionally, the SEC issued an order that bars Meadlin from the securities industry for five years.

This order stems from a complaint filed by the SEC on April 17, 2017 alleging that Meadlin misrepresented and omitted material facts, such as overstating Hyaline's assets under management, in an effort to persuade clients and prospective clients to invest. In addition, Meadlin flaunted Hyaline's quantitative fund that, thanks to a proprietary algorithm, had posted consistently positive returns since to 2009. The SEC, in its complaint, alleged that none of this was true. The quantitative fund did not exist, Hyaline did not achieve the returns that it claimed and none of its funds used a proprietary algorithm.

Insider Trading

The Market Abuse Unit of the SEC has been using its Analysis and Detection Center to identify suspicious trading patterns through trading data analysis.

The increasing focus on trading pattern analysis follows the recent appointment of Robert Cohen and Joseph Sansone to the positions of co-chief at the Market Abuse Unit. Both co-chiefs have extensive experience in analyzing and structuring complex trading data. In response to a recent insider trading settlement, Mr. Sansone said "SEC enforcement staff continue to develop and refine analytical tools to uncover illicit trading activity and hold accountable those abusing the markets for their own financial gain."

Peter C. Chang Case

KEY TOPICS

Insider Trading
Material Non-Public Information ("MNPI")

On September 20, 2017, the SEC charged the former CEO of a Silicon Valley-based fiber optics company with insider trading in company stock by using secret brokerage accounts held in the names of his wife and brother.

The SEC alleges that Peter C. Chang, who also was the founder and chairman of the board at Alliance Fiber Optic Products, generated more than $2 million in illicit profits and losses avoided by trading on nonpublic information and tipping his brother ahead of two negative earnings announcements and the company's merger.

According to the SEC's complaint, Chang was the company's largest shareholder and required under the federal securities laws to disclose his ownership of company securities as an officer and director. Chang allegedly traded company shares secretly in the family member accounts, often times from his work computer after attending board meetings where confidential information was discussed. He also allegedly tipped his brother in Taiwan with nonpublic information to trade ahead of the earnings announcements in 2015 and an announcement in 2016 that the company would be acquired via tender offer by Corning.

Chang allegedly tried to hide his control over one of the accounts by posing as his brother in communications with one of the brokerage firms, and he allegedly obscured his relationship with his wife in response to a market surveillance inquiry by FINRA.

The SEC's complaint charges Chang with violating Sections 10(b), 14(e), and 16(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 14e-3, and 16a-3. The complaint seeks disgorgement with prejudgment interest plus a penalty, permanent injunction, and officer-and-director bar. In a separate action by the U.S. Attorney's Office for the Northern District of California, criminal charges were unsealed against Chang.

Insider Trading

Shane Fleming Case

KEY TOPICS

Insider Trading

Material Non-Public Information ("MNPI")

On September 29, 2017, the SEC charged a former executive at Life Time Fitness Inc., a middleman tipper, and six traders with insider trading ahead of the announcement that the company would be purchased and taken private.

In a complaint filed in U.S. District Court in the Northern District of Illinois, the SEC alleges that Shane P. Fleming, a former vice president of sales at Life Time Fitness, learned of the merger discussions on or before Feb. 23, 2015 and tipped his friend and business partner Bret J. Beshey with the understanding that Beshey would use the information to make a profit and split those profits with Fleming. The SEC alleges that rather than trade in his own name, Beshey tipped his friends Christopher M. Bonvissuto and Peter A. Kourtis with the understanding that both men would kick back a portion of their trading proceeds to Beshey. According to the SEC's complaint, Kourtis tipped his friends Alexander T. Carlucci, Dimitri A. Kandalepas, Austin C. Mansur, and Eric L. Weller, and asked Carlucci, Mansur, and Weller to give him a portion of any profits they made from trading on the information, which they agreed to do.

The SEC alleges that the six traders purchased a total of approximately 2,000 highly speculative out-of-the-money call options for Life Time Fitness shares and sold those options for profits of approximately $866,209 shortly after a newspaper reported that Life Time Fitness was in advanced merger discussions with two private equity firms. According to the SEC's complaint, Bonvissuto and Kourtis shared a portion of their profits with Beshey, who gave approximately $10,000 in cash to Fleming. The SEC also alleges that Carlucci and Mansur paid cash kickbacks to Kourtis, and that Weller gave Kourtis at least 10 pounds of marijuana as a kickback.

Ratan Capital Management Case

KEY TOPICS

Insider Trading

Material Non-Public Information ("MNPI")

Securities Laws

On December 6, 2017, Nehal Chopra, in addition to her firm and husband, settled with the SEC over reputedly engaging in communications with her husband, Paritosh Gupta, that infringed upon securities laws. Nehal Chopra and her firm, Ratan Capital Management ("Ratan") agreed to pay $400,000 to settle the SEC's allegations. While Paritosh Gupta's firm, Brahman Capital ("Brahman") agreed to pay a $250,000 civil penalty for insufficiently monitoring Gupta's activities. Furthermore, the SEC separately fined Gupta $250,000 for the sharing of confidential analysis with Chopra. Chopra, along with Ratan and Gupta, settled with the SEC without admitting or denying any of the regulator's discoveries.

During Gupta's tenure at Brahman, the firm composed private investment analysis that was meant for employees and its clients. According to the SEC, Gupta violated securities laws when he would periodically share investment recommendations with Chopra. Occasionally, Gupta would communicate via e-mail and/or by Bloomberg chat with Chopra regarding the aforementioned investment recommendations, providing guidance as to how big or small her stake should be. At the time, Chopra neglected to communicate to her investors the capacity in which her husband was involved in her business.

Fraud

A large portion of SEC charges this year have been against those who have committed fraud. Ensuring investment advisers' proper disclosure of information to investors is one of the SEC's top priorities.

Maksim Zaslavskiy Case

KEY TOPICS

Initial Coin Offerings (ICOs)

Fraud

Misleading Investors

On September 29, 2017, the SEC charged businessman Maksim Zaslavskiy ("Zaslavskiy") and his two companies, REcoin Group Foundation ("REcoin") and DRC World ("DRC") (collectively the "Companies"), for allegedly defrauding investors in two initial coin offerings ("ICOs"). Zaslavskiy solicited investors to purchase unregistered securities, as part of the ICO, that were supposedly backed by real estate and diamonds, with the promise of large returns from the Companies' operations.

Zaslavskiy lied to investors by claiming that REcoin had employed a team of highly skilled lawyers, accountants and brokers who would invest REcoin's ICO proceeds into the real estate market, even though no such professionals had been hired. Additionally, Zaslavskiy overrepresented the amount of money that had been raised from the ICO, claiming that REcoin had brought in between $2 million and $4 million, when in reality, it had raised just over $300,000.

Zaslavskiy also orchestrated a fraudulent ICO at DRC by falsely promising investors that their money would be used to acquire diamonds. The SEC alleges that DRC never purchased any diamonds or conducted business.

The SEC's complaint alleges that Zaslavskiy and the Companies violated anti-fraud and registration provisions of the federal securities laws. The SEC seeks to bar Zaslavskiy from holding future director or officer-level positions and from participating in any future digital securities offerings, in addition to paying disgorgement plus interest and penalties.

Michael Scronic Case

KEY TOPICS

Misleading Investors

Material Misrepresentations

On October 5, 2017, the SEC charged Michael Scronic, New York-based investment advisor, with fraud originating from untruthful and fabricated lies to retail investors regarding the value of their investments. According to the SEC, Scronic began to raise capital by soliciting friends and fellow community members in his attempt to invest in a precarious options trading strategy.

During 2010, Scronic supposedly lured prospective investors by communicating that he had a substantial track record of impressive returns, in addition to falsifying the liquidity of the investments he was allegedly peddling. According to the SEC, Scronic told one investor that "what's cool about my fund is that I'm [sic] only in publicly traded options and cash so any redemptions are met within 2 business days so if you do need to withdraw for your business needs it will be quick and painless." The SEC alleges that Scronic was in fact exuding investor money by way of massive trading losses, with at least $15 million in investment losses since April 2010. Moreover, as of quarter end, June 30, 2017, Scronic had said to have reported to investors that total assets were of at least $21,837,475; however, Scronic's brokerage account balance at quarter end was just below $27,500.

The SEC's complaint documents instances where Scronic's clients had attempted to redeem their investments, only to be met with an array of constant excuses as to why he could not pay them back. Scronic's method of satisfying redemptions was contingent on the amount of money received by continuing to pursue new and existing investors. In addition, the SEC documented that Scronic even identified himself as an investment advisor of a fabricated hedge fund and claimed to sell interests, or "shares."

Accompanying the SEC's charge was the U.S. Attorney's Office of the Southern District of New York announcing criminal charges against Scronic. The SEC's complaint charges Scronic with violating the Securities Act of 1933, the Exchange Act of 1934, and the Investment Advisers Act of 1940. The SEC is pursuing an injunction, disgorgement, and penalties against Scronic.

Fraud

Mohammed Ali Rashid Case

KEY TOPICS

Fraud
Gifts & Entertainment
Expense Allocation

On October 25, 2017, the SEC charged Mohammed Ali Rashid, a former senior partner at Apollo Management L.P., with defrauding his fund clients. The charges stem from Rashid secretly billing fund clients for approximately $290,000 in personal expenditures.

The SEC's complaint alleged that Rashid made efforts to conceal his activity, including claiming that certain individuals accompanied him to dinners in order to make them appear as if they were for a legitimate business purpose. In addition, Rashid doctored a receipt in an effort to validate a purchase of a high-end suit.

Rashid had been warned on two separate occasions, both in 2010 and 2012 to stop billing personal expenditures to clients, but continued to do so in 2013. Upon being confronted on the third occasion, Rashid admitted to the improper billing.

The SEC's complaint alleged that Rashid violated, and in the alternative aided and abetted violations of, Sections 206(1) and 206(2) of the Investment Advisers Act of 1940.

Millennium Management LLC Case

KEY TOPICS

Market Manipulation
Illegal Short Selling

On October 31, 2017, Investment advisory firm Millennium Management LLC has agreed to pay more than $630,000 to settle charges that it shorted U.S. stocks in companies planning follow-on offerings and then illegally bought shares in the follow-on offerings.

An SEC investigation found that Millennium violated an anti-manipulation provision of the federal securities laws known as Rule 105 on four occasions in 2012. Rule 105 prohibits short selling an equity security during a restricted period (generally five business days before a covered public offering) and then purchasing that same security through the offering. By illegally purchasing shares in the follow-on offerings, Millennium reaped $286,889 in illicit profits.

Millennium must pay disgorgement of $286,889 plus interest of $51,820.11 and a penalty of $300,000 for a total of $638,709.11. Without admitting or denying the findings in the SEC's order, Millennium agreed to cease and desist from violating Rule 105 in the future.

Fraud

SEC Halts ICO Scam

KEY TOPICS

Embezzlement
Initial Coin Offerings (ICOs)
Cybersecurity

On December 4, 2017, the SEC announced that it ordered an immediate asset freeze to a fast-moving ICO embezzlement that grossed nearly $15 million from a vast number of investors since August 2017. The fraudulent ICO was assuring its investors of a 13-fold profit in less than a month.

The SEC charged a recidivist Quebec securities law violator, Dominic Lacroix, and his firm, PlexCorps. The Commission's accusation is that Lacroix and PlexCorps solicited and sold securities labeled as PlexCoin on the internet to investors in the United States, among other places. Lacroix and PlexCorps allegedly communicated to investors that they would realize a 1,254 percent profit in under 29 days. In connection with the SEC's charges, the agency also charged Lacroix's business partner, Sabrina Paradis-Royer, as being part of the conspiracy.

Additionally, the SEC's new Cyber Unit division was the first to file charges against the PlexCoin scheme. The SEC's Cyber Unit was established to focus on unlawful practices by distributed ledger technology and ICOs, which consists of the roll out of untrue electronic and social media, hacking, and threats to trading platforms.

The SEC's Robert Cohen, Chief of the Cyber division, said "this first Cyber Unit case hits all of the characteristics of a full-fledged cyber scam and is exactly the kind of misconduct the unit will be pursuing." Upon the SEC's charges, the agency acquired an immediate court order to freeze the assets of PlexCorps, in addition to Lacroix and Paradis-Royer. The SEC charged the aforementioned parties with infringing upon the anti-fraud provisions, along with charging Lacroix and PlexCorps with violating the registration provision of the U.S. federal securities laws. The filed complaint is pursuing indefinite injunctions, disgorgement plus interest and penalties. Moreover, the SEC is also requesting an officer-and-director bar and a bar from offering digital securities against Lacroix and Paradis-Royer.

In closing, the SEC's Office of Investor Education and Advocacy published an Investor Alert in August 2017 warning investor about the possible fraud being conducted by companies that claim to be engaging in ICOs.

Fraud

Brokers Charged with Defrauding Customers

KEY TOPICS

Fraud
Kickbacks
Initial Public Offerings (IPOs)
Investment Allocation Violations

On December 6, 2017, the SEC charged two New York-based brokers with making unsuitable trades that were costly for customers and lucrative for the brokers.

The SEC's complaint, filed in federal court in Manhattan, alleges that Zachary S. Berkey of Centerreach, New York, and Daniel T. Fischer of Greenwich, Connecticut, conducted in-and-out trading that was almost certain to lose money for customers while yielding commissions for themselves. According to the complaint, 10 customers of Four Points Capital Partners LLC, where Berkey and Fischer previously worked, lost a total of $573,867 while Berkey and Fischer received approximately $106,000 and $175,000, respectively, in commissions.

According to the SEC's complaint, since the customers incurred significant costs with every transaction and the securities were held briefly, the price of the securities had to rise significantly for customers to realize even a minimal profit. The complaint also alleges that Berkey and Fischer churned customer accounts and concealed material information from their customers, namely that the costs associated with their recommendations, including commissions and fees, would almost certainly exceed any potential gains on the trades. The complaint further alleges that Fischer engaged in unauthorized trading.

Without admitting or denying the SEC's allegations, Fischer consented to a final judgment that permanently enjoins him from similar violations in the future and orders him to return his allegedly ill-gotten gains with interest and pay a $160,000 penalty. The settlement is subject to court approval. Fischer separately agreed to an SEC order barring him from the securities industry and penny stock trading. The SEC's litigation against Berkey will proceed in federal district court in Manhattan.

The case follows similar charges of excessive trading by brokers brought on January 9, 2017, April 25, 2017, and September 28, 2017, demonstrating that the SEC is continuing its crackdown on brokers who defraud customers.

Fraud

Louis G Mohlman Jr. Case

KEY TOPICS

Fraud
Misleading Investors
Conflicted Transactions

On December 8, 2017, the SEC charged Louis G. Mohlman Jr. and two investment advisers he owns – Mohlman Asset Management, LLC (MAM) and Mohlman Asset Management Fund, LLC (MAMF) – with engaging in conflicted transactions and misleading investors.

The SEC's complaint stems from Mohlman not fully disclosing the nature of a loan made from a private fund managed by one of the investment advisers. The complaint alleged that in 2013 Mohlman made a $150,000 unsecured loan using the private fund's assets, which constituted 16% of the fund's portfolio. Mohlman had been warned previously by SEC examiners to fully disclose the details of the loan, but failed to do so.

The complaint also alleged that Mohlman made payments to satisfy the obligations of third-parties and encouraged clients to invest in what he deemed his "Roth IRA Strategy", which he falsely claimed was endorsed by accounting and law firms. Further, the SEC alleged that MAMF was not in compliance with the Custody Rule, that MAM filed materially inaccurate Forms ADV and that both advisers had deficient compliance programs.

The SEC's complaint charged Mohlman, MAM and MAMF with violating Sections 206(1), 206(2) and 206(4) of the Investment Advisers Act of 1940; Mohlman and MAM with violating Section 207 of the Advisers Act; Mohlman and MAMF with violating Rule 206(4)-8 under the Advisers Act; MAM and MAMF with violating Rules 206(4)-7 under the Advisers Act; and MAMF with violating Rule 206(4)-2 under the Advisers Act. Without admitting or denying the allegations in the SEC's complaint, Mohlman, MAM and MAMF agreed to the entry of permanent injunctions and to pay, on a joint-and-several basis, a $100,000 civil penalty. MAMF also agreed to disgorge $862.03 in ill-gotten gains, plus $75.34 in interest.

Brian Hirsch Case

KEY TOPICS

Fraud
Kickbacks
Initial Public Offerings (IPOs)
Investment Allocation Violations

On December 19, 2017, the SEC charged a Wall Street stockbroker with illegally accepting more than $1 million in undisclosed kickbacks for giving certain customers preferential access to lucrative IPOs, enabling them to reap major trading profits in the secondary markets.

The SEC alleges that Brian Hirsch subverted allocation policies and procedures at two brokerage firms where he worked on the wealth syndicate desk, making long-running arrangements with certain customers to give them larger allocations of coveted public offerings being marketed by the firms. In most instances, the customers sold their stock into the market as soon as possible to turn a substantial profit at the expense of the firms' other brokerage customers and the issuers' interests in raising capital from long-term investors.

The SEC's complaint also charges Hirsch's customer Joseph Spera, who allegedly made approximately $4 million in trading profits on the offering allocations he received from Hirsch. Spera allegedly paid Hirsch approximately $1 million in cash.

The U.S. Attorney's Office for the District of New Jersey filed parallel criminal charges against Hirsch.

Fraud

Westport Capital Markets, LLC Case

KEY TOPICS

Unjust Enrichment
Breach of Fiduciary Duty

On December 11, 2017, the SEC charged a Connecticut-based investment advisory firm and its principal with breaching their fiduciary duties and defrauding advisory clients, including by repeatedly purchasing securities that generated significant amounts of undisclosed compensation.

The SEC's complaint, filed in the U.S. District Court for the District of Connecticut, alleges that Westport Capital Markets, LLC, a dually registered investment adviser and broker-dealer, and Westport's principal, Christopher E. McClure, repeatedly invested advisory clients' funds in risky securities that generated hundreds of thousands of dollars in undisclosed mark-ups for Westport and resulted in more than $1 million in losses for clients. According to the complaint, Westport for several years purchased securities from underwriters at a discount to the public offering price and then, acting as a principal for its own account, re-sold those same securities to its advisory clients at higher prices without disclosing the mark-up. Westport and McClure sometimes held the securities in client accounts for only a short period of time before re-selling the securities and then investing client funds in another offering with a mark-up. The complaint further alleges that Westport and McClure defrauded a client by acting contrary to the client's express objectives and instead repeatedly investing the client in risky offerings that generated hidden mark-ups. In addition, the complaint alleges that Westport and McClure made false and misleading representations to clients regarding the compensation that Westport would receive from their accounts.

The complaint further alleges that Westport, in its capacity as a broker-dealer, received undisclosed mutual fund distribution fees, known as 12b-1 fees, when Westport and McClure invested advisory clients in certain mutual fund share classes. Westport and McClure allegedly did not disclose to clients the conflict of interest that this created. According to the complaint, in certain instances, Westport and McClure invested clients in mutual fund shares with 12b-1 fees even when cheaper shares of the same funds were available without 12b-1 fees.

The SEC's complaint alleges that Westport's advisory clients paid approximately $780,000 in undisclosed mark-ups and fees on top of the advisory fees they paid the firm.

Fraud

$1.2 Billion Ponzi Scheme Case

KEY TOPICS

Fraud
Misappropriation of Investor Funds
Registration Violations
Marketing

On December 21, 2017, the SEC announced charges and an asset freeze against a group of unregistered funds and their owner for operating a $1.2 billion Ponzi scheme. According to the SEC's complaint, Robert H. Shapiro and a group of unregistered investment companies (the Woodbridge Group of Companies LLC), defrauded more than 8,400 investors in unregistered Woodbridge funds.

The SEC alleged that Woodbridge and Shapiro used aggressive tactics to swindle investors, many of whom were seniors. According to the SEC complaint, Woodbridge allegedly promised investors 5 to 10 percent interest annually through the issuance of loans to third-party commercial property owners. However, Shapiro failed to disclose his ownership interest in these third-party borrowers. In addition, Shapiro and Woodbridge used investors' funds to pay other investors as well as commissions to sales representatives. In an effort to maintain the scheme and avoid investors from cashing out, Woodbridge and Shapiro marketed a 90% renewal rate. However, when Woodbridge filed for Chapter 11 bankruptcy protection in December, it was unable to further perpetrate the scheme.

In accordance with the complaint, the SEC charged Shapiro, Woodbridge, and certain affiliated companies with fraud and violations of the securities and broker-dealer registration provisions of the federal securities laws. The SEC is also seeking return of allegedly ill-gotten gains with interest and financial penalties.

Miscellaneous

The Potential Undoing of the Broker Protocol

KEY TOPICS

Broker Protocol

Independent RIAs and BDs

Wirehouses

Morgan Stanley and UBS, two longstanding members of the Broker Protocol, announced in the fourth quarter their intention to exit the pact, leaving questions surrounding the continued viability of the accord going forward.

As background, the Protocol for Broker Recruiting is an industry trade agreement, originally established by Merrill Lynch, Smith Barney and UBS in 2004, which allowed financial advisors to take basic client information with them when they switched firms. The "Broker Protocol," as it is now known, resulted in a sizeable reduction of litigation between member firms which sought to block brokers from taking client assets with them to their new employers. The agreement, which now has roughly 1,700 signatories, is maintained by an independent law firm, Bressler, Amery & Ross LLP, and initially included only the large wirehouses, however, many smaller regional and independent shops have also voluntarily signed on in order to avail themselves of the same protections. If both the firm from where the broker is resigning and the firm to where the broker is moving are both participants, then a broker can rely on the Protocol as insulation from legal action, so long as he or she does not operate beyond the bounds of what is permitted (i.e., take client information that is not afforded protection under the terms of the Protocol).

The effect of these two high profile departures is unknown at this point, but could be quite resounding considering the fact that these two firms collectively represent some 22,000 advisors. While some commenters believe the regional and independent firms can continue to sustain the industry pact; others believe that these moves – and other potential exits in the near term – could have a chilling effect on the independent movement, which has seen unprecedented growth over the last decade or so.

Potomac Asset Management Case

KEY TOPICS

Investment Adviser

Expense Allocation Violations

On September 11, 2017, the SEC brought a case against Potomac Asset Management Company ("Potomac" or the "Firm") and its founder and president, Goodloe Byron Jr. ("Byron") for allegedly failing to follow procedures stated in its limited partnership agreement ("LPA") and private placement memorandum ("PPM") regarding the allocation of expenses to its pooled investment vehicles (each a "Fund", collectively the "Funds").

Potomac's LPAs allowed the Firm to charge its portfolio companies for services that the Firm provided. In exchange, the affected fund would receive a 50% discount in management fees. The SEC contends that, between 2012 and 2013, Potomac provided $2.2 million worth of services to a portfolio company in one of its Funds. Instead of billing the portfolio company, however, the fees were charged to the Fund itself. Although the portfolio company eventually reimbursed the Fund, the transaction was not authorized by the LPA, no disclosure was made to investors and the Firm failed to reduce its management fee as promised.

Potomac supposedly misallocated expenses by improperly charging operating expenses and employee salaries to its funds, in violation of the PPM. The Firm also triggered an inadvertent violation of the custody rule by failing to disclose the related party transactions between the Fund and portfolio companies on its audited financial statements, as required by GAAP. Thus, Potomac was unable to rely on providing audited financial statements for its Funds as an exemption to the custody rule.

As part of the settlement, the Firm consented to a cease and desist order and was ordered to pay a fine of $300,000.

Miscellaneous

BlackRock Executive Pay-to-Play Case

KEY TOPICS

Pay-to-Play Rule

Political Contributions

In September 2017, it was reported that BlackRock may be prohibited from collecting $37 million in fees from the State of Ohio, as a result of a political donation made to former US Presidential Candidate and current and then sitting Ohio Governor, John Kasich. The donation in question was made by Mark Wiedman, a senior executive with BlackRock and member of the firm's Executive Committee. Wiedman reportedly donated $2,700 to Governor Kasich in January of 2016, in an effort to support Governor Kasich's Presidential campaign. Wiedman's donation violated Rule 206(4)-5 under the Advisers Act, the Pay-to-Play Rule. Violations of the Pay-to-Play Rule can have serious implications on an investment adviser's ability to manage money for a U.S. state or local government entity. An investment adviser may even need to return fees received or waive fees to be received from such government entity for up to two years.

A firm can seek a waiver from the SEC if it can prove that it had a compliance program implemented at the time of the donation, which addressed the Pay-to-Play issue and that the donation was not meant to influence a state or local government's decision to award business. BlackRock requested such a waiver; however, If the waiver is not approved, BlackRock will have to waive approximately $37 million in fees generated through mutual funds offered to Ohio public pension plans.

It was reported that Wiedman was unaware of the pay-to-play restrictions and subsequently requested and received a refund on his donation. A response to the waiver has not yet been provided by the SEC.

Duff & Phelps

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