SEC Enforcement Actions: Are you prepared for the inevitable?

October 7, 2014
GENERAL BACKGROUND: THE SEC AND THE ENFORCEMENT DIVISION
CURRENT SEC COMMISSIONERS

Mary Jo White
Chair since 2013

Luis A. Aguilar
Commissioner since 2008

Daniel M. Gallagher
Commissioner since 2011

Kara M. Stein
Commissioner since 2013

Michael S. Piwowar
Commissioner since 2013
BACKGROUND ON DIVISION OF ENFORCEMENT

Over 1,000 Enforcement staff professionals and growing

Offices located in:

- Washington, DC
- New York
- Boston
- Philadelphia
- Atlanta
- Miami
- Chicago
- Denver
- Forth Worth
- Salt Lake City
- Los Angeles
- San Francisco
SPECIALIZED UNITS

Asset Management
Investment advisers, hedge funds, mutual funds, private equity funds

Market Abuse
Potential large-scale market abuses and complex manipulation schemes by institutional traders and market professionals

Complex Financial Instruments (formerly Structured and New Products)
Complex derivatives and financial products, including credit default swaps, collateralized debt obligations and other securitized products

Foreign Corrupt Practices

Municipal Securities and Public Pensions
Offering and disclosure issues, tax and arbitrage-driven activity, unfunded or underfunded liabilities, “pay-to-play” schemes
THE FEDERAL SECURITIES LAWS

The Commission’s Staff investigates and prosecutes violations of the federal securities laws, principally:

Securities Act of 1933
Securities Exchange Act of 1934
Investment Company Act of 1940
Investment Advisers Act of 1940

Because the scope of these statutes is so broad, the SEC can investigate a broad array of conduct and virtually anyone.
TYPES OF ENFORCEMENT ACTIONS

Civil suits in federal district court

- SEC obtains civil relief – e.g., injunctions against future violations, disgorgement of illegal gains, civil penalties, orders barring violators from serving as D&O’s of public companies
- Administrative proceedings

SEC, through an administrative law judge, acts as an adjudicative body and the Division of Enforcement is the “petitioner” bringing charges

- ALJ can issue orders sanctioning regulated entities and individuals, order penalties, require disgorgement of ill-gotten gains, and issue cease and desist orders
- ALJ decisions are appealable to the full Commission; the Commission’s decision is appealable to the US Court of Appeals
2003 – 2013 SEC ENFORCEMENT ACTIONS

2003-2013 SEC Enforcement Actions

Year


Number of SEC Enforcement Actions

0 100 200 300 400 500 600 700 800

- FCPA (first tracked in 2011)
- Other
- Market Manipulation
- Insider Trading
- Financial Fraud/Issuer Disclosure
- Securities Offering
- Delinquent Filings
- Broker-Dealer
- Investment Adviser/Investment Co.

2013 SEC ENFORCEMENT ACTIONS

2013 SEC Enforcement Actions

- Investment Adviser/Investment Co.: 20%
- Broker-Dealer: 18%
- Delinquent Filings: 19%
- Securities Offering: 15%
- Financial Fraud/Issuer Disclosure: 10%
- Insider Trading: 7%
- Market Manipulation: 7%
- Other: 2%
- FCPA: 3%
2004 – 2013 SEC MONETARY SANCTIONS

2004-2013 SEC Monetary Sanctions

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<tr>
<th>Year</th>
<th>Total Sanctions (in billions)</th>
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<td>2013</td>
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Penalties | Disgorgement

SEC ENFORCEMENT ACTIONS: ARE YOU PREPARED FOR THE INEVITABLE?
THE INVESTIGATIVE PROCESS
WHAT TRIGGERS A SEC INVESTIGATION?

Investor/whistleblower complaints

Dodd-Frank creates new bounty program for whistleblowers who provide information that lead to enforcement actions with penalties greater than $1 million.

Investigative curiosity (industry surveys)

Financial restatements

Significant financial reporting issues (e.g., onetime charges or write downs) or disagreements with auditors disclosed in Forms 8-K

News coverage/academic studies

Civil litigation
SEC ENFORCEMENT ACTIONS: ARE YOU PREPARED FOR THE INEVITABLE?

2012 – 2013 SEC WHISTLEBLOWER PROGRAM TIPS

2012-2013 SEC Whistleblower Program Tips

Number of Complainants

<table>
<thead>
<tr>
<th>Category</th>
<th>FY 2012</th>
<th>FY 2013</th>
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<tbody>
<tr>
<td>Corporate Disclosures</td>
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<td>Offering Fraud</td>
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<td>465</td>
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<td>Manipulation</td>
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<td>Insider Trading</td>
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<tr>
<td>Trading and Pricing</td>
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<td>FCPA</td>
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<td>Unregistered Offerings</td>
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<td>Unspecified</td>
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<td>84</td>
</tr>
<tr>
<td>Municipal, Secs. &amp; Pub. Pensions</td>
<td>64</td>
<td>48</td>
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FORMAL VERSUS INFORMAL INVESTIGATIONS

Informal stage

- Production of documents and testimony largely voluntary
- Examination authority over regulated entities

Formal stage

- SEC Staff prepares “formal order memorandum”
- Senior enforcement staff, through delegated authority from the Commission issues a formal order – does not mean that anyone has violated the law or that the SEC has found misconduct
- SEC can subpoena documents and witness testimony; FRCP do not govern SEC discovery

Non-public and confidential
INVESTIGATION TWISTS AND TURNS

- SEC investigations can be protracted, complex affairs that last for years.
- The SEC Staff can issue successive, and extensive document requests ultimately calling for several hundred thousand or several million pages of documents.
- The SEC Staff can interview and take testimony from numerous witnesses.
- Discovery is a one-way street. The SEC Staff has no obligation to disclose if it is seeking information from others and details about that.
- Limited statute of limitations.
Legal authority ultimately resides with the Commission, not the Staff.

The Commission must authorize all major enforcement steps, such as commencing enforcement actions and settlements.

The Commission delegates certain authority to the Staff. For example, Division Director and other Division senior officers can approve formal orders of investigation.

The Staff, on its own, conducts the investigation, and makes significant decisions, such as charging recommendations, negotiating settlements, closing investigations.
WHAT IS THE WELLS PROCESS?

- The SEC Staff submits a written recommendation ("an action memorandum") to the Commission after it has completed its investigation

- Wells Process
  - "Wells Notice" – Staff usually allows entities and individuals an opportunity to make a written submission
  - "Wells Submission" – potential respondents/defendants can submit a written submission to dissuade the Commission from bringing an enforcement action

- Under Dodd-Frank, the Commission has six months from the date of the Wells Notice to commence an enforcement action
Analytics-based approach to identifying misconduct, such as sophisticated trade analysis for advisers and financial statement analysis for public companies.

“Broken-windows” approach toward conduct warranting enforcement action.

Focus on “Gatekeepers” means inquiries about conduct of auditors, compliance officials and counsel.

Madoff and Financial Crisis have set the tone.
ENFORCEMENT PROCESS TRENDS

Aggressive factual and legal theories mean more litigation and trials.

Requiring admissions of wrongdoing could result in more trials.

Focus on individuals, not just entities.

Preference for Administrative Proceedings over Federal Court actions.

Increased reliance on technology and economic analysis during investigations – Center for Risk and Quantitative Analytics.
INVESTMENT ADVISER ENFORCEMENT PRIORITIES

Insider Trading

Allocation of Investment Opportunity

Allocation of Advisory Expenses

Cross-trades

Policies and Procedures

Other conflicts of interest
Recent significant enforcement actions against mutual funds, investment advisers, and investment companies:

- In the Matter of The Robare Group, Ltd., Mark L. Robare, and Jack L. Jones Jr. (9/2/14) (failure to disclose conflicts of interest)
- In the Matter of TL Ventures Inc. (6/20/14) (violation of pay-to-play rules)
- In the Matter of Clean Energy Capital, LLC and Scott A. Brittenham (2/25/14) (allegations regarding expense allocations)
- In the Matter of Navigator Money Management, Inc. and Mark A. Grimaldi (1/30/14) (misleading advertisements regarding performance)
- In the Matter of Brian Williamson (1/22/14) (case against individual for falsifying valuation)
MANAGING AN SEC INVESTIGATION
RESPONDING TO AN SEC INQUIRY

BEST PRACTICES

- Involve experienced SEC enforcement counsel
- Document preservation (both hard copy and electronic)
- Investor or client relations contingency planning
- Personnel actions (administrative leave, temporary reassignment, enhanced supervision, etc.)
- Make appropriate reports to Board of Directors and relevant Board Committees
- Exercise considered judgment in timing of proactive disclosures to investors, clients, regulators, and outside auditors
- Consider public disclosure obligations:
  - Formal vs. informal investigations
  - Continuing Disclosure Agreements
- Broadly disseminated document preservation notice can increase likelihood of a leak
RESPONDING TO AN SEC INQUIRY (cont.)

Consider whether the matter warrants an independent, internal investigation

If an internal investigation indicates a potential violation, assess:

- whether it would be material;
- the impact of public disclosure;
- who in the company knew about it; and
- whether that person made any statements litigants might subsequently assert were false.

Do Not

- Dialogue informally with the SEC Staff (no “casual calls” with the Division of Enforcement)
- Assume the SEC Staff does not have an investigative agenda
- Assume cooperation = no enforcement action (a fine line between advocate and cooperator)

Document Preservation

- Identification of relevant personnel/third parties
- Identification of relevant timeframe
- Distribute document preservation notice
RESPONDING TO AN SEC INQUIRY (cont.)

**Document Collection**

Document production protocol

Understand relevant IT infrastructure—discuss with IT personnel if necessary

- Address any automatic archiving/deletion protocols for email and other electronic messages (e.g., text messages, Blackberry messages, etc.)
- Address backup tapes, if any

**Defense Strategy**

Preliminary Fact Development

- Early interview with person most knowledgeable about relevant incident or trigger event
- Early interviews of others identified
- Identification of relevant timeframe
- Identification of key participants and third parties
RESPONDING TO AN SEC INQUIRY (cont.)

Defense Strategy (cont.)

- Identification of any core documents
  - Relevant disclosures to investors, agreements
- Create a Chronology of Events

Identify source of information that led to SEC inquiry

- Gather all relevant press related to entity or individual
- Gather all documents related to incident/trigger that led to SEC inquiry

Possible Presentation at the SEC

- Outside Counsel
- Delivery of PowerPoint and Key documents
HOW TO MITIGATE/AVOID AN ENFORCEMENT ACTION

**Be Proactive**
Get arms around facts early and develop themes of defense

**Be Cooperative**
Strike the right tone with the SEC investigative staff to establish credibility and earn goodwill

**Self Police**
Identify causes of misconduct and take clear and decisive action
HOW TO MITIGATE/AVOID AN ENFORCEMENT ACTION

Talk with the SEC Staff in order to understand their theory of the case and their level of interest in pursuing an action

Where possible, preempt the Wells process by asking for meetings to address their concerns and, if necessary, submit position papers to advocate strengths of your case (and point out weaknesses of theirs)

Identify who needs separate counsel and, if appropriate, assist in the selection of legal representation

Goal is to achieve a soft landing!
Investigations by the SEC, DOJ, or a state Attorney General may trigger private securities class action litigation:

- Government investigations can create a “roadmap” for class action litigants
- Plaintiffs' lawyers encourage the SEC to investigate to benefit the private suit

Testimony taken by, and documents produced to, the SEC may be discoverable by civil litigants:

- Discovery of Wells submission by plaintiffs
  - Consider whether to give an oral, not written, Wells if there is a parallel private suit
- Discovery in the private action may assist the defense in the SEC matter
- PSLRA discovery stay may prevent discovery of documents/testimony produced to SEC while a motion to dismiss is pending
- Coordinating deposition/testimony preparation
PARALLEL INVESTIGATIONS AND ACTIONS

Intentional disclosure to the SEC of a confidential attorney-client communication could affect the parallel proceedings:

- Potential privilege waiver

Admissions in SEC settlement agreements may affect parallel investigations and private actions:

- Plaintiffs may use admissions in related civil proceedings
- Descriptions of wrongdoing could trigger criminal charges from DOJ
- Consider appropriate insurance coverage
  - SEC and other regulatory investigations should be covered
NOTICE

- Notice of Circumstances (Informal Inquiries) v. Claims (Wells Notice, Formal Order of Investigation)
- Proper Notice under the Policy
- Proper notice under the policy avoids surprises both to the Insured and the carrier
COVERAGE

- Policy Triggers
- Interrelation of Related Claims/Investigations
- Conduct Exclusions
- Reimbursement of Costs vs. settlements/judgments
Insurance carrier is your partner (particularly with respect to management of costs)

Confidentiality concerns should be addressed through a Non-Disclosure Agreement
COST CONTROL

- Along with reputational damage this should be biggest concern for risk managers
- Biggest driver is legal costs along with document production
- Early preparation is key in management of costs
- Cooperation with carrier and early communication is essential
- SEC mandate pushing for admissions of wrong-doing is a cost multiplier
- One subpoena can lead to multi-million dollar exposure
CLAIMS CONSIDERATIONS

- Cases against investment advisers have come to represent the single largest component of the SEC’s enforcement docket.
- Process management is key as announcement of a SEC/DOJ investigation can lead to company stock drop.
- SEC focus areas: marketing, portfolio management, conflicts of interest, safety of client assets, and valuation.
- SEC investigation can prompt private securities litigation filings.
- Settlement costs associated with private litigation is increased by existence of regulatory investigations.
ILLUSTRATIVE CASE SCENARIOS

Insider trading/expert network investigations
- defense costs alone can range from $1M - $10M

Whistle blower retaliation under Dodd/Frank
- $1.7M in disgorgement and $300K civil penalty

Misallocation of portfolio company expenses
- $2.3M settlement

Excess management fees for lavish personal expenditures
- investment advisor investigated for improper supervision)
STRATEGIC ENFORCEMENT ACTION
KURT ALFREY
SEA
STRATEGIC ENFORCEMENT ACTION

- Historically the in-house plan has been to call external counsel and pull together key stakeholders at the time an investigation is launched.

- Industry has shifted now to a range of possible interactions with enforcement:
  - Tag along to meetings for education;
  - Referral due to deficiencies reported from OCIE;
  - Discrepancies in fund returns;
  - Whistleblower situations (potentially unfounded); and
  - Specific trade related queries.

- No longer “bad actors” but a day-to-day reality of being an RIA.
**In-house concerns for RIAs:**

- Cost of compliance today;
- Lack of solutions to avoid issues, prevent requirement for investigation;
- Reporting and the risk of investigation from numerous managers;
- The “we’ll just shut down” approach vs. reality during enforcement action;
- Minimizing risk while maximizing efficient use of time;
- Compliance and regulatory fatigue; and
- Enforcement counsel vs. compliance consultants.
STRATEGIC ENFORCEMENT ACTION

New level of investor expectations:
- Large institutional investors are seeing a number of enquiries from enforcement;
- Management of expenses;
- Reputational damage;
- Ensure time and focus are not impacted;
- Manage expectations of investors; and
- Protect investor interests through planning.

Fiduciary duty to ensure investor interests are protected at all times.

Value of contingency planning for regulatory action.
COMPLIANCE PARADIGM SHIFT

A shift in the compliance paradigm:

- We are seeing a shift in the industry where managers have to adopt a more institutional approach to the risk of investigation.
- Beyond routine examinations!
- Some strategies are more susceptible to this risk than others – equity strategies focusing on healthcare vs PE.
- Clear that there is a benefit to planning in advance and testing to ensure the length and impact of an investigation is minimized.
- Hedge funds and private equity managers are at the top of the list in terms of facing this risk.

Preparation for an interaction with enforcement distinguished from implementation of a robust compliance program
Response Planning as a new component of compliance management:

- Staff training
- Reputational risk management
- Pro-Active Planning and Preparation
- Decision-making
- IT Testing
- Conflict management
- Due Diligence

Divergence in approaches to the changing market.
Why pre-plan your regulatory response?

Number one risk to RIAs today

Unforeseen implications of an investigation:

- Marketing implications
- Staff flight
- Investor redemption risk
- Time management

Pre-planning can mitigate damage, benefitting investors and the RIA.
Q & A