

## The dangers of recidivism and the SEC's compliance initiative

Mar 30 2015 Kurt Nuñez

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In the past few years, the Securities and Exchange Commission (SEC) has taken a tougher stance against recidivist behavior by registered investment advisory firms (RIAs). Recidivism refers to occurrences where an RIA has not corrected deficiencies noted in previous regulatory examinations. The SEC is focusing on recidivist behavior through its Compliance Program Initiative, which seeks to identify firms who have failed to correct such deficiencies.



This initiative was first brought to light in November 2011, when the SEC issued a press release announcing enforcement actions against three investment advisory firms. The release stated:

"The cases stem from an initiative within the SEC Enforcement Division's Asset Management Unit to proactively prevent investor harm by working closely with agency examiners to ensure that viable compliance programs are in place at firms. Investment advisers are required by law to adopt and implement written compliance policies and procedures. When SEC examiners identify deficiencies in a firm's compliance program, those deficiencies need to be corrected before they lead to other securities law violations that could harm investors. Investment advisers that essentially ignore SEC examination warnings risk being the subject of SEC enforcement actions."

The SEC continues to demonstrate its growing impatience with recidivist behavior through public speeches by commissioners and enforcement actions that carry severe penalties and consequences for recidivist offenders, including being permanently banned from working in the industry. The SEC has also dedicated resources for utilizing technology as part of their initiative, which was opined upon in a speech given by SEC Commissioner Daniel Gallagher, wherein he stated: "I am pleased to report that in recent years, the agency has made great strides in developing programmatic and technological tools aimed at efficiently ferreting out the most egregious misconduct and identifying those individuals and firms most likely to be recidivists."

### Enforcement actions

There have been many SEC enforcement actions in the last decade for recidivist activity and lack of adequate compliance programs. Below is a summary of some of the more recent cases.

- **Modern Portfolio Management, Inc.:** The SEC found (PDF) that Modern Portfolio Management, Inc. (MPM), and its owners G. Thomas Damasco II and Bryan Ohm, had failed to correct ongoing compliance violations at the firm despite prior warnings from SEC examiners. In particular, the SEC said the respondents failed to

complete annual compliance reviews in 2006 and 2009, and made misleading statements on MPM's website and investor brochure. The respondents agreed to be censured and to pay \$175,000 in penalties. Damasco and Ohm had to complete 30 hours of compliance training, while MPM agreed to designate a new chief compliance officer (CCO) and retain a compliance consultant for three years.

- **Equitas Capital Advisors, LLC and Equitas Partners, LLC:** The SEC found that Equitas Capital Partners, LLC (Equitas) had wrongly billed certain clients and negligently made false and misleading disclosures to clients and potential clients about the firm's historical performance, compensation, conflicts of interest, and prior examination deficiencies. Equitas also violated the compliance-related rules under the Investment Advisers Act of 1940 (PDF), as did Equitas Partners, a registered investment adviser under common control with Equitas, by failing to implement and maintain reasonable policies and procedures to prevent violations and carry out annual compliance reviews, the SEC said. The regulator also found that Equitas chief executive officer (CEO) David Thomas aided, abetted, and caused the violations and that both he and CCO Susan Christina aided, abetted, and caused the compliance-related violations. These violations occurred despite warnings issued by the SEC's Office of Compliance Inspections and Examinations in 2005, 2008, and 2011. Equitas Capital Advisors was ordered to reimburse all overcharged clients, while it, Thomas, and former CCO Stephen Derby Gisclair, were fined a total of \$225,000 in additional penalties. Both Equitas firms agreed to censures and to hire independent compliance consultants. They, along with Gisclair, were ordered to provide their clients with a written notice of the SEC's enforcement actions.

### **Correct violations now**

Many examinations result in deficiency letters outlining the items of concern and violations found by examiners. When responding to a deficiency letter, firms should carefully address the problems by providing a detailed description of the actions they have taken (or will be taking) to correct each deficiency. When addressing items that will be corrected through future action, firms should be careful not to outline corrective actions that are not within their capabilities.

Once a firm has responded to the SEC's deficiency letter, the CCO should take steps to ensure the promised corrective are carried out in a timely manner. The CCO may want to consider taking the following additional steps to help prevent recidivist deficiencies:

- Implement a heightened review and testing program to target the areas noted for non-compliance. For example, if a deficiency was issued for not adhering to a certain part of a rule, then take steps to ensure not only that the deficiency is corrected, but also that other requirements under the same rule are being followed. Apply procedures that are reasonably designed to prevent future violations.
- Ensure that the annual compliance review process includes a review of all prior deficiency letters and confirm that corrections remain in place. If any reforms cease to be applicable, for instance if the firm's business practices have changed, then document the changes, including when they took place.

- Provide compliance training upon hiring new employees and re-train current employees at least annually to help ensure they understand all compliance requirements.

## Conclusion

In this current regulatory environment, firms that maintain inadequate compliance programs, especially after being found deficient by regulators, run the risk of enforcement actions and costly penalties that could include the termination of a firm's registration. Senior management should confirm that adequate resources are directed toward the firm's compliance program to ensure it is robust and appropriately designed to prevent future violations.

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