JACKO LAW GROUP, PC

**Legal Risk Management Tip**
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## 2017 SEC ENFORCEMENT CASES: A YEAR IN REVIEW

As part of its "Fiscal Year 2017 Agency Financial Report" released by the U.S. Securities and Exchange Commission ("SEC") last month, the SEC discussed enforcement cases for its fiscal year of 2017 (which for the SEC concludes on September 30th). According to the Report, the SEC filed 754 enforcement actions in 2017,[1] resulting in disgorgements and monetary penalties of roughly $3.8 billion.[2] From the $3.8 billion, the SEC returned a record $1.0 billion to harmed investors, and ordered over $50 million in payments to whistleblowers.[3] These enforcement actions also led to 625 bars and suspensions in 2017.[4]

Moreover, in an effort to further define regulatory oversight, in September 2017, the SEC announced the formation of a new group within the Division of Enforcement – the "Retail Strategy Task Force" which is designed to develop proactive, targeted initiatives to identify misconduct impacting retail investors. Per comments made by the SEC, the task force "is focused on applying lessons learned from past frauds and leveraging data analytics and technology to identify large-scale misconduct affecting retail investors."[5]

These actions undertaken by the SEC further exemplify the agency's commitment to enforcement matters. In fact, the SEC stated "more than half" of its budgetary resources were dedicated to the agency's enforcement and examination programs.[6] It is also targeting the advisory side more than ever. Citing the significant growth in assets under management by investment advisers registered with the SEC, in recent years the Commission "has shifted more resources to investment adviser exams," and in 2017, examined approximately 15 percent of all investment advisers, which is almost double from what the staff examined five years ago.[7]

### Notable Enforcement Actions of 2017

The enforcement actions in 2017 were spread out over a broad spectrum of misconduct. However, certain enforcement actions stood out due to their nature and/or the potential impact that such enforcement actions might have on the financial services industry. The following is a sampling of some of the more notable enforcement matters during the SEC's past fiscal year:

1. **Fraudulent Representations and Improper Fees**

*In the Matter of Barclays Capital Inc.*, IA Rel. No. 4705 (May 10, 2017).[8] In one of the largest and most publicized matters of 2017, the SEC performed a thorough investigation into Barclays Capital Inc. ("Barclays"). The SEC alleged that Barclays, a dually-registered broker-dealer and

[1] *See* https://www.sec.gov/files/sec-2017-agency-financial-report.pdf
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *See* https://www.sec.gov/litigation/admin/2017/33-10355.pdf.

investment adviser, had committed multiple violations, in both its capacity as a broker-dealer and an investment adviser. Concerning advisory violations, the SEC alleged (among other things) that two of Barclays Capital's wrap-fee advisory programs charged fees to more than 2,000 clients – totaling $48 million in fees - for due diligence and monitoring of certain third-party investment managers and investment strategies, when in fact, Barclays did not perform such services. In a separate violation, the SEC also alleged that 22,138 client accounts paid excess fees to Barclays due to miscalculations and billing errors by the firm, amounting to roughly $2 million.

Without admitting or denying the SEC's findings, Barclays created a "Fair Fund" to refund advisory fees to clients. The Fair Fund consists of nearly $50 million in disgorgement, plus another $14 million in interest and a $30 million penalty. Barclays also refunded an additional $3.5 million to advisory clients who "invested in third-party investment managers and investment strategies that underperformed while going unmonitored."[9]

*Risk Management Tip:* These matters clearly illustrate the fiduciary obligations to provide full and fair disclosures to clients, the importance of performing adequate due diligence of third-parties and the need to perform internal testing on billing practices. Had Barclays reviewed their disclosures and tested the firm's billing practices for accuracy, these violations may not have occurred. Moreover, a financial firm's policies and procedures must remain dynamic, with review, analysis and testing performed at meaningful intervals to help reasonably ensure that violations of industry rules and regulations are prevented.

2. **Failure to Conduct Due Diligence – Making False Performance Claims**

*In the Matter of Pacific Investment Management Company, LLC*, IA Rel. No. 4577, (December 01, 2016).[10] The SEC alleged, among other things, that Pacific Investment Management Company, LLC ("PIMCO") violated rules pertaining to Section 206 of the Investment Advisers Act of 1940 as it pertains to performance advertising.

This matter stemmed from marketing materials disseminated by PIMCO discussing its Total Return ETF (the "Fund") - an actively managed exchange-traded fund. The Fund employed an "odd lot"[11] strategy using non-agency mortgage-backed securities. This strategy involved (1) purchasing odd lot positions that traded at a discount to the round lot prices; (2) valuing those positions in the Fund at the higher pricing for institutional round lots; and (3) as a result, obtaining immediate positive returns for the Fund.

The SEC alleged that PIMCO "attracted significant investor attention as [the Fund] outperformed even its flagship mutual fund in the four months following its launch in February 2012. The initial performance was attributable to buying smaller-sized bonds known as "odd lots" as part of a strategy to help bolster performance out of the gate. But in monthly and annual reports to investors, PIMCO provided other, misleading reasons for [the Fund's] early success and failed to

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[9] *Id.*

[10] *See* https://www.sec.gov/litigation/admin/2016/ia-4577.pdf.

[11] An "odd lot" is an order amount for a security that is less than the normal unit of trading for that particular asset (typically 100 shares). This is the opposite of a "round lot" which are orders in the normal unit of trading for that particular asset (typically 100 shares).

disclose that the resulting performance from the odd lot strategy was not sustainable as the fund grew in size."[12]

The SEC further argued that such misleading statements stemmed from PIMCO's failure to properly monitor third-party providers. In its order, the SEC stated that PIMCO valued the bonds using prices provided by a third-party pricing vendor for round lots (which are larger-sized bonds compared to odd lots). By "blindly relying on the vendor's price for round lots without any reasonable basis to believe it accurately reflected what [the Fund] would receive if it sold the odd lots," PIMCO overstated the Fund's net asset value.

Without admitting or denying the SEC's findings, PIMCO agreed to retain an independent compliance consultant, pay disgorgement fees of $1,331,628.74 plus interest of $198,179.04 and a penalty of $18.3 million.

*Risk Management Tip:* This matter shows the importance of tailoring a firm's policies and procedures to cover activities actually performed by the firm. In its order, the SEC stated that PIMCO's "policies and procedures were not reasonably designed to properly address issues concerning odd lot pricing." Had such policies and procedures been tailored to the activities performed by the Fund, PIMCO could have noted the pricing discrepancies generated by the third-party provider, and been able to provide accurate performance results of the Fund as a result.

### 3. Unsuitable Investments

*In the Matter of Laurence M. Torres*, Rel. No. 81752 (Sep. 28, 2017).[13] The SEC alleged that three brokers[14] registered with Alexander Capital LP, a registered broker-dealer, put clients into unsuitable investments involving frequently traded stocks that caused them to receive generous commissions but left clients with losses. Specifically, the SEC alleges that each of the brokers recommended a pattern of high-cost frequent trading without telling clients that such a strategy was unlikely to produce profits because assets were held for short time periods. The brokers also engaged in churning, according to the SEC.

While two of the brokers are currently disputing the charges, one of the brokers, Laurence M. Torres ("Torres"), reached a settlement with the SEC. From August 2012 to September 2014, the SEC found that Mr. Torres violated the antifraud provisions of the federal securities laws by recommending a high-frequency trading strategy that had no reasonable basis for being applied to Mr. Torres' clients. As a result of Torres' actions, "eight customers incurred trading costs of approximately $531,742...customer accounts were not profitable and customer losses ranged from $3,203 to $199,530, when commissions and other costs are considered."[15] Without admitting or denying the allegations, Mr. Torres agreed to a fine of $411,107, is now barred from the securities industry and can no longer engage in penny-stock trading.

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[12] *See* https://www.sec.gov/news/pressrelease/2016-252.html.
[13] *See* https://www.sec.gov/litigation/admin/2017/33-10419.pdf.
[14] The named brokers were William C. Gennity, Rocco Roveccio and Laurence M. Torres.
[15] *See* https://www.sec.gov/litigation/admin/2017/33-10419.pdf.

*Risk Management Tip*: This matter exemplifies the SEC's position concerning suitability of investments made on behalf of clients. In connection with this matter, Mr. Andrew M. Calamari, Director of the SEC's New York Regional Office, stated "we have no tolerance for unscrupulous brokers, and our examiners and enforcement investigators are working together to proactively catch insidious practices before they spread and impact even more customer accounts." Firms who have not recently reviewed their policies and procedures, or have not developed policies and procedures related specifically to suitability matters, should do so immediately to ensure that such policies reasonably address the risks associated with the firm. Further, firms should be sure that proper books and records are kept evidencing recommendations made to clients.

## 4. Reach of the SEC

In 2017, the United States Supreme Court (the "Court") issued a decision applying a five-year statute of limitations to SEC claims for disgorgement. In *Kokesh v. SEC*, No. 16-529 (US 5 June 2017), the Court unanimously held that "disgorgements in the securities-enforcement context is a 'penalty' within the meaning of" 28 U.S.C. §2462,[16] and therefore SEC enforcement actions seeking disgorgement "must be commenced within five years of the date the claim accrues."[17]

The SEC frequently uses disgorgements as a basis for securing the return on ill-gotten gains or improperly obtained profits earned by wrongdoers as a result of federal securities law violations. Unlike restitution (which focuses on making the victims of a crime whole), the SEC argued that disgorgement focuses on depriving the wrongdoer of gains it would not have enjoyed but for the illegal conduct, and, therefore, disgorgements are equitable in remedy rather than punitive (and consequently, not subject to 28 U.S.C. §2462). In *Kokesh*, the Court rejected this view, and noted that the SEC's orders typically go beyond the compensation of wronged investors, and are therefore intended to punish wrongdoers. Such penalties are punitive in nature and thus are subject to Section 2462.[18]

The decision is the second loss for the SEC in this area, and tracks the rationale employed by the Court in *Gabelli v. SEC* where the Court upheld a five-year statute of limitations period to SEC claims for civil monetary penalties. The broad ruling in the *Kokesh* case could also affect other penalties typically utilized by the SEC, such as bars or injunctions, should they be sought more than five years following the date the claim accrues. However, it is unclear whether the Court intended its ruling to go beyond the scope of considering disgorgement penalties only.

*Risk Management Tip:* This is an area that advisers should continue to monitor as further developments unfold. Clearly, the full impact of this Court decision is not fully known. It is likely, however, that the end result could be a more aggressive investigation of potential violations by the SEC in order to bring claims within the five-year statute of limitations.

[16] Section 2462 states, in pertinent part, that any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued."
[17] *See* https://www.supremecourt.gov/opinions/16pdf/16-529_i426.pdf.
[18] *See* http://www.bakermckenzie.com/en/insight/publications/2017/06/kokesh-v-sec/.

## Conclusion

These cases highlight the SEC's position to enforce regulations in all situations, no matter the size of the registrant or egregiousness of the violations. With a new US Supreme Court ruling handed down, and a new leader in place at the SEC, change is likely in our midst. But as stated in the opening paragraph of the Division of Enforcement's Annual Report, "vigorous enforcement of the federal securities laws is critical to combat wrongdoing, compensate harmed investors and maintain confidence in the integrity and fairness of our markets."[19] The new chair has stressed his focus on the protection of retail investors and the markets in general. With this in mind, its recommended firms perform a robust review as to the adequacy and efficiency of the firms' internal controls in order to help mitigate potential enforcement risks moving forward in 2018.

For more information on this topic, please contact us at (619) 298-2880 or at info@jackolg.com.

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[19] *See* https://www.sec.gov/files/enforcement-annual-report-2017.pdf at p. 1.