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INSIDE...

November 5, 2018

Vindication arrives for former adviser six years after declaring SEC case 'baseless'

Within days of an **SEC** action against **Yorkville Advisors** in 2012, the defendants filed a furious response, calling the claim of fraud "baseless," "an egregious abuse of prosecutorial discretion" and a waste of "taxpayer dollars" (**IA Watch**, Oct. 22, 2012).

On Oct. 30, the SEC quietly announced the case has been formally dismissed – seven months after a federal judge threw out nearly all of the charges and excoriated the agency for attempting "to support its allegations by misinterpreting and mischaracterizing the record."

From the first day, Yorkville Advisors' founder **Mark Angelo** told his attorney, **Caryn Schechtman**, a partner with **DLA Piper** in New York, that he was innocent and would never settle the enforcement action.

"The day that you win, there is no victory parade," Angelo tells **IA Watch**. He tabulates that more than 100 outlets published news of the SEC's action in 2012. Only **IA Watch** reached out to talk about the vindication.

The SEC's muted Oct. 30 announcement took prodding from Schechtman. The agency actually dropped the remaining minor charges in May. She had to twice press the SEC to announce the end of the case. "It's pretty outrageous" that the SEC waited five months to announce it, she says.

An SEC spokesman didn't respond to an **IA Watch** request for comment.

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OCIE urges advisers to review their compliance with cash solicitation rule

It's difficult to confuse the plain dictates of the cash solicitation rule, Advisers Act rule 206(4)-3, yet it seems some advisers have done just that.

OCIE's latest risk alert highlights common exam deficiencies tied to the rule, and directs advisers that use solicitors to review their P&Ps and practices.

It's technically illegal to pay a solicitor to find new clients for an adviser. The cash solicitation rule sets out conditions that would permit the activity. One staple is the presence of a written contract between the adviser and the solicitor. A second is not turning to a "bad actor" as the solicitor.

Common deficiencies

OCIE's risk alert lists deficiencies found by its examiners that really come down to advisers simply not adhering to the rule. For instance, the rule mandates that advisers keep documentation signed by a new client and

(Cash Solicitation, continued on page 2)

Disclosure enhancements for variable annuities, insurance contracts proposed

Concerns about the current volume, format and content of variable contract disclosures have led the **SEC** to propose a new "layered" disclosure approach. The Commission voted Oct. 30 to modernize and improve the current disclosure framework for investors about variable annuities and variable life insurance contracts by, among other things, permitting the use of a summary prospectus to satisfy statutory prospectus delivery obligations.

The 480-page proposal would allow for the provision to investors of key information relating to a variable contract's terms, benefits and risks – and even what investment advisers are paid. The SEC's aim is to better help investors understand these contracts' features, fees, and risks. The agency wants investors to more easily put their hands on the particulars they need to make an informed investment decision.

Products' complexity

The Commission believes the change is particularly

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Cash Solicitation *(Continued from page 1)*

dated in which the client has acknowledged receiving the adviser's Form ADV. In some cases, advisers showed examiners documentation that was undated or dated after the person became a client.

The rule's clear that the contract between the adviser and the solicitor must cover the solicitor's duties and compensation. Yet examiners found contracts that lacked these requirements.

The rule gives advisers the duty to check that their solicitors are complying with their agreements. However, some advisers "were unable to describe any efforts they took to confirm" their solicitors' compliance with the agreements, according to the risk alert.

Here's a description of what the cash solicitation requires, from the alert:

1. The solicitation agreement must contain certain specified provisions (e.g., a description of the solicitation activities and compensation to be received);

2. The solicitation agreement must require that, at the time of any solicitation activities, the solicitor provide the prospective client with a copy of (a) the adviser's brochure and (b) a separate, written disclosure document containing required information that highlights the solicitor's financial interest in the client's choice of an adviser;

3. The adviser must receive from the client, before or at the time of entering into any written or oral agreement with the client, a signed and dated acknowledgment that the client received the adviser brochure and the solicitor disclosure document; and

4. The adviser must make a bona fide effort to ascertain whether the solicitor has complied with the solicitation agreement, and must have a reasonable basis for believing that the solicitor has so complied. ■

This story first appeared as breaking news at www.regcompliancewatch.com on Oct. 31. ■

A Hollow Victory *(Continued from page 1)*

Publicity from the SEC action drained Yorkville Advisors, an RIA that once managed $1 billion in AUM. The hedge fund adviser deregistered as an SEC RIA in 2014. But the firm continues from Mountainside, N.J., still under its two principals, Angelo and CFO/COO **Edward Schinik**.

A 'death spiral'

The SEC claimed in 2012 that Yorkville "was caught in a death spiral" sparked by the financial crisis and that the pair hatched a "fraudulent scheme" to report "false and inflated values for certain convertible debentures" to earn $10 million in fees (**IA Watch**, Oct. 17, 2012).

Last March, U.S. District Court Judge **George Daniels** in New York dismissed the case's most serious charges, leaving those two negligence claims that evaporated in May.

The judge noted that debentures "were difficult to value because they were not publicly traded and had little to no market activity" in a decision that sliced up the SEC's case like a butcher chopping a shank.

In one example involving the firm's CCO, the SEC stated that the firm had no evidence that documented that the compliance officer had signed off on a "special valuation" as required by the firm's compliance P&Ps. But the judge held that the SEC didn't have "sufficient evidence that Schinik or Defendant Angelo knew that this was occurring, let alone that they instructed anyone

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3. Bad Actor Acknowledgement Form
4. Consent Form
5. Annual RIA Compliance Obligations ■

A Hollow Victory *(Continued from page 2)*

not to document the special valuations."

Time and again, the judge hit the agency for a lack of evidence, including no proof Angelo ever instructed anyone to inflate values, that the principals derived any benefit from the alleged fraud and that the SEC's theory about the firm's "compensation incentives plainly fails as a matter of law to establish scienter."

It helped the adviser's case that its valuation committee had three ranges for fair value (low, middle and high) and yet never used the high range, the judge wrote.

"We hired people right out of the SEC" to sit on our valuation committee, Angelo recalls. He notes none of the SEC alumni were named in the legal action. Angelo didn't sit on the valuation committee.

While Angelo did seek a $10 million redemption at the height of the crisis in 2008, Judge Daniels found that the request came as the adviser was "actively marketing the fund *down* by approximately $33 million."

Pressure post-Madoff

Some examples bordered on incompetence. The SEC pointed to a private placement memo as evidence that Angelo was a partner at the advisory firm. However, the judge noted the document actually refers to Angelo as a "managing member" and "principal" of the RIA.

In a second incidence, the SEC held up an e-mail as evidence that Angelo didn't want a report shown to anyone. But the judge replied that "the email thread plainly shows" that Angelo wanted only to review the report before it was shared – "not because he wanted to hide it from anyone."

Angelo's experience teaches him that "the SEC is not an impartial regulator. It's basically a law firm" with lawyers "trying to get jobs at other law firms that pay better," Angelo tells **IA Watch**. "The entire system is stacked against you .... It is designed to make you settle," he adds.

Schechtman says the enforcement action grew out of pressure on the SEC post-Madoff to target hedge fund advisers. Yorkville "got flagged" by a hastily constructed algorithm. The program detected that the adviser's returns exceeded the **S&P**'s. Angelo says only 7% of the firm's investments were in equities so any comparison would be defective.

Cost: Into eight figures

"Always buy insurance," counsels Angelo. It paid for much of their legal fees, which reached into eight figures, says Schechtman.

As much as the ordeal cost the pair, "the bigger cost was to our investors," says Angelo. "Our investors lost hundreds of millions of dollars" due to the enforcement action, he contends.

"By bringing an action for which they had no basis, [the SEC staff] were only harming those who they were supposed to be protecting," Schechtman says. ■

Annuities' Proposal *(Continued from page 1)*

necessary due to the long-term nature of the contracts and since the structure of variable contracts typically is more complex than other types of investment products.

The proposal would mandate more concise and reader-friendly presentations along with access to detailed information online and electronically or in paper format, upon request. Currently, variable contract prospectuses frequently run more than a hundred pages.

Two prospectus types

To cut the clutter, the SEC's proposed new Securities Act rule 498a would require that an "initial summary prospectus" be provided to new investors as well as an "updating summary prospectus" be given to existing investors. Under the proposal, investors would still continue to have access to the contract statutory prospectus and other information about the contract online and in paper format.

The initial summary prospectus would include items such as an overview of the contract; a table summarizing key information about the contract's fees, risks, and other important considerations; and more detailed disclosures relating to fees, purchases, withdrawals and other contract benefits.

The updating summary prospectus would include a brief description of certain changes to the contract that occurred during the previous year. The key information table from the initial summary prospectus also would be included.

Layered approach precedent

The SEC noted that mutual funds have been permitted to use a similar layered approach to disclosure—with investors receiving a summary prospectus, and more-detailed information available on request—since 2009.

The proposed rule also would permit variable contracts to make prospectuses for underlying mutual fund investment options, and other documents relating to these funds, available online.

Amendments to Forms N-3, N-4, and N-6 that the Commission proposed are ultimately aimed at

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Annuities' Proposal *(Continued from page 3)*

updating and enhancing the disclosure regime for variable contracts.

The SEC has requested public comment on the proposed rule changes, as well as on hypothetical summary prospectus samples that it has published. The comment period closes Feb. 15.

Subscriber-suggested story

Comply with federal e-mail rules but worry mostly about what the states do

Anyone with internet access has gotten them – advertisements via e-mail.

Most modern business enterprises turn to e-mail to advertise, including advisers, so you should know about the **Federal Trade Commission**'s Can-Spam rules. The *Can Spam Act* took effect in 2004. It targets misleading commercial e-mails, but you're not likely to be targeted for non-compliance.

"There's no private right of action for individuals" under the Act, says **Richard Newman**, attorney with **Hinch Newman** in New York. It's mostly attorneys general and internet service providers who use the law to prosecute big offenders.

Seven keys to compliance

The FTC has published a compliance guide, which explains the seven ways to not run afoul of the rules:

1. Don't use false or misleading header information.

2. Don't use deceptive subject lines.

3. Identify the message as an ad.

4. Tell recipients where you're located.

5. Tell recipients how to opt out of receiving future e-mails.

6. Honor opt-out requests promptly.

7. Monitor e-mail marketing companies you hire for their compliance.

The FTC only occasionally enforces the rules, which can carry penalties up to $41,000.

"Always clearly and conspicuously identify the message as an advertisement," recommends Newman. Be sure your "from," "to" and "reply to" information in the e-mail is accurate, he adds.

California active

The leading state targeting fraudulent commercial e-mails is California. "That's where you see most of the action," says Newman. Other states are following suit. He suggests you become familiar with California and other states' laws "because that's where a lot of the risk is." If you e-mail a person in California, e.g., you must comply with the Golden State's rules.

California's rules largely mirror the FTC's with one big difference. Fines in California can reach $1 million "per incident."

Editor's Note: What's your story idea? Contact publisher **Carl Ayers** at cayers@regcompliancewatch.com or 212-796-8332.

Appellate court upholds conviction of serial SEC caller

Just as you can't yell "fire" in a crowded, smoke-free theatre, you apparently can't pester the **SEC** with your concerns about market oversight.

The **Ninth Circuit Court of Appeals** in San Francisco Oct. 25 upheld the conviction of **Ken Sandhu** for "making harassing telephone calls" to the SEC and **FINRA**. We told you about Sandhu's story earlier this year (**IA Watch**, Feb. 8, 2018).

For years, Sandhu placed thousands of calls to regulators, hoping to persuade them to look into his allegations that **Netflix** is a Ponzi scheme. The Tracy, Calif. resident received five years of probation in 2017 after a jury found him guilty of making harassing phone calls to regulators.

His public defender attorneys appealed the case on First Amendment grounds. The court's decision determined that jury instructions weren't deficient in Sandhu's trial. The appellate judges ruled that there "was sufficient evidence to justify Sandhu's conviction based on the sheer number of calls, as well as the ensuing conversations evidencing the intent Sandhu had in making those calls."

First Amendment claims

The judges stated that the First Amendment's right to free speech didn't enter the verdict because the federal statute Sandhu was convicted of "regulates conduct and does not regulate speech."

Sandhu's attorney disagrees. "I think there are definite First Amendment implications" to criminalizing Sandhu's language, says **Carolyn Wiggin** of Sacramento, Calif. "He was talking with government agencies about public policy matters."

The federal statute prosecutors used to convict her client targets prank calls, those in which someone hangs

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SEC Harasser *(Continued from page 4)*

up when the phone is answered, maintains Wiggin. She objects that the jury in Sandhu's original trial wasn't told this. Wiggin tells **IA Watch** she will file a petition for the court to rehear the case.

"It's the conduct of the constant calls and the ringing of the phone that was the issue," says Assistant U.S. Attorney **James Conolly** of Sacramento, who prosecuted Sandhu. "This was never a First Amendment issue," he adds.

Sandhu's "conduct is what is illegal," Conolly continues. "Whatever political motivations he said he had were not relevant to the" conversations, he says.

"I don't have a personal vendetta" against regulators, Sandhu tells **IA Watch**. "I'm screaming for the pension funds that are being looted," he adds, claiming that debt heavily weighs on Netflix and that the firm may go bankrupt next year. ■

FINRA tries spelling out sanction considerations

How **FINRA** calculates fines has always been something of a mystery – and a source of industry frustration. Now, the SRO seems to be making good on a promise to be more transparent, even in cases where firms don't get credit for "extraordinary cooperation."

Take last month's settlement of charges with **BAC Florida Investments Corp.**, which ran into trouble over a series of fixed income transactions in which it allegedly skirted a fee agreement it had with another firm.

The alleged misconduct was discovered during a review by FINRA market regulation department investigators, the settlement indicates, and a failure to self-report would alone normally disqualify the firm from getting credit under Regulatory Notice 08-70.

But the firm went on to take a number of other remedial steps, which FINRA detailed in the settlement, and indicated it considered them in calculating sanctions against the firm.

Over the last year, various FINRA officials have cited a need to provide more information publicly on the factors that drive enforcement outcomes (**BD Watch**, June 21, 2018; **BD Watch**, June 15, 2017). One factor they have highlighted as important: how customers are treated when something goes wrong, such as efforts at proactive restitution.

Here are the "Investigation and Remediation" steps taken by BAC Florida that FINRA cited in its recent settlement:

- ► Paid restitution, including interest, totaling $117,123.35, to the 18 customers who were impacted by the scheme, "before FINRA completed its investigation of this matter";
- ► Terminated its former CEO and head trader, who was behind the scheme;
- ► Retained an independent consultant to identify weaknesses in, and recommend enhancement to, the firm's supervisory systems, procedures and controls, particularly as they related to fixed income securities, and implemented recommendations resulting from that review;
- ► Terminated its CCO's dual compliance responsibilities with the firm and an affiliated bank;
- ► Appointed a new managing director and new CCO with responsibility to review transactions affected for the managing director's clients;
- ► Created a compliance committee to provide guidance regarding compliance-related concerns; and
- ► Revised and enhanced its supervisory system and WSPs, to identify the trading activities in which the firm engages, the person responsible for supervisory review of each activity, and the frequency and documentation of such reviews.

"In determining to resolve this matter on the basis set forth herein," FINRA stated in the settlement, "enforcement took into account the previously-referenced remedial measures implemented by the firm, including its retention of an independent consultant."

BAC Florida agreed to a censure and a $100,000 fine. A FINRA member since 1987, the firm, based in Coral Gables, Fla., with 23 registered representatives, had no previous history of discipline.

Robert Harvey of **Jenks & Harvey** in West Palm Beach, Fla., who represented the firm in the FINRA matter, declined to comment.

Pre-arranged trades

According to the settlement, between July 1, 2013 and June 30, 2014, the former CEO and head trader of BAC Florida engaged in 61 pre-arranged, fixed-income securities transactions with a broker-dealer identified as "Firm A."

The pre-arranged trades were used to manipulate the price of bonds that were bought and sold for customers of a registered investment adviser identified as "Firm B."

Inaccurate acquisition cost and sales proceed information given to Firm B meant its customers received

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More Transparency (Continued from page 5)

inferior prices for the bonds they had purchased from or sold to BAC Florida. The effect was to circumvent a fee agreement under which BAC Florida agreed to charge Firm B customers no more than 15 basis points on each security bought or sold on their behalf.

The former CEO and head trader, **Alejandro Falla**, was separately disciplined by FINRA in 2016, fined $60,000 and suspended for 18 months, according to a separate settlement. Falla was terminated by BAC Florida in 2014.

Complaint reporting and AML program failures land LPL a $2.75 million fine

A too narrow interpretation about requirements surrounding the disclosure of customer complaints resulted in **LPL Financial** failing to file or amend registered reps' Forms U4 or U5 tied to dozens of reportable customer complaints. That failure—coupled with issues with the firm's anti-money laundering program spanning more than three years—have landed LPL a $2.75 million fine from **FINRA**.

The Form U4/U5 problem stemmed from LPL too narrowly interpreting the requirement that a complaint contain "a claim for compensatory damages of $5,000 or more" to be reported.

FINRA stated that the firm incorrectly construed this phrase to mean that the firm was not required to report "any complaint that did not expressly request compensation, even when the customer alleged a sales practice violation that caused him or her a loss of $5,000 or more, and the complaint, when viewed as a whole, made clear that the customer was seeking compensation."

Customer complaints

The settlement revealed that LPL ultimately failed to report on Forms U4 and U5 at least 31 reportable customer complaints alleging sales practice violations involving the firm's registered reps, FINRA found. The firm further failed to amend in a timely manner its reps' Forms U4 and U5 to disclose at least 149 customer complaints and other reportable events, including judgments, bankruptcies, terminations, and regulatory and criminal actions.

Those failures were a red flag for FINRA. "Forms U4 and U5 … serve as an essential source of information to the investing public in deciding whether to entrust their assets with a broker," stated **Susan Schroeder**, FINRA executive VP of the enforcement.

Distinct investigations

The issues were uncovered by FINRA via a number of distinct investigations. One involved a customer.

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