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ACA COMPLIANCE GROUP

ACA Insight

The weekly news source for investment management legal and compliance professionals

"Wherever the agency has identified compliance lapses, it raises the specter of supervision."

Failure to Supervise Chief Compliance Officer Leads to Loss of SEC Registration

If only they had properly supervised the chief compliance officer...

Then $840,000 in client funds might not have been allegedly misappropriated by the CCO, the adviser might not have had to endure multiple enforcement actions, the advisory firm owners might have avoided civil money penalties, and the firm's investment adviser registration might not have been revoked.

Unfortunately, that's not the way it played out.

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Accounting Firm Settlement is Latest Example of SEC Focus on Gatekeepers

An SEC settlement with a Maryland-based accounting firm over allegations that the firm conducted deficient surprise custody examinations provides new evidence that the agency is pursuing what it calls "gatekeepers" – accounting firms, attorneys, consultants and other third parties that work with advisers.

The SEC, in the April 29 settlement, accused the accounting firm **Santos, Postal & Co.**, along with one of its partners, **Joseph Scolaro**, of having conducted inadequate surprise examinations of Washington, DC-based adviser **SFX Financial Advisory Management Enterprises**, as well as not adequately considering other risk factors.

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No-Action Letter Clears Up Sub-Adviser Custody Question

It's good news for advisers that find themselves acting as sub-advisers in a certain kind of custody arrangement.

The SEC staff on April 25 issued an unprompted no-action letter, which it sent to the **Investment Adviser Association** to "share with your members." The just-over-two-page letter lets advisory firms know that the staff would not seek enforcement if a sub-adviser does not obtain a surprise examination when it is in an investment advisory program with a "related person qualified custodian" that is also the primary adviser (or an affiliate of the primary adviser), and the primary adviser is responsible for complying with Rule 206(4)-2, the Custody Rule.

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Failure to Supervise

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The SEC on April 27 revoked the registration of Ohio-based **Professional Investment Management**, an agency registered adviser for more than 35 years. It's the latest chapter in an ongoing saga going back to 2014, involving charges of theft of client funds by PIM's CCO, failure to supervise the CCO by the firm's then-owners, and more.

"This is a case about employee malfeasance, the internal controls necessary to prevent such misconduct and the oversight of a key person with access by firm management," said **Faegre Baker Daniels** partner **David Porteous**. A core issue from the case, he said, was "making sure that that firm management and owners appreciate the potential harm anyone with too much access can cause, especially if there is not enough oversight."

The adviser's registration revocation was apparently triggered by an April 15 final judgment against PIM in a civil action brought against the firm and its former CCO in April 2014 by the SEC in U.S. District Court for the Southern District of Ohio (*ACA Insight*, 5/12/14). The agency contended that, since at least December 2010 through December 2013, PIM had reported in its account statements to clients that they collectively held approximately $7.7 million in a money market fund, when the fund actually held only approximately $6.9 million. The SEC also charged that PIM tried to disguise the shortfall through the use of falsified reports to agency staff.

And that's only part of the story.

The owners, the CCO and the allegations

James Budden and **Alexander Budden** were co-owners of PIM, with James owning the majority share. James was president and director of the firm from approximately 1973 to approximately July 2013. Alexander was vice president and a director of the firm from approximately April 1981 to July 2013. Both supervised several employees, including the CCO, **Douglas Cowgill**.

PIM, which had about $125 million in assets under management, provided third-party administration services and investment advisory service to about 15 retirement plan clients. Those clients consisted of approximately 325 participants who, in turn, owned approximately 425 individual retirement accounts that PIM advised. In addition, PIM provided advisory service to about 25 individual clients for non-retirement accounts. The firm had custody of client assets through omnibus accounts.

Cowgill, who joined the firm in July 1981, was promoted by the Buddens from accounting clerk to vice president and treasurer in 1983. He was named CCO in September 2004.

In its civil suit in federal court, the SEC said that the alleged discrepancy was discovered while the SEC conducted an examination of the firm to verify the existence of client assets. The examination was held after agency staff raised questions concerning alleged Custody Rule requirement failures by PIM.

Cowgill, according to the agency, attempted to disguise the shortfall in client accounts from SEC examiners "by entering a fake trade in PIM's account records. The purported trade was later reversed." This was just one of several falsified reports that the agency said Cowgill provided to SEC staff.

Cowgill also "later transferred funds from a cash account at another financial institution to eliminate the shortfall in the money market fund account," the agency said, but that cash account was also held for the benefit of clients, so the transfer simply "moved the shortfall from one asset holding to another in an effort to avoid detection."

"This was a pure shell game," the SEC said in the complaint.

On September 8, 2014, following an August 2014 federal court judgment by consent against Cowgill, the SEC barred Cowgill from the securities industry.

There was still more litigation coming, this time in the way of criminal charges. In March 2015, Cowgill pled guilty to five counts of wire fraud, 19 counts of theft or embezzlement from an employee benefit plan, and 21 counts of perjury, according to a court-issued amended judgment. He was sentenced to four years in prison and ordered to pay more than $840,000 in restitution. The attorneys representing Cowgill in the civil and criminal cases, when reached, chose not to comment.

Charges against CCOs

SEC charges against CCOs are a touchy subject in the asset management industry. SEC Division of Enforcement director **Andrew Ceresney**, in a November 2015 speech, said that the agency will bring such charges only in egregious circumstances that fall into three categories:

- When a CCO is "affirmatively involved in misconduct" unrelated to his or her compliance function,
- When a CCO engages in "efforts to obstruct or mislead the Commission staff," or
- When a CCO has exhibited a "wholesale failure to carry out his or her responsibilities." It is this category, which includes CCOs charged for causing their firms' compliance failures under Rule 206(4)-7 and other compliance-related rules, that has raised concerns.

That said, others feel that the agency brings such charges too often. Former SEC commissioner **Daniel Gallagher**, in a June 2015 statement, warned that such cases "fly in the face of my admonition" to "tread carefully when bringing enforcement actions against compliance personnel. ... The Commission needs to be especially cognizant of the messages it sends to the compliance community, and in particular to CCOs of investment advisers," Gallagher said. "To put it bluntly, for the vast majority of advisers, CCOs are all we have."

Of course, bringing charges against a CCO, and bringing charges against the owners of an advisory firm for failing to supervise a CCO, are two different things.

Failure to supervise

The two Buddens "failed to adopt or implement any policies or procedures regarding their supervision of Cowgill," the SEC said in an October 2015 administrative order instituting a settlement on charges that they failed to supervise Cowgill. They "merely assumed, without ever confirming, that Cowgill performed his responsibilities in compliance with the federal securities laws."

"There seem to be a fair number of failure-to-supervise cases the agency has been settling recently," said **Willkie Farr** partner **James Burns**. "In one sense, wherever the agency has identified compliance lapses, it raises the specter of supervision. On a more practical level, the cases we are seeing underscore the importance of not only developing, but carefully enforcing written compliance procedures."

More specifically, the agency alleged that the Buddens' failure to supervise led to violations of Rule 206(4)-7, the Compliance Program Rule, and the Custody Rule. According to the SEC, either one or both of the Buddens:

- Never provided any funding, training or resources to support Cowgill in his CCO role.
- Took no steps to ensure that Cowgill or anyone else at PIM resumed conducting compliance reviews at least annually after 2007, when Cowgill, according to the agency, last conducted one.
- Did not ensure that PIM established policies and procedures to prevent client assets from being misappropriated via checks or wire transfers to ensure that client statements were reviewed for accuracy.
- Did not follow up with Cowgill to ensure that he had fulfilled his responsibility of engaging an independent accountant to conduct annual surprise examinations to verify all client assets of which PIM had custody, as well as requiring the accountant to appropriately file Form ADV-E.

Assuming that the problems as laid out by the SEC are accurate, the improper behavior "apparently went on for years, the red flags were flying," said **Eaton & Van Winkle** partner **Paul Lieberman**. He also said that the accounting firm, which was not named in the settlement, should have contacted the Buddens sooner with its concerns, and/or reported the matter to the SEC itself. Eventually, the firm itself contacted the accountant.

"In 2013, J. Budden realized that he had not seen any accountants at PIM for 'some time,' and sought to learn the status of PIM's compliance with the Custody Rule," the SEC said. The two Buddens then spoke with the principal of the accounting firm that had historically completed PIM's annual surprise exam, and "learned that the accounting firm was terminating its relationship with PIM because, among other reasons, Cowgill had not sufficiently cooperated with the accounting firm in 2010 and 2011 to enable it to complete the annual surprise exam during those two years ...." They also learned that "Cowgill had not engaged the accounting firm to perform any work on behalf of PIM since 2011," the agency said.

Despite these findings, the SEC said that the Buddens did not take any disciplinary action against Cowgill.

"Instead, on July 22, 2013, each [Budden] executed a stock purchase agreement in which they each agreed to sell all of their interest in PIM to Cowgill," the agency said. They did so while allegedly knowing at the time of sale that the advisory firm was not in compliance with the federal securities laws, including the Compliance Rule and the Custody Rule.

"The principals of a registered adviser must not abandon their duties at any time prior to the actual sale of the firm to new owners," said Lieberman. "Selling principals remain liable as such until the date of sale and the new owners' names are listed on Form ADV."

Violations and punishment

As part of the settlement with the Buddens, the SEC charged that they "failed reasonably to supervise Cowgill" within the meaning of Section 203(e)(6) of the Advisers Act, specifically in terms of preventing and detecting the CCO's violations of multiple sections and related underlying rules of the Exchange Act and the Advisers Act.

In a separate charge, the agency said the Buddens caused PIM's violation of Section 206(4) of the Advisers Act and is Rule 206(4)-7, the Compliance Program Rule, which requires, among other things, that a registered adviser adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. James Budden was separately charged with having caused the firm's violation of Section 206(4) and its Rule 206(4)-2, the Custody Rule, for not having client assets over which it had custody verified by an independent public accountant at least annually via a surprise examination, and that the adviser require the accounting to file Form ADV-E.

James Budden, as part of the settlement, was barred from the securities industry for three years. He was also ordered to pay a civil money penalty of $125,000. Alexander Budden was barred from the securities industry for two years, and ordered to pay a civil money penalty of $75,000. The attorney representing the Buddens did not respond to a voice mail and email seeking comment.

Accounting Firm Settlement

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A separate settlement with SFX and its chief compliance officer was reached in June 2015, and an SEC administrative law judge in March issued an initial decision against SFX president **Brian Ourand** for allegedly misappropriating $670,000 from client accounts.

"Surprise custody exams of investment advisers serve a critical role in protecting against the misuse of client assets and uncovering such misuse when it occurs," said the SEC Division of Enforcement's Asset Management Unit chief **Anthony Kelly**. "Santos, Postal & Co. failed to confirm with SFX's clients the contributions made to and from their account and then made untrue statements about its custody exams."

The emphasis on gatekeepers

SEC chair **Mary Jo White** made plain the agency's interest in pursuing gatekeepers as far back as October 2013, in a Washington, DC speech before the Securities Enforcement Forum.

"We are focusing on deficient gatekeepers – pursuing those who should be serving as the neighborhood watch, but who fail to do their jobs," she said. "Cases against delinquent gatekeepers remind them, and the industry, of the important responsibilities that gatekeepers share with us to protect investors."

Among other gatekeepers, White singled out accounting firms that work as auditors, and spoke of an agency initiative, Operation Broken Gate, that seeks to identify auditors who "neglect their duties and the required auditing standards. This initiative probes the quality of audits and determines whether the auditors missed or ignored red flags; whether they have proper documentation; and, whether they followed their professional standards."

"Auditors serve as critical gatekeepers – experts charged with making sure that the processes that companies use to prepare and report financial information are ones that are built on strength and integrity," she said. "Investors rely on auditors and need them to do their job and do it very well."

The audit failures are linked to misappropriation of client funds, noted **Rogers & Hardin** partner **Stephen Councill**, "but even where there are no client losses, the SEC will have concerns over custody audits if the proper procedures are not followed. Advisers need to make sure the auditors they engage to conduct custody audits know all the requirements."

The lesson for chief compliance officers is that "you can't take anything for granted," said **Morrison & Foerster** partner **Jay Baris**. "CCOs should not assume that everyone, including the auditor, is doing his or her job correctly."

SFX allegations

Advisory firm SFX's business specialized in high-net-worth individuals, the SEC said. The firm had the authority to both deposit to and withdraw client assets from both bank and brokerage accounts to pay bills, which meant that SFX had custody over client assets, the agency said, adding that one of two individuals at the advisory firm with the authority to withdraw SFX dollars was Ourand.

SFX first retained SPC to perform custody examinations in 2004, and SPC did so until SFX withdrew its Commission registration in 2012, according to the SEC's administrative order instituting the settlement. But from 2006 through 2011, the agency said, Ourand misappropriated funds from client accounts, including by writing unauthorized checks from client bank accounts to himself or to "cash," and by wiring unauthorized amounts to himself. He also allegedly wired money using client credit cards to others for their personal use. Ourand, who represented himself in the hearing, could not be reached for comment.

SFX informed Scolaro that Ourand had been terminated for misappropriating client funds, and that SFX had reimbursed the clients whose money had been improperly taken, the agency said.

The examination reports

The exam reports in question concern a revised report of an exam performed in 2010 and a report from an exam performed in 2011. These two reports "contained untrue statements of material facts," the SEC said. Specifically:

- **2010 revised report.** The report "represented that SPC had confirmed with SFX's clients contributions to and withdrawals from client accounts, when it had not," the agency said. It also "falsely stated that all of the testing procedures were performed for the period ended November 11, 2010, when they were actually performed for the period ended July 31, 2010 (over three months earlier)."
- **2011 report.** SPC, in this report, provided its "unqualified opinion that management's assertion that SFX complied with the requirements of Advisers Act Rule 206(4)-2(a)(1) as of May 31, 2011, relating to a qualified custodian maintaining client funds and securities, was fairly stated, in all material respects." However, the SEC noted, "before filing the 2011 report, SPC and Scolaro knew that Ourand had misappropriated client funds. In light of the misappropriation, all client funds were not maintained with a qualified custodian as of May 31."

Conduct during the examinations

The SEC also alleged that "Scolaro's conduct in performing SFX's 2010 through 2011 examinations violated the professional standards for certified public accountants" as established by the **American Institute of Certified Public Accountants** in its standards for attest engagements and compliance attestation.

Here are just some of the SEC's allegations in this regard. The agency said that Scolaro:

- Did not exercise due professional care or the proper degree of professional skepticism in the planning and performance of the engagements.
- Did not adequately consider fraud risk factors related to fraudulent reporting or misappropriation of assets, including those involving deficiencies in internal compliance controls, monitoring of management, and unusual related party transactions.
- Failed to identify any specific attestation risks regarding SFX's compliance with the Custody Rule, even though there were "significant risks that Scolaro should have identified."
- Did not gain an adequate understanding of SFX's internal controls over compliance as they related to SFX's compliance with the Custody Rule.
- Did not document that fraud had occurred or perform any additional procedures after learning of the misappropriation, "including (for example) evaluating the nature and magnitude of the misappropriation, how Ourand stole client funds, or whether the misappropriation should affect the timing and extent of attestation procedures."
- Failed to obtain sufficient evidence to provide a reasonable basis for the conclusions expressed in the examination reports or to provide reasonable assurance of detecting non-compliance "because he failed to obtain sufficient evidence through effectively designed sampling plans, independent confirmations with clients, or alternative procedures that provide relevant and reliable evidence."
- Did not separately evaluate or examine the "significant unusual checks" made to Ourand or to cash, "which a proper degree of professional skepticism should have dictated were high risk transactions."
- Falsely stated that SPC had confirmed contributions to and withdrawals from client accounts when, "in fact, these procedures were not performed and SPC had not performed adequate alternative procedures to obtain sufficient evidence to provide a reasonable basis for these conclusions."
- Did not assign an engagement team that had adequate technical training and proficiency to perform the attestation engagement.

CCOs interested in checking up on their own auditors should schedule regular meetings with them, and review their audit reports, Baris suggested.

Violations

SPC and Scolaro both willfully violated Section 207 of the Advisers Act, which makes it illegal to make a false statement of material fact on a registration application or report filed with the SEC, the agency said. In addition, it alleged that both parties engaged in improper professional conduct, as defined in Section 4C(b) of the Exchange Act and its Rule 102(e)(1)(iv) of the Commission's Rules of Practice.

Under Section 4C, the SEC may censure any person or deny the privilege of appearance before the Commission, which was among the sanctions the agency placed on SPC and Scolaro, although SPC was given the right to file for reinstatement after one year, Scolaro after five years.

In addition, SPC was ordered to pay disgorgement of $25,800, plus prejudgment interest of $3,277, and civil money penalty of $15,000. Scolaro was also ordered to pay a civil money penalty of $15,000. An attorney representing both parties did not respond to a voice mail or email seeking comment.

No-Action Letter

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That's a lot to carry, so let's unpack it.

First, the advisory firm must be acting in a sub-advisory capacity to its affiliate, the primary adviser. Second, the sub-adviser and the adviser must be in an investment advisory program together, such as a wrap program. Third, the primary adviser (or its affiliate) must be the qualified custodian for the client's assets in the program, and the primary adviser must be responsible for Custody Rule compliance.

Under those circumstances, the sub-adviser would not need to separately arrange, for its own Custody Rule compliance requirements, an additional surprise custody examination, as that is the responsibility of the primary adviser – and it need not worry about the SEC coming down on it for failing to do so.

Sounds like common sense, right? After all, why would the SEC want both the adviser and the sub-adviser to arrange a surprise examination over the same assets? Because that point was not clear in the Custody Rule, said **Mayer Brown** attorney **Adam Kanter**. The no-action letter clears it up.

The no-action letter allows a sub-adviser "to avoid the cost of a surprise examination when a primary adviser in the same program is a related person, acts as the custodian, and is already getting a surprise exam on the same assets," said IAA assistant general counsel **Laura Grossman**.

"Say an adviser is running a wrap fee program, and its affiliate is the sub-adviser," said Kanter. "The letter makes clear that the sub-adviser would not have to comply with the surprise examination requirements under the Custody Rule, which makes sense since it doesn't even have access to the money, and the primary adviser is already getting its own surprise exam. This eliminates the duplicative exam.

Conditions

The SEC staff listed four conditions, in such a situation, for it not to pursue enforcement:

1. The "sole basis" for the sub-adviser having custody is its affiliation with the qualified custodian and primary adviser;
2. The primary adviser will comply with Rule 206(4)-2, including by arranging a surprise examination;
3. The sub-adviser does not hold client funds or securities itself, have authority to obtain possession of client funds or securities, or have authority to deduct fees from client accounts; and
4. The sub-adviser will continue to be required to annually obtain from the primary adviser or qualified custodian a written internal control report prepared by an independent public accountant.

No-action letters

It is fairly unusual for the SEC staff to send an unsolicited no-action letter to the asset management industry, whether through an association like the IAA or in some other way. Usually, the staff issues a letter in response to a letter it receives from a law firm representing an adviser or some other party asking for assurance that the staff will not recommend enforcement action if the adviser meets certain representations.

But in this case – "the IAA did not request the letter," said Grossman – the SEC staff apparently wanted to get the word out to the industry anyway.

"Contrary to what we sometimes cynically think, the SEC staff does recognize when things don't make sense, and this is one instance of them pro-actively doing something about it," said Kanter.

He nonetheless noted that "it's always interesting when the SEC touches the Custody Rule," given the rule's complex nature. "The staff always seems a bit trepidatious before doing so, as they don't want what they say to affect some other issue under the rule that they did not intend. They don't want to open a window and find that they also opened a door."

The annual surprise exam

The agency staff reminded advisers that a registered investment adviser with custody of client funds or securities is required by Rule 206(4)-2 to take a number of steps designed to secure client assets, one of which is an annual surprise examination by an independent public accountant to verify the client funds and securities.

The SEC "recognizes that affiliated custodial relationships present higher risks to advisory clients than where client funds or securities are maintained with an independent custodian," it said. For that reason, "where an investment adviser, or its related person, maintains client funds or securities, it must obtain or receive a written internal control report from an independent public accountant that demonstrates that it, or its related person, has established appropriate custodial controls."

"Notwithstanding these concerns," the agency staff said that, under the conditions described in its letter, it would not seek enforcement action if a sub-adviser does not arrange for a surprise examination.

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