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ACA Insight

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"This case reflects the SEC's heightened focus on compliance officers, and finding them personally liable for the acts of others."

Internal Controls: CCO and Adviser Pay After SEC Charges President with Theft

It's not easy to set limits on an advisory firm's owner, president or chief executive officer. But as one chief compliance officer found out, failure to do so may lead to harsh consequences, not only for the top executive, but for the firm and its CCO.

SFX Financial Advisory Management Enterprises and its CCO, **Eugene Mason**, both settled with the SEC on June 15. The settlement came on the same day that the Commission brought charges against the firm's former president, **Brian Ourand**, for allegedly stealing approximately $670,000 in client funds over a five-year period.

"SFX failed to supervise Ourand and also committed compliance failures," the SEC said. More specifically, the agency charged that the firm "failed to adopt policies and

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Court Orders Broker-Turned-Adviser to Pay More Than $1 Million in Two Cases

It's been a rough five years for **Sage Advisory Group** and **Benjamin Lee Grant**. Now, with more than $1 million in disgorgement and civil money penalties ordered in two final judgments, the worst, at least, may be over.

The U.S. District Court for the District of Massachusetts last month entered final judgments against the former registered investment adviser and its owner, Grant, resulting from two fraud cases filed by the SEC. The Commission itself settled with Grant in regard to both cases on June 1, barring him from the securities industry.

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Fees and Expenses: What Examiners Want to Know

Do what you say, and say what you do.

Securities regulations have been described as a disclosure regime. As long as a firm discloses to clients what it plans to do with their investments – and does so in a way that will be read and understood by a reasonable person – the firm in many instances can rest easy that it is not breaking its fiduciary duty to those clients.

There are few areas where this principle is more central than fees and expenses. "It's very much a disclosure issue," said **Zaccaro Morgan** partner **Nicolas Morgan**. SEC

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Internal Controls

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procedures reasonably designed to prevent the misappropriation of client assets, failed to implement the policies it did have, violated the Custody Rule, and falsely stated in its Form ADV that it reviewed client accounts used for bill-paying services. SFX also failed to conduct its annual compliance review in 2011."

As for Mason, the agency alleged that he caused the firm's failure to implement its compliance policies, failed to conduct the annual review and was responsible for a material Form ADV misstatement.

"The SEC has and will likely continue to charge chief compliance officers who clearly fail to carry out their assigned responsibilities under an investment adviser's compliance program."

Both the firm and Mason were censured, with SFX agreeing to pay a civil money penalty of $150,000, and Mason agreeing to pay $25,000. The charges against Ourand were not settled, and now move to an administrative proceeding. An attorney representing SFX and Mason declined a chance to comment on the case, while an attorney representing Ourand could not be located for comment.

"SFX failed to detect an alleged misappropriation for years because it had insufficient internal controls to limit Ourand's ability to withdraw client funds for personal use," said SEC Division of Enforcement Asset Management Unit co-chief **Marshall Sprung**. "Investment advisers have a fiduciary obligation to safeguard client assets."

"This case reflects the SEC's heightened focus on compliance officers, and finding them personally liable for the acts of others," said **Rogers & Hardin** partner **Stephen Councill**. Noting the SEC's allegations that the CCO failed to conduct an annual compliance review and follow the firm's procedure for reviewing cash flows in client accounts, he said that "while it's hard to tell whether these alleged failures actually caused the theft, it's a good reminder that the SEC is willing to bring charges when compliance officers fail to follow their own procedures."

"It is particularly important for compliance officers to monitor the design and implementation of a firm's compliance policies, especially when they are specifically assigned those responsibilities under the compliance program," said **Mayer Brown** partner **Matthew Rossi**. "The SEC has and will likely continue to charge chief compliance officers who clearly fail to carry out their assigned responsibilities under an investment adviser's compliance program."

The relationship and what went wrong

SFX, which as of March 2014 managed approximately $14 million for clients on a discretionary basis, provides advisory and financial management services to both current and former professional athletes. Those services, according to the administrative order instituting the settlement with the firm and Mason, include management of investment portfolios, payment of bills, financial planning and tax consultations and support.

Under the SFX system, the firm had the authority to withdraw and deposit assets from several of its client bank and brokerage accounts, the SEC said. Ourand, who in addition to being president was a "relationship manager" for several of the clients, was authorized to pay bills, transfer money and deposit checks, according to the agency. He also had "unauthorized access" to some client credit card accounts, as well as discretionary authority to trade in client brokerage accounts and provide clients with securities investment advice, the agency said.

"In July 2011, an SFX employee learned that Ourand had misappropriated assets when a client complained that he could not use one of his credit cards," the agency said. "SFX and the employee promptly conducted an investigation," which it said resulted in the firm firing Ourand and reporting his alleged conduct to the criminal authorities.

What was the scope of the alleged crime? "From 2006 to 2011, Ourand misappropriated at least $670,000 from clients" by writing unauthorized checks from client bank accounts to either cash or himself, and wired unauthorized amounts to himself for his personal use, the agency charged. "He also wired money using client credit cards for unauthorized amounts to others for their personal use" and "forged a client's name and engaged in other deceptive conduct."

The role of the firm and the CCO

Given that Ourand and other individuals at SFX had "full signatory power" over client bank accounts relating to the firm's bill-paying services, "there was significant risk that those individuals could misappropriate client funds," the SEC said. But the firm's compliance policies and procedures "were not reasonably designed, and were not effectively implemented, to prevent the misappropriation of client funds." Further, the settlement document states, "as CCO, Mason was responsible under the policies and procedures for implementation of the policies and procedures."

"SFX's policies were not reasonably designed to prevent the person authorizing payments that SFX made from client accounts from circumventing secondary review of those payments," the SEC said. "Thus, Ourand was able to circumvent secondary review of the payments he authorized from client accounts."

"This is, without a doubt, one of the toughest positions for a CCO to be in," said **Mayer Brown** attorney **Adam Kanter**. While in this case "the compliance program probably was deficient," he said that for many CCOs confronted with non-compliant plans from firm owners, presidents and CEOs – their bosses – there may be difficulty in resolving such situations. "The president says, 'We want to do this,' and the CCOs says, 'No, you can't.' Sometimes the president agrees, and sometimes the president doesn't. So what happens next?"

A responsible CCO could choose to document his or her objections to a proposed non-compliant course of action, said **Aaron De Angelis**, chief compliance officer at **Spring Mountain Capital**, a New York City-based advisory firm specializing in private equity and hedge funds. But if the proposed action is particularly egregious, the CCO has little choice but to resign, as staying with the firm may leave the CCO liable should the non-compliant activity ever be found out and, if that happens, "your career is over," he said. A third option, reporting the firm to the SEC, while potentially protecting a CCO from being charged as a participant in the non-compliant activity, may also make it difficult for him or her to find another job, he said.

"I think you're going to see more and more of this," De Angelis said of CCOs being charged when they either have inadequate compliance programs and/or fail to stop non-compliant activities at their firms. "But," he said, "we have always been the ones responsible."

Custody, Form ADV and the compliance program

Beyond the alleged lack of controls over clients' funds, the SEC charged violations in three other areas:

- **Custody.** SFX did not have a reasonable basis to believe that, after due inquiry, custodians were providing clients with bank statements, the agency said, charging the firm with violating Rule 206(4)-2, the Custody Rule. The rule requires, among other things, that an adviser have a reasonable basis to believe that such account statements are sent to clients at least quarterly. In addition, the agency said, SFX and Mason did not follow the firm's own compliance policy in requiring that there be a review of cash flows in client accounts.
- **Form ADV.** According to the SEC, the firm's Form ADV, Part 2 brochure, filed in March 2011, said that a client's cash accounts used specifically for bill paying were reviewed several times a week by senior management for accuracy and appropriateness. "This statement was untrue because a review for 'appropriateness' indicates a review by senior management other than the person responsible for the relevant transactions, yet no one other than Ourand reviewed the bill-paying accounts over which he had signing authority and from several of which he misappropriated funds," the agency said. SFX and Mason were charged with violating Section 207 of the Advisers Act for making an untrue statement of

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material fact in a registration application or report filed with the Commission.

- **Compliance program.** SFX did not conduct an annual review of its compliance program in 2011, even though it was in the midst of an internal investigation following the discovery of Ourand's alleged misappropriation, the SEC said. As the CCO, Mason "was responsible for ensuring the annual review was completed and was negligent in failing to conduct the annual review," the agency charged. Mason was charged by the SEC with violating Section 206(4) of the Adviser Act and its Rule 206(4)-7, the Compliance Program Rule.

Court Orders

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The two cases, while related, address separate alleged violations. In the first case, filed by the SEC in 2010, the Commission charged that Grant, a broker-dealer who became an investment adviser, engaged in misrepresentation when he "fraudulently led his brokerage customers to transfer their assets to Sage, his new advisory firm." In the second case, filed by the Commission in 2011, the SEC alleged that Sage and Grant, along with Grant's father, **John Grant** (sometimes referred to in the complaint as **Jack Grant**), violated a Commission bar set up to prevent the elder Grant from working for an investment adviser or acting as one himself.

Sage and the younger Grant lost a jury verdict – although they beat charges that they willfully filed a materially false and misleading Form ADV – in the misrepresentation case on August 13, 2014, but it has taken almost a full year for the final judgments to come down from the court.

"The takeaway here is that even that partial victory (in being acquitted on the Form ADV charge) provided the Grants and Sage cold comfort when the process recently concluded," said **Zaccaro Morgan** partner **Nicolas Morgan**. "Based on its partial success with the jury, the SEC was able to obtain Lee Grant and Sage's consent to pay $550,000 in disgorgement and interest as well as an additional $500,000 in civil penalties. Perhaps even more significantly, Lee Grant consented to an administrative bar prohibiting him from associating with any broker, dealer, or investment adviser."

Further, Morgan said, the damage to defendants from a loss in an SEC case can linger. "The saga may not be over, as collateral impacts of the settlement become clear going forward." For example, state regulators may pursue independent enforcement actions based on the SEC administrative order. In addition, he said, certain securities registration exemptions and other benefits may now become unavailable because of the judgments and orders entered. "And unfortunately, the reputational damage from an SEC lawsuit is tough to overcome."

The dangers of dual registration

Dually registered investment advisers and broker-dealers should pay attention to both the SEC's allegations in the first case and the final judgment. They serve as a warning that the Commission watches their activities closely.

Firms and individuals electing to do more business under the investment adviser business model rather than the broker-dealer business model is "one of the larger risks to investors that is out there today," said Office of Compliance Inspections and Examinations former director **Andrew Bowden**, (*ACA Insight*, 11/11/13). OCIE, in both its 2015 and 2014 exam priorities, expressed concerns about the issues, such as excess fees and reverse churning, raised by entities becoming dual registrants. The 2014 priorities list described dual registration as a "significant risk."

The SEC wants to ensure that clients are provided with adequate advisory services from dual registrants in exchange for their management fee. That view was made evident by the SEC's statement in its complaint that, "in short, even though he styled himself as an investment adviser, Grant did little more than sit back and wait for the client's wrap fee payments to roll in."

That perceived risk includes not only dual registration, but firms deregistering as broker-dealers and re-regis-

tering (or maintaining existing registration) as investment advisers, firms shifting business and relationships from their broker-dealer side to their investment adviser side, and new market entrants choosing to start their business by registering solely as an investment adviser instead of as a broker-dealer or as a dual registrant.

Case one: Misrepresentation

In the case, the agency alleged that Grant, a former registered representative at a Los Angeles-based broker-dealer, "lied to his brokerage customers in order to induce them to transfer their assets to a new investment advisory firm (Sage) of which he was the sole owner." Grant had customer accounts representing approximately $100 million in assets, with the assets managed by a Pasadena-based investment adviser, **First Wilshire Securities Management**.

After resigning from the broker-dealer in 2005 to go into business for himself at Sage, Grant allegedly sent a letter to his former broker-dealer customers, telling them that Sage had been formed to handle their investments and that, at the suggestion of the former broker-dealer, their brokerage accounts were being moved from the broker-dealer to a discount broker, the SEC said.

The letter also allegedly said that the charge for the customer accounts would be changed: Instead of the customers paying a 1 percent management fee to First Wilshire, plus brokerage commissions to the broker-dealer, they would pay a 2 percent wrap fee to Sage. The letter went on to say that, according to First Wilshire, such a wrap fee was slightly less expensive, the SEC said.

The SEC, however, said that the statements in the letter ware "materially false and misleading. ... First Wilshire had not suggested the transfer of the customers' accounts from [the broker-dealer] to [the discount broker], and First Wilshire had not refused to continue managing their assets at [the broker-dealer] – meaning that the customers were not forced to transfer their business to Sage and [the discount broker] if they wanted to retain First Wilshire as their money manager," the agency said in its complaint.

Nor did Grant tell his customers that "the only person likely to benefit from the new 2 percent wrap fee was himself," the agency charged.

As it turned out, Grant's "scheme" to induce his brokerage customers to follow him to Sage was a success. "Virtually all of his brokerage customers at [his brokerage firm] became his advisory clients at Sage, and his compensation more than doubled as a result – from less than $500,000 in 2004 and in 2005 to more than $1 million in 2006 and in 2007," the SEC said.

Case two: Ignoring the bar

The elder Grant, despite a bar that prevented him from associating with an investment adviser or from acting as an adviser himself, "continued to provide investment advice to individuals and small businesses," the SEC charged. The bar was the result of a 1988 Commission enforcement action against Jonathan Grant alleging that he sold $5.5 million of unregistered securities and misappropriated investors' funds, the agency said. The elder Grant, who was also an attorney, was indicted for bankruptcy fraud in 1990 and was subsequently convicted, with Massachusetts Supreme Judicial Court suspending him from the practice of law in 1994 for one year.

According to the SEC, the elder Grant, after he joined his son's firm, in order to elude the bar on investment adviser activities, simply "retooled his service as the Law Office of Jack Grant and used his son, Lee Grant, to help implement his investment advice." Further, neither of the Grants, nor Sage, advised their clients that the elder Grant was barred from associating with advisers, the agency said.

The two cases are related in more than the last name of two of the parties. "Lee Grant understood that Jack Grant often advised his clients to place their assets with First Wilshire Securities Management ... and to do so through Sage and his son Lee Grant, who previously worked at First Wilshire," the agency said.

"As of 2011, Sage's client base had come almost exclusively from referrals from Jack Grant," the SEC charged. "The overwhelming majority of Sage's clients

were clients of Jack Grant or had some familial or other relationship with one of Jack Grant's clients. In fact, approximately 25 percent of Lee Grant's clients at Sage had been Jack Grant's brokerage customers before he was barred from associating with a broker-dealer or investment adviser back in 1988."

The lesson here for a compliance officer at an adviser or broker-dealer is to perform due diligence on the source of their client referrals, said **Eaton & Van Winkle** partner **Paul Lieberman**. In this case, according to the SEC's complaint against John Grant, he was allegedly referring clients to his son when the son was still employed at First Wilshire and then later at the broker. Effective due diligence should have discovered that an individual who was barred from adviser activities was related to the broker, he said. "That is a red flag right there. Alarm bells should have gone off."

Violations and fines

Sage and Lee Grant, as part of the final judgment in the misrepresentation case, were ordered to pay $500,000 in disgorgement plus more than $51,000 in prejudgment interest. In addition, Lee Grant was handed a $350,000 civil money penalty. The final judgment in the second case resulted in an additional $150,000 judgment against Grant. The court reached a separate final judgment against the elder Grant in May 2013 for violating the SEC bar, ordering him to pay a total of more than $201,000, the agency said.

Among the charges against Sage and Lee Grant, in addition to violating a Commission bar, were violations of Section 17(a) of the Securities Act for committing fraud; Section 10(b) of the Exchange Act and Rule 10b-5, also for committing fraud; Sections 206(1) and 206(2) of the Advisers Act; Section 206(4) of the Advisers Act and Rule 206(4)-7 for failing to have a proper compliance program in place; Section 207 of the Advisers Act for making untrue statements on an SEC registration application or report; and Section 204A of the Advisers Act and its Rule 204A-1 for failing to adopt a code of ethics with certain minimum standards. Attorneys representing Sage and Lee Grant, as well as attorneys representing Jonathan Grant, did not respond to telephone messages or emails seeking comment.

Fees and Expenses

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examiners, when they visit firms, want to determine if "what the adviser is telling investors is matched by the practice on the ground."

"Informed consent is the key. So long as you fully and fairly provide disclosure, and investors have a chance to accept or reject, charging that fee or expense generally should be acceptable," said **Mayer Brown** partner **Rory Cohen**, provided, of course, that what you charge is within the legal charge limits.

Hedge funds and private equity funds are where fee and expense issues typically come up when examiners visit, said Cohen. In that vein, SEC Office of Compliance Inspections and Examinations former director **Andrew Bowden** addressed the issue of fee disclosure in a May 2014 speech, "Spreading Sunshine in Private Equity," in New York City.

"Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser)," Bowden said. "This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors. Poor disclosure in this area is a frequent source of exam findings. We've also seen limited partnership agreements lacking clearly defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation."

"By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses," he continued. "When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50 percent of the time."

Examiner questions

With that in mind, it should not come as a surprise that examiners visiting your firm will bore deeply into how

you disclose fees and expenses. Expect examiners to look at your Form ADV, limited partnership agreements, operating agreements and periodic reports, said Morgan. They will look for differences between what is said in these documents and what is actually being done, such as:

- **Where is compensation coming from?** Some advisers, particularly those managing private equity funds, sometimes work with professionals whose employment status is not clear, said Morgan. For instance, if an adviser is considering having one of its funds invest in a solar energy company, it might draw on the expertise of a subject expert to get advice on solar energy to help guide the fund's investments. "The expert might start off giving advice to the adviser and be paid by the adviser, but as time goes on, the adviser might want to shift some of that cost to the fund," he said. The issue is not so much whether it would be a reasonable expense for the fund to bear – many might say that it would be – but whether it had been previously disclosed to fund investors that the adviser might retain such an expert and charge his or her compensation to the fund. If the adviser did, then it is probably in the clear, he said. But if the adviser did not, and that failure to disclose is found by examiners, it will, at a minimum, need to be addressed. It might, particularly if the problem is seen as systemic, be referred to enforcement. This situation can also occur with back-office administrative functions, such as accounting. Is the fund or the adviser paying for these employees, and was that disclosed to investors?
- **Are fees charged in excess of what was disclosed?** Take that same adviser who is considering investing in a solar energy company. Prior to making any investments, the adviser will want to investigate the company through due diligence. But in order to pay for that research, investors, who were told that only $100,000 would be spent on individual investments, would now have expenses of $200,000. In such cases, to avoid problems with examiners, "firms should monitor their compliance with any fee limits. If it goes over, the overage should be addressed. One way would be through charging any overage back to the adviser," Morgan said.
- **Is there improper shifting of expenses or fees among an adviser's funds?** Misallocation of this sort might occur when firms are managing side-by-side funds that make similar investments, and one set of clients

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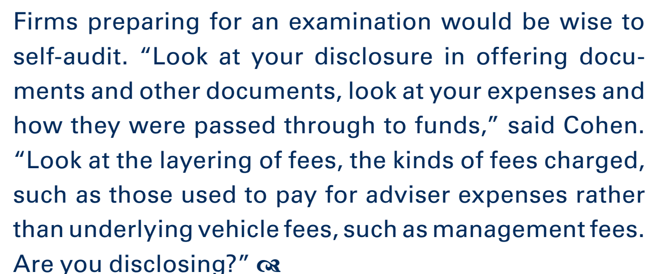
absorbs fees or expenses that should be allocated to other clients, said Cohen.

- **Are fees being mischaracterized?** This is when fees that are personal or considered investment management overhead are represented as fund-related expenses or fees for services that are misrepresented or are not provided, said Cohen. Among the recent actions that the SEC has brought in this regard are two: a January 2014 case in U.S. District Court where the agency brought charges against a private equity manager for allegedly concocting a sham due diligence arrangement under which fund assets would be used to pay fake fees (*ACA Insight*, 2/17/14), and a February 2014 administrative action against a private equity manager and his advisory firm for allegedly mischaracterizing fees charged to fund investors that actually were used to pay firm expenses (*ACA Insight*, 3/10/14).
- **Are firms utilizing fund expenses for their own benefit?** Such fees might include an adviser's compliance or internal marketing costs; the costs of completing a major document, such as Form PF; or even the cost of attending a conference, Cohen said. In many of these cases, one can argue that it is justifiable to charge the costs to a fund rather than the adviser. For instance, an adviser has an obligation to complete Form PF, but if the adviser is doing the form for the fund, it can make the case that it would be proper to charge the fund. The key, though, is not whether charging the fund for completing Form PF is justifiable, but whether it was disclosed to investors, Cohen said.

Firms preparing for an examination would be wise to self-audit. "Look at your disclosure in offering documents and other documents, look at your expenses and how they were passed through to funds," said Cohen. "Look at the layering of fees, the kinds of fees charged, such as those used to pay for adviser expenses rather than underlying vehicle fees, such as management fees. Are you disclosing?"



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