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"Capital markets and capital market actors or, as the Fed labels them, non-bank financial institutions, are not engaged in 'shadow banking.'"

Piwowar Turns the Tables on Prudential Regulation Advocates

SEC commissioner **Michael Piwowar** apparently knows how to play poker.

In a recent speech, Piwowar decried the efforts of bank regulators and others to expose the asset management industry to "prudential regulation," which would leave advisers, funds and others subject to the same kind of rules that cover the banking industry. But instead of just voicing the same objections to prudential regulation that others have made, he raised the ante by calling for banks to be subject to enhanced disclosure requirements, which he called "market-based prudential regulation."

"Rather than imposing prudential regulations on markets, I would argue that expos-

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Firm Pays the Price for Failing to Act on OCIE Deficiencies

It's a simple lesson: Don't promise the SEC something you can't or won't deliver.

One adviser and its owner last month paid the Commission $50,000 as part of a settlement because, according to the SEC, it didn't learn that lesson. The firm, its owner and its chief financial officer also agreed to retain a compliance consultant, both the president and the CFO agreed to undergo personal compliance training, and the CFO was separately ordered to pay a civil money penalty of $10,000.

All unnecessary if the firm had simply made the changes it promised to make following two examinations by the Office of Compliance Inspections and Examinations, the

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Whistleblower Program Demonstrates Clout … But Some See Problems

Not everyone is happy with the SEC's whistleblower program – except perhaps the SEC and the whistleblowers.

Recent developments involving the SEC's four-year old program that allows some informers to become rich make the case that, like it or not, the whistleblower program is here to stay:

- **The number of whistleblowers approaching the SEC is high and getting higher.**

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Piwowar Turns the Tables

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ing banks to the disclosure-oriented focus of market-based regulation would provide better protection to the financial system," he said. "In other words, instead of 'prudential market regulation,' the financial system would be safer with 'market-based prudential regulation.'"

Prudential regulation

Much of the debate over prudential regulation of the asset management industry goes back to the question of what – and what kind of institutions – contributed to the 2008 financial crisis. Piwowar believes that those who blame asset managers and investment companies for the crisis are mistaken. "They did not precipitate the 2008 financial crisis and, in fact, continue to flourish today."

"If all firms are invested in the same types of assets, then during a period of market stress the entire financial system is more likely to collapse."

Focusing on the Federal Reserve in particular, Piwowar said it "apparently believes that because asset managers and investment companies have been so successful, they somehow pose a systemic threat to the financial system and therefore have earned an additional layer of regulation – prudential market regulation. Of course, what they ignore is that those entities have been subject to extensive and highly effective regulation by the Commission for 75 years."

The Fed and other banking regulators are not experts on capital markets, he said. "They do not even understand the basics."

"Capital markets and capital market actors or, as the Fed labels them, non-bank financial institutions, are not engaged in 'shadow banking,'" Piwowar said. "Investors in the capital markets operate with the knowledge that the money they invest is subject to risks and, unlike bank deposits, is not guaranteed. Investors make a tradeoff between the risk of loss of principal and the hope of earning a higher return on their investment. The Fed may be risk averse and suspicious of those motivated by profits, but risk taking and profit seeking are the cornerstones of the capital markets."

The danger of trying to mitigate risks on a macro level is that it would result in a "narrowing of the differences in the way assets are managed," he said, which could result in all financial firms having similar investments. "If all firms are invested in the same types of assets, then during a period of market stress the entire financial system is more likely to collapse," he said. In addition, he noted that prudential regulation could force asset managers to face "the impossible task" of balancing their fiduciary duties to clients and investors against regulatory obligations to do what is best for the financial system as a whole.

The role of the SEC

Piwowar argued that those calling for prudential regulation of non-bank financial institutions not only lack an understanding of the capital markets, but show little appreciation of the SEC's mission. "I am very concerned about the extent, fervor and momentum of those proposals."

"It is the Commission, not the banking regulators, that has the statutory authority and responsibility for regulating the capital markets. It is the Commission, not the banking regulators, that has the requisite expertise and experience with capital markets. It is the Commission, not the banking regulators, that should be regulating the capital markets," he said.

SEC commissioner **Daniel Gallagher** has also criticized the proposed use of prudential regulation for asset managers. Prudential regulators "and the policymakers they have captured adhere to a false narrative of the financial crisis that says capital markets regulators like the SEC failed, and the markets and market participants overseen by capital markets regulators were a major cause of the financial crisis," he said in an April 10 speech, "Bank Regulators at the Gates: The Misguided

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Quest for Prudential Regulation of Asset Managers" (*ACA Insight*, 4/20/15).

Efforts to label the asset management industry as systemically risky have also drawn criticism from other quarters. The **Investment Adviser Association** and the **Securities Industry and Financial Markets Association**, in a March 25 comment letter sent to the **Financial Stability Oversight Council** (FSOC), said that the risks in asset management are not systemic and, in any event, should be addressed by the SEC, not the FSOC. The letter was sent in response to a FSOC notice seeking public comment on its evaluation of potential risk in the asset management industry.

The IAA and SIFMA also sent separate letters last month to the **Financial Stability Board** and the **International Organization of Securities Commissions** on similar issues.

"It is the Commission, not the banking regulators, that has the requisite expertise and experience with capital markets. It is the Commission, not the banking regulators, that should be regulating the capital markets."

"The right regulator and the primary regulator (for advisers and others in the asset management industry) is the SEC," said IAA general counsel **Robert Grohowski** separately.

"Piwowar's speech makes a very direct, sensible, and well-supported case for two primary points," said **Ropes & Gray** counsel and former IAA executive director **David Tittsworth**. "First, the asset management profession is fully and appropriately regulated by the SEC. Second, the banking industry should be subject to a higher level of disclosure – what he calls market-based prudential regulation."

"The asset management profession is already heavily regulated and the SEC is in the best position to serve as the primary regulator of asset management firms and activities," he said.

Tittsworth added that "pending proposals before the SEC will require additional disclosures by asset management firms and funds. The SEC and FSOC and other regulators need to work together to avoid regulatory arbitrage and duplication. Adding an additional layer of regulation and bureaucracy is unnecessary and would result in costly and burdensome requirements."

Increased bank regulation

Instead of imposing prudential regulation on markets, Piwowar called for banks to be subject to the "disclosure-oriented focus of market-based regulation," as that would provide better protection to the financial system.

"One of the most important lessons from the financial crisis is that bank investments are not adequately disclosed," he said. "There is limited public information about how banks are investing their assets, so investors have difficulty making informed investment decisions, and creditors cannot assess the true creditworthiness of banks. Moreover, the Commission and the banking regulators do not have key information that would allow them to monitor bank risk at the individual bank level and/or across the banking system."

Saying that he would "never be so bold as to call banks 'shadow investment companies'" – a clear jibe at those who use a similar term for asset managers and investment companies – "it is worthwhile to think of banks as being similar to investment companies in that their assets are invested in a myriad of products," Piwowar said. "Investment companies are subject to the Commission's disclosure regime, which requires extensive information about an investment company's portfolio holdings. Banks are not."

"'Sunlight is said to be the best of disinfectants; electric light the most efficient policeman,'" Piwowar said, quoting former Supreme Court Justice **Louis Brandeis**. "Banks should be subject to sunlight, and in fact a direct spotlight, in much the same way as investment companies, such as through market-based prudential regulation."

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Firm Pays the Price

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agency said. The firm's alleged failure to repeatedly put off making the changes it promised led the SEC to show, via the sanctions it levied, that it means business.

Trust & Investment Advisors, an Indianapolis-based advisory firm with approximately 270 clients and about $150 million in assets under management, along with its owner/president, **Larry Pitts**, and its CFO and investment committee chairman, **George Prugh**, allegedly failed to correct ongoing securities violations noted during on-site examinations in 2005 and 2007. When exam staff found the same deficiencies plus others during their 2011 exam, the SEC apparently decided that enough was enough.

Not acting on deficiencies is something of a hot button with the SEC, which tends to see such firm as "recidivists" that do not take compliance seriously. Advisers classified as such may well find themselves getting more attention than they otherwise might receive.

"Investment advisers should be aware that if OCIE identifies deficiencies during an exam – particularly if the deficiencies concern areas of high priority to the SEC – there is a very good chance OCIE will come back again to check whether those deficiencies have been properly addressed," said **Mayer Brown** partner **Matthew Rossi**. "The failure to address such deficiencies may result in enforcement action, as was the case here."

SEC Division of Enforcement Asset Management Unit co-chief **Julie Riewe**, in a February 26 speech, explained that her unit was working with OCIE on a compliance program initiative to identify advisory firms that lack effective compliance programs for possible enforcement action. "The goal is to drive firms to address repeated or systemic compliance failures that may lead to bigger problems," she said, "so the initiative targets firms that have been previously warned by SEC examiners about compliance deficiencies but failed to effectively act upon those warnings, or firms that have wide-ranging compliance failures."

It's not that there was anything particularly complicated about the alleged deficiencies in this case. They included the firm's failure to complete an annual compliance review or develop a compliance manual, as well as its "continued use of misleading statements in its marketing materials," according to the May 18 administrative order instituting the settlement. Trust & Investment Advisors "willfully violated, and Pitts and Prugh willfully aided, abetted and caused [the firm's] violations of Section 206(2) and 205(4) of the Advisers Act" and its Rules 206(4)-1(a)(5) and 206(4)-7. Attorneys representing the firm and the two executives did not respond to messages seeking comment.

"Firms and their principals can and will incur regulatory liability for failing to implement an adequate compliance program even without allegations of underlying client harm," said **Montgomery McCracken** of counsel **Terrance Reilly**. "Here, clients weren't defrauded nor was any money lost. The firm simply didn't have a compliance program in place or a culture of compliance."

Examinations and inaction

OCIE conducted three separate on-site examinations of Trust & Investment Advisors between 2005 and 2011. Here's what happened at each:

- **2005.** Examiners discovered that the firm had failed to develop compliance policies as required by Rule 206(4)-7, known as the Compliance Program Rule. Following the on-site visit, the firm "reported that it had 'made progress with our written policies and procedures designed to prevent violation of the Advisers Act and rules,'" according to the administrative order, and promised to send the agency "'a copy with the typed version of this response.'"
- **2007.** Despite the promises made after the 2005 examination, the SEC said, "OCIE found during its 2007 exam that: (i) [the firm] still had not yet completed its compliance manual; (ii) [the firm] had not conducted an annual compliance review; and (iii) [the firm's] designated chief compliance officer (CCO A) did not have appropriate knowledge of the Advisers Act," such as not being aware of the requirement to conduct a compliance program review. OCIE told Trust & Investment Advisers that

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"it was concerned that [the firm] employed a 'cavalier approach to compliance' that called into question [the firm's] commitment to operate its business in accordance with the federal securities laws." Trust & Investment Advisors again assured OCIE that "it would remedy its compliance shortcomings," the SEC said. The firm said it would retain a compliance consulting firm to assist it in developing a compliance manual, and that it would provide compliance training to CCO A and other employees.

- **2011.** "When OCIE staff returned for the 2011 exam, they discovered that [the firm] had made no progress on its compliance deficiency," the agency said. Prugh – who said he was now acting as the de facto CCO because CCO A was unable to complete the Series 65 exam – said that the firm's compliance committee had become inactive, and that the firm "had not had time since the last exam three years ago to work with [the compliance consulting firm] to develop a compliance manual and implement a compliance program."

Performance claims

As if hitting one SEC hot button was not enough, Trust & Investment Advisors may have hit another when examiners found several instances where the firm provided allegedly misleading performance information in its marketing material to clients. Performance statements have a history of being closely scrutinized by the agency, as have marketing materials. A firm would really have to work to come up with better attention-grabbers than these.

Let's break these allegations down:

Examiners in 2007 found that Trust & Investment Advisors' one-on-one performance presentations to clients were misleading. "The presentations included gross of fee performance returns over an extended period of time; yet, the same presentations did not explain the impact that advisory fees could have on the value of a client's portfolio," the SEC said.

Once again, however, a promise to fix did not result in an actual fix, if the agency is to be believed. "Following the 2007 exam, [the firm] indicated it had corrected this issue. However, when staff returned for the 2011 exam, they discovered that [Trust & Investment Advisors] continued to distribute marketing pieces showing bar charts with cumulative returns that did not explain the impact that advisory fees could have on the value of a client's portfolio."

2011 and beyond

Similar allegations were made after the 2011 exam. This time they included charges that Pitts appeared on a local access public television show using PowerPoint slides to compare the firm's cumulative returns over a 10-year period to the S&P 500's returns over that same period. "These comparisons were misleading because they neglected to deduct applicable advisory fees from [the firm's] cumulative returns," the SEC said. "Moreover, the charts did not include a disclosure stating that [Trust & Investor Advisor's] cumulative returns did not reflect the deduction of advisory fees, and that such fees would reduce client returns. These TV show appearances led to client referrals."

Aside from the deficiencies OCIE discovered during the exams, the SEC also charged that the firm distributed misleading performance information in weekly summary marketing emails from at least 2009 through 2012. These allegedly included weekly summaries sent to certain clients, as well as solicitors, that compared percentage increases in the S&P 500 index to percentage increases in Trust & Investor Advisors' portfolios. "The table materially overstated the performance of the [firm's] portfolios vis-à-vis the S&P 500 index because [the firm's] performance included the reinvestment of dividends, while the S&P 500 index number did not," the agency said.

At long last, change

After the 2011 examination was over and the SEC had apparently had enough, compliance began to improve at Trust & Investment Advisors. After that examination, the firm hired another CCO, this time one with Advisers Act experience, completed its compliance manual, and engaged a new compliance consulting firm to perform annual reviews, which it did in 2012 and 2013, the agency said. In addition, the new CCO reviews all marketing pieces, including those used on television.

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Whistleblower Program

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The agency received more than 3,600 tips in fiscal year 2014 – about 10 per day – and that was up from 3,200 tips in 2013, said SEC chair **Mary Jo White** in an April 30 speech, "The SEC as the Whistleblower's Advocate," in Chicago. "In the first quarter of this year, we have seen the numbers increase again – by more than 20 percent over the same quarter last year," she said, adding that the tips have come from all 50 states and "span the full spectrum of federal securities laws violations."

- **The quality of tips and whistleblower assistance is improving.** The SEC is receiving "higher quality tips that are of tremendous help to the Commission in stopping ongoing and imminent fraud, and lead to significant enforcement actions on a much faster timetable than we would be able to achieve without the information and assistance from the whistleblower," White said. Whistleblowers, she said, "have provided us with original information leading to the opening of new investigations, 'insider' views as to how a company approaches its disclosures to investors and highly technical analyses of rapidly evolving fraud schemes."
- **First award in retaliation case.** A whistleblower will receive more than $600,000, which represents the maximum 30 percent award payment, for aiding the SEC's June 2014 settlement with **Paradigm Capital Management**, in part for retaliating against the whistleblower (*ACA Insight*, 6/23/14), which was the first such award, the agency announced on April 28. "My hope is that the award … encourages potential whistleblowers to come forward in light of our demonstrated commitment to protect them against retaliatory conduct and make significant financial awards to whistleblowers who suffer employment hardships as a result of reporting possible securities law violations," said SEC Office of the Whistleblower chief **Sean McKessy**.
- **Second award to a compliance professional.** The SEC on April 22 said it would present a compliance officer with between $1.4 million and $1.6 million by coming forward to help prevent "imminent misconduct" from causing substantial financial harm to a company or investors. The name of the entity involved was not released, but the award was the second given under the program to an employee with internal audit or compliance responsibilities, the agency said.
- **More than $50 million in awards.** This amount is the total of the awards given out since the program's inception in 2011, with 17 whistleblowers receiving awards. Three individual awards were in excess of $1 million, White said. "In the last fiscal year, the Commission issued more awards to more people for more money than in any previous year – and that trend is expected to accelerate."

The whistleblower program, "while still developing, has proven to be a game changer," White said.

A whistleblower can receive an award if he or she voluntarily provides the SEC with original information that leads to a successful agency enforcement action or related action with monetary sanctions exceeding $1 million. Awards can range between 10 percent and 30 percent of the amount collected, depending on a number of factors. Those factors include the significance of the volunteered information, assistance provided by the whistleblower, the importance of the law enforcement interest advanced, the culpability of the whistleblower, and whether there was a delay in reporting.

Pluses and minuses

"Many in-house lawyers, compliance professionals and law firms representing companies have told us that since the implementation of our program, companies have taken fresh looks at their internal compliance functions and made enhancements to further encourage their employees to views internal reporting as an effective means to address potential wrongdoing without fear of reprisal or retaliation," White said.

This represents, at least to some degree, an evolution in the way the whistleblower program was initially viewed by compliance professionals. At that time, "concerns were raised about undermining companies' internal

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compliance programs," White said. The SEC, at least partially in response to these concerns, established a framework to incentivize employees to report internally first. As the program currently works, a whistleblower's participation in internal compliance systems is a factor considered in determining the size of an award.

But the incentive program really doesn't solve the problem, said **Mayer Brown** attorney **Adam Kanter**. "There is no requirement to inside-report before going to the SEC. Consequently, firms can still run into situations where the progress of an ongoing internal investigation is actually impeded by the SEC showing up 'early'—before the investigation is concluded—due to a whistleblower tip, which can ultimately delay final resolution of the problem."

"Beyond that," Kanter said, "if the SEC acts on a concurrently-reported whistleblower tip before the company's own internal investigation has had time to make any progress, the information asymmetry between the SEC and the company can lead to problems. The SEC may believe that the firm is being recalcitrant by failing to be forthcoming with additional information, when in fact it simply hasn't had enough time to properly investigate the alleged conduct."

Firms can still run into situations where they conclude an internal investigation and fix the problem, then voluntarily report it to the SEC, only to find that the SEC already knows of the problem because a whistleblower reported to the agency first. Or the SEC might pay a firm a visit in response to a whistleblower report, not knowing that the firm was already conducting an investigation of it and planning to fix it.

"White focuses on the positive aspects of the Dodd-Frank whistleblower bounty programs while ignoring the downsides," said **Zaccaro Morgan** partner **Nicolas Morgan**. He noted the nearly 7,000 tips the program reportedly generated in fiscal years 2013 and 2014. "That sounds like an unadulterated success until you see that only 17 people have received awards since the inception of the program. The overwhelming majority of the tips pouring in do not result in awards."

"These non-award tips impose a cost," he said. "The SEC staff spends scarce time and resources pursuing tips. Companies spend time and resources investigating allegations. When the tips and allegations have merit, those are resources well spent. When the tips and allegations are not meritorious, the resource expense is wasteful at best, and certainly in some situations a

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diversion from more effective compliance efforts. To truly evaluate the value of the Dodd-Frank whistleblower program, the SEC should be transparent about the costs imposed by 'false positives.'"

Compliance officers and whistleblowers

There are strict requirements as to the conditions under which compliance and audit professionals, as well as officers and directors, are eligible to receive awards. Generally, they are not eligible to receive them, "but the rules provide an exception to the general prohibition if the information is reported to the SEC at least 120 days after providing it to the employer's audit committee, chief legal officer, chief compliance officer, or a supervisor," White said. These excluded personnel can also receive an award when there is a reasonable basis to believe that disclosure to the SEC was necessary to prevent imminent misconduct from causing substantial harm to the company or investors. Awards have, in fact, been made under both of these exceptions, she said.

Compliance officers are a particular challenge for firms when it comes to the whistleblower program, said **Morgan Lewis** partner **Thomas Linthorst**. They "are privy to a tremendous amount of information." Compliance officer are hired to ensure compliance with laws and regulations, but "you can have people misusing the role."

Serial submitters

The Commission itself has had some problems with the whistleblower program.

Among these are what White called "serial submitters" who file a claim "for virtually every case in which over $1 million in sanctions is awarded when there is no connection between their tip and the case."

Nonetheless, the SEC staff is required to "thoroughly assess" every claim and make recommendations, even in cases where the award claims turn out to have no basis, she said. ☙

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