CORE REGULATORY FORUM

Q3 UPDATE

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Regulatory Deadlines

- Advertising Rule Compliance Date – November 4
- Form 13F – November 14
- Form PF Large HF – November 30
- Form D – 15 Days after First Sale
- Schedule 13D/G – 10 Days after Triggering Transaction
- Form 13H – Promptly if mid-quarter changes

Notable News Headlines

- "GOP will look to defang SEC…"
  P&I
- "The Lehman Brothers of Crypto:…"
  Business Insider
- "Elevated Inflation Looms as Risk…"
  WSJ

Upcoming Events

- SEC Compliance Outreach National Seminar – November 15
- CORE Private Fund Training & Networking Events

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COMPLIANCE: OUTSOURCED RESOURCES AND EXPERTISE

Regulatory Updates and Enforcement

Introduction

September 30th marked the end of the 2022 fiscal year for the Securities and Exchange Commission (***SEC***) and the U.S. government in general. The fiscal year saw changes in agency leadership and a flurry of new rulemaking proposals, exam and enforcement activities, which are discussed below and in prior quarter updates. The overall tone of the SEC under the leadership of Chairman Gensler is considerably more aggressive than in recent past. At the Practicing Law Institute's annual SEC Speaks conference in September, Chairman Gensler and the SEC leadership laid out the agency's plans to adapt existing regulations to address market innovations and police emerging sources of risk, with a focus on five key areas:

- Digital Asset Revolution – Gensler and other SEC leaders have made it very clear they believe that the SEC's investor protection mission extends to the cryptocurrency market, a position highlighted in the Digital Asset Developments section below and in previous CORE quarterly updates.
- Enforcement Focused on Individual Accountability – In leading an aggressive enforcement agenda characterized by many as "regulation-by-enforcement," Division Director Gurbir Grewal has stressed that the SEC seek to impose accountability and incentivize compliance, thereby bolstering investor trust, by focusing on the key individuals and gatekeepers within regulated entities. Corporate and individual liability has been targeted through disgorgement, in increasingly larger monetary penalties by firms and individuals (now regularly in the millions and hundreds of millions and even billions of dollars), as well a broader use of director and officer bars.
- Cybersecurity Risks & Disclosures – Citing cybersecurity risk as a top investor concern, the SEC continues to focus heavily on cybersecurity controls and disclosures, including by way of rule proposals made during the period aimed at mandating cybersecurity risk management programs, procedures, and providing investors more timely and consistent disclosures regarding cybersecurity incidents.
- Environment, Social & Governance – Following the launch of the SEC Division of Enforcement's (***Enforcement Division***) Climate and ESG Task Force, the SEC has confirmed that its enforcement staff, in particular the Asset Management Unit that focuses on private fund managers and other investment advisers, are heavily focused on ESG and climate-related disclosures for accuracy and consistency with firm activities. This theme was reiterated in multiple recent rule proposals to enhance ESG disclosures for public companies, investment advisers, and investment companies.
- Emerging Risks – Finally, the SEC is focused on ensuring adequate risk disclosures among public companies, private funds, and investment advisers, in areas of emerging risk resulting from economic and geopolitical developments, including the Russia-Ukraine war, supply chain issues, and inflation, among others. Significantly, SEC staff have advised registrants to consider whether these developments affect their business and, if so, to avoid boilerplate statements in their communications and disclosures.

As SEC rulemaking activity continued, the SEC Inspector General (***IG***) released its annual Statement on the SEC's Management and Performance Challenges, a statutorily-required report, in October. The report has now been cited by members of Congress in a comment letter on recent rule proposals, highlighting deficiencies within the SEC pertaining to its workforce, level of rulemaking experience, and the length of public comment periods. The Congressional comment letter noted that "cumulatively, these deficiencies make it hard to understand how the SEC is adequately performing the necessary due-diligence and analysis required for its many pending rules." The letter noted that in the first eight months of 2022, the final date covered by the IG report, the SEC introduced 26 new rule proposals, representing three proposals per month—more than double the number proposed in the entirety of 2021 and more than the SEC had proposed in any of the past five years. Congress members and many outside groups have repeatedly requested the SEC slow its rulemaking tempo to ensure proper time for stakeholder feedback and deliberation, requests which Gensler has largely shrugged off through the end of this fiscal year. Whether Gensler or the SEC heeds these requests going forward, only time will tell.

Regulatory Updates and Enforcement

Recent SEC Rulemaking

As the quarter came to a close, the November 4 compliance date for the Investment Adviser Marketing Rule loomed, and the date for compliance with the rule is now fully upon us. Meanwhile, the SEC reopened comment periods for a number of the rule proposals from earlier in 2022. CORE has continued to follow the comments submitted and themes of those letters. Significant opposition to many proposals continues, with many noting that the sweeping changes proposed represent a paradigm shift from a principles-based to a proscriptive framework that oversteps the SEC's mandate. Comments indicated that recent rulemaking is, in many cases, not aligned with investor expectations and would create significant costs and burdens to market participants, raising barriers to entry for smaller and emerging managers. Notably while we do not expect any rule proposals to be rescinded or the rulemaking agenda to be modified materially, we are cautiously hopeful that the SEC will thoughtfully consider comments received and revert to a more principles-based approach in the final rules it adopts. Significant SEC rulemaking continues post quarter-end, with an October proposal for new oversight requirements for outsourced service providers. We will summarize this proposal in the next quarterly update and continue to closely follow and update clients regarding ongoing rulemaking initiatives.

Rule Proposal Comment Periods Reopen

On October 7, 2022, the SEC reopened the public comment periods for 11 rulemaking releases and one request for comment due to a technological error resulting in a number of public comments not being received by the SEC. The majority of affected comments were submitted in August 2022; however, the technological error is known to have occurred as early as June 2021. The comment periods for the affected releases were reopened for 14 days following publication of the reopening release in the Federal Register and are now closed. Among the proposals affected were Short Position and Short Activity Reporting by Institutional Investment Managers; Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure; Private Fund Advisers – Documentation of Registered Investment Adviser Compliance Reviews; and Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices.

SEC Press Release – https://www.sec.gov/news/press-release/2022-186

Form PF Disclosures – Hedge Funds & Private Funds

On August 10, 2022, the SEC and the Commodities Futures Trading Commission (***CFTC***) jointly proposed additional amendments to Form PF, the reporting form for private funds designed to provide the SEC and Financial Stability Oversight Counsel (***FSOC***) with important, confidential information about the operations and strategies of private funds and to enhance their ability to monitor systemic risk, bolster regulatory oversight of private funds and enhance investor protection. An earlier proposal in January of this year considered amendments to Form PF that would require SEC-registered advisers to private funds to immediately report certain events that may present material implications to fund investors or indicate systemic risks. The August proposal focuses on Large Hedge Fund Advisers (an adviser with at least $1.5 billion in hedge fund Assets Under Management (***AUM***) and their Qualifying Funds (a fund with a net asset value of at least $500 million), but it also proposes to gather additional data about the information reported by advisers and the private funds they manage. All private funds would be required to report additional or different information about withdrawals, redemptions, inflows and outflows, borrowings and types of creditors, fair value hierarchy, beneficial ownership, and fund performance. The proposed rule would also add new or enhanced reporting on credit and borrowing arrangements, counterparty exposure, market risk factor effects, currency exposure, turnover, country and industry exposures, and central clearing information. In addition, it would remove the aggregate reporting for Large Hedge Fund Advisers and require reporting of "complex structures" at the fund level.

The SEC requested comment on whether to revise the definition of "Hedge Fund" in the Form PF Glossary to relieve certain private equity funds from being classified as hedge funds due to broad investment discretion in their governing documents. The current definition generally defines a hedge fund as a fund that pays a performance fee or allocation to its manager or investment adviser, may use leverage, or may engage in short selling. The SEC asked participants whether the definition should be amended such that "deemed hedge funds," could report as private equity funds if, for example, they have not engaged in short selling or borrowing activity in the last 12 months or only borrow using lines of credit. The drafters noted that certain private equity funds have been filing as hedge funds because, although they have not recently engaged in short selling, their governing documents permit it, or because they borrow secured by unfunded commitments (subscription lines of credit). The SEC is also soliciting comment from advisers on whether certain changes in the proposal should be applied to the Form ADV.

SEC Commissioners voted 5-2 to move forward with the proposal. Recently-appointed Commissioner Mark T. Uyeda criticized the proposal in a statement expressing the rationale for his "no" vote. The statement indicated that the proposal fell short of actually addressing the systemic risks as it purports and warned that the costs of additional reporting would ultimately be borne by investors and smaller advisers, constituting a barrier to entry in a market already dominated by large participants. He also echoed the comments of industry groups, such as the Investment Advisers Association, to the original 2011 and January 2022 Form PF rulemakings expressing concerns over the amount of detailed proprietary information requested. Commissioner Uyeda stressed the significant potential for damage to an adviser's ability to compete if its proprietary fund strategies were inadvertently disclosed. He also indicated that even the statutory confidentiality protections may not be sufficient to protect such data, stating "it is simply not possible for the many employees of the Commission, Office of Financial Research, and member agencies of the FSOC who have access to Form PF Data to unlearn what they have seen when they leave federal employment and pursue positions in the private sector." Although he thanked the contributors for their hard work on the proposal, he stated that it "blurred the line" between public and private fund reporting. In comments submitted since the proposal was issued, hedge fund managers and their representative groups have reiterated similar concerns regarding the costliness of the August Form PF proposal and the breadth of confidential and proprietary information requested.

SEC Press Release – https://www.sec.gov/news/press-release/2022-141

Final Rules Governing Proxy Voting Advice & Rescinded Investment Adviser Proxy Guidance

Certain hedge fund managers and other advisers rely on proxy voting advisory businesses (***PVABs***) to provide proxy voting advice and assist with voting execution, including through an electronic vote management system. In 2019, the SEC issued guidance discussing how the fiduciary duty and Rule 206(4)-6 (the ***Proxy Voting Rule***) under the Investment Advisers Act of 1940 (***Advisers Act***) relate to an investment adviser's exercise of voting authority. In 2020, the SEC adopted amendments to the Proxy Voting Rule under the Securities Exchange Act of 1934 (***Exchange Act***) which, among other things, set forth two requirements for PVABs: (i) make their advice available to the related companies (or issuers) at or before the time they disseminate advice to clients and (ii) provide clients with a mechanism by which they could reasonably be expected to become aware of written responses by such companies to the proxy voting advice given. At that same time, the SEC issued supplemental guidance to investment advisers about their proxy voting obligations when utilizing PVABs, particularly in circumstances where additional information regarding an issuer's responses to proxy voting advice becomes available after the PVAB pre-populates the electronic voting system but before votes are cast. Since 2020, institutional investors and others have expressed concern that the rules impacted their ability to receive independent proxy voting advice in a timely manner. Consequently, the SEC reassessed the amendments in light of this feedback and certain developments in the market for proxy voting advice. In July 2022, the SEC adopted additional amendments to enhance PVABs' ability to deliver independent proxy voting advice to their clients in a timely manner. The newest amendments rescinded these two PVAB-specific provisions and removed a note that indicated the failure to disclose material information regarding proxy voting advice, such as a PVAB's methodology, sources of information, or conflicts of interest, may, depending upon the particular facts and circumstances, be misleading. The July 2022 adopting release also rescinded the SEC's 2020 supplemental guidance issued to investment advisers about their proxy voting obligations. Accordingly, the 2022 amendments may expedite information available to advisers from PVABs, reduce costs for such services and/or relieve certain expectations for hedge funds and other advisers with respect to their proxy-voting activities.

SEC Final Rule – https://www.sec.gov/rules/final/2022/34-95266.pdf

Pushback on the Proxy Voting Rule Rollback

The U.S. Chamber of Commerce (***Chamber***) filed a lawsuit against the SEC for not following proper procedures or providing adequate justification for its decision to roll back the 2020 Proxy Voting Rule before its effective date. This challenge comes on the heels of Commissioner Hester Peirce's criticism of the rollback following the SEC's vote to adopt the proposed rule, which Peirce also opposed, in 2021. Commissioner Peirce outlined the flaws commenters on the proposal identified, many of which were the same or similar to those used in support of the Chamber's challenge of the rollback. The Chamber and other plaintiffs alleged the SEC did not provide adequate justification for its rollback because nothing had materially changed since the rule was proposed in 2020, and that the SEC's economic cost-benefit analysis was flawed as one-sided and opportunistic, in violation of the Administrative Procedure Act. Regardless of whether the Chamber's challenge results in amended or additional proxy rulemaking, it would not be surprising if adviser-specific guidance remains rescinded.

Commissioner Statement – https://www.sec.gov/news/statement/peirce-statement-proxy-voting-advice-071322
Chamber of Commerce v. SEC – https://www.chamberlitigation.com/cases/chamber-commerce-v-sec-0

Shareholder Proposal Rule Amendments

In July 2022, the SEC proposed amendments to Rule 14a-8 of the Exchange Act, which governs the process for including shareholder proposals in a company's proxy statement. Under the rule, companies generally must include shareholder proposals in their proxy statements, with certain specified exclusions. Currently, the rule outlines 13 substantive bases by which companies may exclude shareholder proposals from their proxy materials. The proposed amendments would revise the following three of the bases for exclusion:

- Substantial Implementation – A proposal may be excluded under this provision if the company has already implemented the "essential elements" of the proposal.
- Duplication – A proposal "substantially duplicates" another proposal previously submitted for the same shareholder meeting if it addresses the same subject matter and seeks the same objective by the same means.
- Resubmission – A proposal constitutes a resubmission if it substantially duplicates another proposal that was previously submitted for the same company's prior shareholder meetings.

While not materially impacting investment adviser or fund managers' businesses, the proposal may impact the nature or number of proposals in proxy statements on which hedge funds and other advisers are required to vote and could potentially impact activist tactics.

SEC Press Release – https://www.sec.gov/news/press-release/2022-121

Exam Developments

Exam activity continued primarily remotely throughout the quarter, although certain limited SEC exams may now include on-site fieldwork, with more expected in the coming months. As examiners wrapped up their FY22 exams, they also trained on and prepared to examine investment advisers' compliance with the new Marketing Rule. After the end of the quarter but prior to the publication of this quarterly update, the SEC Division of Examinations (***Exam Division***) announced the appointment of two new Deputy Directors, Keith Cassidy, who also serves as the Associate Director of the Division's Technology Controls Program, and Natasha Vij Greiner, who also serves as the National Associate Director of the Investment Adviser/Investment Company Act examination program, to which the Private Fund Unit reports.

Regulatory Updates and Enforcement

The Exam Division is preparing for a National Compliance Outreach program on November 15, which will cover (i) SEC exam priorities and initiatives, rulemaking and enforcement actions; (ii) investment adviser fiduciary duty and Form CRS; (iii) the new Marketing Rule; (iv) registered funds topics; (v) environmental, social, and governance topics; (vi) private fund adviser topics; and (vii) other hot topics. CORE encourages clients to view the webcast if they are able and will provide highlights to those who are not able to do so.

Risk Alert: Investment Adviser Marketing Rule

The Exam Division issued a Risk Alert in September 2022, in advance of the Marketing Rule compliance date to inform advisers of their anticipated review areas under the Marketing Rule. The areas highlighted and commentary were as follows:

- Policies and Procedures – Effective policies and procedures should include objective and testable means reasonably designed to prevent violations of the final rule in disseminated advertisements. Examples of objective and testable means include: (i) conducting an internal pre-review and approval of advertisements, (ii) reviewing a sample based on risk, or (iii) pre-approving templates.
- Reasonable Basis/Substantiation – Whether the adviser can substantiate material statements of fact. If an adviser cannot substantiate a material claim, examiners will presume the adviser did not have a reasonable basis for its belief.
- Performance Presentations in Advertising – Specifically:
  - Gross/Net
  - Specified Time Periods (except "private fund" (*i.e.*, 3(c)(1) and 3(c)(7)) performance)
  - Statements Regarding SEC Review/Approval
  - Related Portfolios – If an adviser presents performance of portfolios other than the one being advertised, whether the adviser includes fewer than all portfolios with substantially similar investment policies, strategies, and objectives as the portfolio being offered ("with limited exceptions")
  - Extracted Performance – Whether the adviser provides a subset of investments without providing or offering to provide promptly the results of the total portfolio
  - Hypothetical Performance – Specifically, policies and procedures surrounding:
    - Relevance to the intended audience's financial situation
    - Disclosures and information given
  - Predecessor Performance
- Books and Records
  - Amendments to the Books and Records Rule made in connection with the Marketing Rule – Generally surrounding:
    - All advertisements disseminated, including certain internal working papers
    - Performance-related information
    - Documentation for oral advertisements
    - Testimonials and endorsements
  - Form ADV – Reminder to advisers to complete the information requested in Item 5 in their next Form ADV annual amendment.

The Exam Division is encouraging advisers to reflect on their practices, policies, procedures, and implement any training, supervisory, and oversight modifications as necessary. As we know, the SEC often looks to see whether advisers have reviewed its risk alerts and other actions and guidance and taken appropriate measures to update their compliance programs. CORE published a Marketing Rule FAQ and worked with clients to update policies, procedures, marketing materials and training to comply with the amended rule and continues to provide ongoing guidance to clients as needed.

SEC Risk Alert – https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf

Regulatory Updates and Enforcement

Electronic Communications Exam Initiatives

According to media reports, the SEC's scrutiny of how firms handle work-related communications on personal devices and apps, such as WhatsApp, has expanded beyond broker-dealers to investment advisers. According to Reuters, the SEC's Enforcement Division has sent inquiries to a number of advisers asking for information about their protocols for so-called "off-channel" business communications and asked firms to preserve and produce documents and share information on policies related to the use of devices and platforms. The Exam Division has also included specific requests surrounding electronic communications in recent examinations. A sample request list circulated recently contained items such as electronic communications policies and procedures; persons responsible for oversight; documentation of monitoring, testing and review; employee training and certifications; and past violations and disciplinary actions. Separately, the SEC's Fort Worth Regional Office is apparently conducting a sweep regarding the e-signature (*e.g.*, DocuSign) practices of advisory firms and their funds. The sweep appears to be limited and information gathering in nature.

Enforcement Developments

The Enforcement Division concluded FY22 with approximately 700 enforcement actions for the fiscal year and a record high $6.4 billion in judgments and orders, including $4 billion in civil penalties. The Enforcement Division's 2022 summary report is expected to be published in coming weeks. The following are selected summaries of the SEC enforcement actions and other cases from the third calendar quarter of 2022.

Fees & Expenses

<u>Hudson Advisors and Lone Star Global (September 12, 2022)</u>

The SEC brought a settled action against a Dallas-based private equity fund adviser for including the firm's founder and 100% owner's anticipated income tax liability as a component of certain fees charged to the 14 private equity funds it managed. The funds paid an affiliated service provider for "ancillary and underwriting services" which included legal, compliance, audit, accounting, administration and periodic reporting, cash management, hedging, tax, risk management advice, operating company oversight, information technology development, and related services, as well as underwriting and other in-house diligence services. The adviser charged fees for those services based on an hourly rate and a 10% "cost plus" margin.

Hudson applied the hourly rates and 10% margin on an after-tax basis. That is, it added the founder's anticipated tax liability to the hourly rate charged, resulting in $54.6 million of additional fees charged to investors. The fact that the income tax was a component of the fees was not in the limited partnership agreements (***LPAs***), the services agreements, disclosure documents, due diligence questionnaires, or audited financial statements. The order also noted the charging of anticipated income tax was a conflict of interest which should have been disclosed to the funds' limited partner advisory committees.

Hudson found the issue after conducting an internal review of their fee practices and disclosures. The founder was apparently not aware of the practices. He paid the funds back with interest. The SEC found that Hudson was negligent in not disclosing the practice and conflict to investors and ordered Hudson to pay an $11.2 million penalty.

SEC Press Release – <u>https://www.sec.gov/news/press-release/2022-159</u>

<u>Energy Innovation Capital Management, LP (September 2, 2022)</u>

Energy Innovation Capital Management, LLC (***EIC***) is a venture capital ERA that manages two funds. The funds' LPAs stated that management fees were to be calculated in two distinct ways, depending on the periods defined in those agreements. During the commitment period (January 15, 2016 – January 15, 2020) committed capital would be used as the basis for the management fee calculation, and in the post-commitment period, invested capital minus any "dispositions" would be used as the basis. The LPAs defined dispositions to include write-downs of individual portfolio company securities.

EIC wrote down some individual portfolio company securities and wrote off others during the period of January 16, 2020 – March 31, 2022. According to the order, these should have been treated as dispositions as defined in the LPAs, but EIC did not incorporate any of the write-downs or write-offs into the management fee calculations for either fund. Not only did EIC not subtract the dispositions, but it also failed to begin the post-commitment management fee period at the correct date, resulting in a further inflated fee basis.

EIC also made the following errors, which the SEC argued were not permitted by the funds' LPAs:

- Aggregating invested capital at the portfolio company level rather than the individual portfolio company security level
- Including accrued but unpaid interest attributed to certain individual portfolio company securities in the basis of its post-commitment period management fee calculation

Ultimately, EIC agreed in settlement with the SEC that it overcharged its LPs $678,861 in management fees, which it paid back with interest (after being contacted by the SEC). The SEC took this remedial action into account, but still censured EIC, ordered the firm to notify past and current investors about the findings and deliver a copy of the SEC's order to those investors. EIC was also fined $175,000.

SEC Press Release – https://www.sec.gov/news/press-release/2022-154

Insider Trading

Software Engineers Saini & Natividad (September 30, 2022)

At the end of September, the SEC announced insider trading charges against two Canadian software engineers who made $1.6 million by trading ahead of non-public, market-moving financial information. The complaint alleges that software engineers Harpreet Saini and John Lester Mandac Natividad, both employees of a newswire distribution company specializing in corporate press releases, previewed releases which allowed them to transact in advance of public announcements. They collectively traded in advance of more than 1,600 announcements distributed by their employer and routinely exited their positions after the market reacted to the news. In addition to engaging in insider trading, the SEC alleged both bragged about their schemes and repeatedly exchanged information on forthcoming announcements via hundreds of WhatsApp text messages on their personal cell phones. An SEC investigation, conducted with assistance from the Market Abuse Unit's Analysis and Detection Center, determined that Saini and Natividad engaged in an insider trading scheme, which spanned several years, to enrich themselves at the expense of others. Both individuals were required as a condition of their employment to maintain the confidentiality of information belonging to their employer and its clients. Both were required to acknowledge in a number of documents that they were expressly prohibited from engaging in insider trading. Each signed documents acknowledging they read and understood the company's confidential information and insider trading policies. These documents required Saini and Natividad to agree that trading securities while in possession of such information before that information was made public was "against the law," may expose them to "criminal prosecution or civil lawsuits," and that they were prohibited from tipping, including "communicating inside information to any person." The SEC coordinated the investigation with the Ontario Securities Commission, which similarly charged both parties with fraud and insider trading offenses under the Ontario Securities Act. Litigation in the matter is ongoing.

SEC Press Release – https://www.sec.gov/news/press-release/2022-181

Equifax Data Breach Individuals, Dishinger & Palmer (August 15, 2022)

The SEC announced charges against three individuals for illegally tipping and trading in the securities of Equifax, Inc. in advance of the company's public announcement that it had experienced a massive cyber intrusion and data breach. Ahead of the announcement, Equifax engaged a public relations firm to assist in handing the inquiries expected to be generated by the announcement. The SEC complaint alleged that Ann M. Dishinger, an employee at the public relations firm, learned about the Equifax breach through her position and tipped her significant other, Lawrence Palmer. Palmer then arranged for one of his former clients to purchase out-of-the-money Equifax put options in the client's brokerage account with the understanding that the two men would split the profits. The complaint alleges that Palmer reimbursed the client for the purchase by check where he wrote "Blue Horseshoe" in the memo line, a reference to the coded language used to convey insider information in the 1987 movie Wall Street. Palmer also tipped his brother and business partner Jerrold Palmer with the nonpublic information. Jerrold Palmer arranged for a friend to purchase the same series of out-of-the-money Equifax put option in the friend's brokerage account with the understanding that they would split trading profits. The illegal trading netted approximately $35,000 and $73,000 in profits shared by Lawrence Palmer and Jerrold Palmer.

The SEC complaint charged Dishinger and the Palmers with violating the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The SEC sought injunctive relief and civil penalties against each defendant as well as disgorgement of ill-gotten gains and prejudgment interest from the Palmer brothers. The final judgement against Lawrence Palmer ordered him to disgorge $9,000 plus prejudgment interest of $2,026 and pay a civil penalty of $88,698. The final judgment against Jerrold Palmer ordered him to disgorge $28,000 plus prejudgment interest of $6,303 and pay a civil penalty of $73, 399. The litigation against Dishinger remains pending. This is the third set of insider trading charges filed by the SEC in relation to Equifax's public announcement.

SEC Litigation Release – https://www.sec.gov/litigation/litreleases/2022/lr25470.htm

Market Abuse Unit "Data Analytics and Suspicious Trading Patterns" Insider Trading Sweep (July 25, 2022)

The SEC filed insider trading charges against nine individuals in connection with three separate alleged schemes that together yielded more than $6.8 million in ill-gotten gains. In one case, the SEC charged a former chief information security officer who learned material non-public information (***MNPI***) about his employer's plans to acquire two separate companies, traded on such information for himself and in his wife's account, and shared the information with friends who traded on the information, in violation of his employer's policies related to insider trading and safeguarding MNPI. In a second case, the SEC charged an investment banker who regularly received MNPI concerning corporate acquisition transactions. The investment banker provided MNPI regarding impending transactions to a close friend and foreign exchange trader at another large financial institution. The friend traded options based on such information and then divided the trading profits with the investment banker. In the third case, the SEC charged a former FBI trainee who had access to confidential information regarding an upcoming tender offer, wherein a large pharmaceutical company was to acquire another company. The trainee's access to the MNPI came from a romantic partner who was an associate at a law firm representing the target company on the deal. The FBI trainee tipped his friend, who later bought him a Rolex watch to thank him for the tip. Each of the three cases involves separate and distinct tipper-tippee relationships, MNPI, and issuer transactions; however, each originated from the Enforcement Division's Market Abuse Unit's Analysis and Detection Center, which uses data analysis tools to detect suspicious trading patterns. The SEC's enforcement actions were filed in federal district court in Manhattan, and in each case the U.S. Attorney's Office for the Southern District of New York announced parallel criminal charges.

SEC Press Release – https://www.sec.gov/news/press-release/2022-129

Former Congressman and Consultant Stephen Buyer (July 25, 2022)

The SEC filed insider trading charges against former Indiana Congressman Stephen Buyer. After leaving Congress Buyer formed a consulting firm which provided services to T-Mobile and other public and private companies and was on the board of a Canadian company registered with the SEC as a foreign private issuer. According to the SEC's complaint, during a golf outing with a T-Mobile executive, Buyer learned of T-Mobile's then non-public plan to acquire Sprint. He thus acquired $568,000 of Sprint common stock in his personal account, in a joint account held with an extended family member, and in an acquaintance's account. Buyer realized a profit of more than $107,000 when news of the merger leaked. Similarly, Buyer purchased more than $1 million of Navigant Consulting securities ahead of a public announcement that the company would be acquired by another of Buyer's consulting clients. He again spread the purchase over several accounts. When the Navigant acquisition was publicly announced, Buyer sold the shares and profited more than $227,000.

Gurbir Grewal, Director of the Enforcement Division, stated in the litigation release that Buyer not only violated federal securities laws but also undermined public trust and confidence in the fairness of the markets, by illegally profiting from his access. Buyer was charged with violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The complaint seeks disgorgement of ill-gotten gains plus interest, penalties, a permanent injunction, and an officer and director bar against Buyer as well as disgorgement from Buyer's wife, who received proceeds from the trades. The U.S. Attorney's Office for the Southern District of New York has announced related criminal charges.

SEC Litigation Release – https://www.sec.gov/news/press-release/2022-128

Cherry Picking

Buckman Advisory Group, LLC & Harry Buckman, Jr. (September 30, 2022)

In another case originating from the MAU's Analysis and Detection Center, the SEC charged Scott Adam Brander and his former employer Buckman Advisory Group, LLC, and Harry Buckman, Jr., Brander's former supervisor, with fraudulent practices related to Brander's multiyear cherry-picking scheme. The SEC's complaint against Brander alleged that for a five-year period Brander disproportionately allocated profitable trades to his own account and unprofitable trades to his clients. Brander made allocations without performing analysis as to whether potentially volatile securities were suitable for clients or discussing the risks with them. The complaint noted that Brander often traded shares of highly-leveraged exchange traded funds (***ETFs***), which often experienced large price moves over the course of the trading day. Even though prospectuses for these ETFs contained warnings about the risks of holding these investments, and even though all the clients stated in their account opening documents that they were seeking more conservative investments, Brander failed to perform any analysis to determine whether these ETFs were suitable for the clients' stated investment objectives and risk tolerance. Brander received $800,000 of ill-gotten gains from the scheme. Brander was charged with violating the antifraud provision of Section 17(a)(1) of the Securities Act of 1933 (***Securities Act***), Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder, as well as Sections 206(1) and 206(2) of the Advisers Act. The judgment permanently enjoined him from violating these provisions and ordered him to pay disgorgement and penalties of more than $1 million.

The SEC further instituted an administrative proceeding against Buckman Advisory Group and its CEO Harry Buckman, based on failure to implement policies and procedures reasonably designed to prevent violations of the Advisers Act and on failure to supervise Brander. The firm received a censure and was ordered to pay a $400,000 penalty. Buckman was ordered to pay a $75,000 penalty and received a limitation on acting in a supervisory capacity.

SEC Litigation Release – https://www.sec.gov/litigation/litreleases/2022/lr25502.htm

IFP Advisors, LLC (August 10, 2022)

In an earlier matter involving a multi-year cherry-picking scheme, the SEC charged IFO Advisors, LLC, a registered investment adviser with more than $10 billion in assets under management, and its former investment adviser representative, Richard Keith Robertson, with the fraudulent practice of disproportionately allocating profitable trades to his own or family accounts and unprofitable trades to certain of his clients' accounts. Robertson had discretionary authority to place trades for client accounts. However, instead of trading directly in his or his clients' accounts, Robertson often executed trades in an omnibus account that allowed for block trading (that is, purchasing a large number of shares or options at the same time). After placing a trade in the omnibus account, Robertson would wait before instructing the brokerage firm to allocate the purchased securities among his and/or his clients' accounts. By allocating shares or options sometime later in the day, after he placed the trade, Robertson could watch the changes in price and then determine how to allocate the shares among his and his clients' accounts. The SEC's orders found that Robertson engaged in these practices for a nine-year period.

Additionally, the order found that IFP never conducted a branch office audit of Robertson during his eight years as an IFP representative and never reviewed his trading as required by its own compliance manuals. IFP's limited supervision, according to the order, consisted solely of accepting Robertson's annual attestations and obtaining, but not actually reviewing, copies of his brokerage records. In the same time period IFP's Form ADV contained misleading statements that it had safeguards in place to prevent representatives from placing their own interests ahead of those of advisory clients.

The SEC's order found that Robertson violated the antifraud provisions of Sections 206(1) and 206(2) of the Advisers Act, Section 10(b) of the Exchange Act and Rule 10b-5(a) and (c) thereunder. In response to the SEC's order, Robertson consented pay disgorgement of $592,437, prejudgment interest of $28,173, and a penalty of $300,000. Robertson received a permanent associational bar, investment company bar, and penny stock bar. The SEC's order also found IFP in violation of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. IFP failed to reasonably supervise Robertson within the meaning of Section 203(e)(6) of the Advisers Act. The firm was ordered to pay a penalty of $400,000 and retain an independent compliance consultant.

SEC Press Release – https://www.sec.gov/enforce/ia-6086-s

Market Manipulation & Trading

Eight Charged in Fraudulent Securities Promotion Scheme (September 30, 2022)

The SEC charged six individuals and two companies for their involvement in a fraudulent scheme to promote the securities of issuers conducting (or purporting to conduct) offerings pursuant to Regulation A, which, if certain conditions are met, provides an exemption to the Securities Act's registration provisions. The SEC's complaint alleged that Jonathan William Mikula, a recidivist securities law violator, promoted the securities of four issuers without disclosing his receipt of compensation for the promotions, raising approximately $80 million in the securities offered. As alleged, Mikula promoted the securities through Palm Beach Venture, a newsletter for which he served as an author and chief analyst, presenting the recommendations as unbiased and unpaid, while he was secretly compensated by the issuers of the securities he promoted in the form of cash and lavish expenses. The SEC also charged two associates of Mikula, who allegedly acted as middlemen for the promotional scheme by receiving a percentage of investor funds raised in exchange for arranging Mikula's promotional activities, under the guise of consulting agreements with the issuers. According to the complaint, one of the associates collected and disbursed illicit funds related to the promotions by sending sham invoices and funneling the proceeds through various entities and accounts that he controlled, including many offshore accounts. The other associate served as the CEO of one of the companies and authorized payments. Another of the company's co-founders allegedly played a key role in the scheme, and a CFO for another company was charged for her participation through negligence. The case resulted in a combined $2.5 million settlement and bars named individuals from serving as an officer or director. While the facts in this case are clearly egregious, market participants who publicly discuss their views on companies or issuers in newsletters or other forums should expect that they may be scrutinized by the SEC for potential market manipulation.

SEC Press Release – https://www.sec.gov/news/press-release/2022-182

International Scheme to Manipulate Stocks (August 15, 2022)

In a matter involving 18 defendants, the SEC charged individuals and entities with a fraudulent scheme in which dozens of online brokerage accounts were hacked into and microcap stocks improperly used to manipulate the price and trading value of those stocks. The hackers made unauthorized purchases in names where they already controlled large blocks of stock and subsequently sold their holdings at artificially high prices, generating more than $1 million in illegal trading profits. The defendants' scheme used international accounts and dummy account holders to hide their tracks and disguise their scheme. Although the broker-dealers at which the accounts were hacked were not identified by name in the case, it highlights the importance of cybersecurity controls and the need for investment advisors and investors to take precautions, including utilizing strong passwords, different passwords for different accounts, and multi-factor authentication to protect unauthorized account access. The case also reflects a coordinated effort by the SEC, Financial Industry Regulatory Authority, and numerous foreign securities regulators and regulatory authorities to investigate and unwind the scheme.

SEC Press Release – https://www.sec.gov/news/press-release/2022-145

Cybersecurity & Electronic Communications

Morgan Stanley Failure to Safeguard Customer Personal Information (September 20, 2022)

On September 20, 2022, the SEC announced charges against Morgan Stanley Smith Barney (***MSSB***) stemming from the firm's extensive failures, over a five-year period, to protect the personal identifying information (***PII***) of approximately 15 million customers. MSSB agreed to pay a $35 million penalty to settle the charges. The SEC's order found that, as far back as 2015, MSSB failed to properly dispose of devices containing its customers' PII. On multiple occasions, MSSB hired a moving and storage company with no experience or expertise in data destruction services to decommission thousands of hard drives and servers containing the PII of millions of its customers. Moreover, according to the SEC's order, over several years, MSSB failed to properly monitor the moving company's work. The staff's investigation found that the moving company sold to a third party thousands of MSSB devices including servers and hard drives, some of which contained customer PII. The devices were eventually resold on an internet auction site without removal of such PII. While MSSB recovered some of the devices, which were shown to contain thousands of pieces of unencrypted customer data, the firm has not recovered the vast majority of the devices.

The SEC's order also found that MSSB failed to properly safeguard customer PII and properly dispose of consumer report information when it decommissioned local office and branch servers as part of a broader hardware refresh program. A records reconciliation exercise undertaken by the firm during this decommissioning process revealed that 42 servers, all potentially containing unencrypted customer PII and consumer report information, were missing. Moreover, during this process, MSSB also learned that the local devices being decommissioned had been equipped with encryption capability, but that the firm had failed to activate the encryption software for years. The SEC cited the action as a clear message to financial institutions to take their obligation to properly safeguard sensitive information.

SEC Press Release – https://www.sec.gov/news/press-release/2022-168

Identity Theft Program Deficiencies, JP Morgan, UBS, TradeStation (July 27, 2022)

The SEC settled actions against registered broker-dealers J.P. Morgan Securities LLC (***JP Morgan***), UBS Financial Services Inc. (***UBS***), and TradeStation Securities, Inc. (***TradeStation***) for deficiencies in their programs to prevent customer identity theft in violation of Regulation S-ID (the ***Red Flags Rule***). JP Morgan and UBS are also registered investment advisers. According to the SEC's press release, from at least January 2017 to October 2019, the three firms' identity theft prevention programs "did not include reasonable policies and procedures to identify relevant red flags of identity theft in connection with customer accounts or to incorporate those red flags into their programs." The release further noted that "the firms' programs did not include reasonable policies and procedures to respond appropriately to detected identity theft red flags, or to ensure that the programs were updated periodically to reflect changes in identity theft risks to customers." The Red Flags Rule requires investment advisers to design and operate identity theft prevention programs that are appropriately tailored to their businesses and update them in response to the increased threat and changing nature of identity theft. Each firm agreed to cease and desist from future violations of the charged provision, to be censured, and to pay the following penalties: JPMorgan: $1.2 million, UBS: $925,000, and TradeStation: $425,000.

The Red Flags Rule does not apply to many private fund managers in that they do not have covered accounts for individual clients and do not have authority to withdraw or transfer, or direct custodians to withdraw or transfer, funds or securities from an investor's account to third parties. Nonetheless, the orders for these three settlements provide insight regarding what the SEC staff expects in policies and procedures of registered firms.

Regulatory Updates and Enforcement

The orders noted failures by each of the firms, in varying degrees, to: (i) identify relevant red flags for covered accounts and incorporate them into their programs; (ii) respond appropriately to detected red flags to prevent and mitigate identity theft; and (iii) ensure that their programs were updated reviewed and periodically. The SEC orders noted governance failures by the firms for not involving the boards of directors, appropriate committees, or senior management in the oversight, development, implementation and administration of their programs. For example, the UBS order noted that reports to the board of directors lacked "sufficient information addressing the effectiveness of the [p]rogram's policies and procedures concerning the risk of identity theft at UBS or the firm's service providers." Notably, two of the firms failed to train employees to effectively implement their programs.

The orders described the following specific details about the failures:

- Service Provider Oversight – The JP Morgan and TradeStation orders noted that the firms did not appropriately monitor all of their service providers to ensure that their activities were being conducted in accordance with their identity theft programs and that their programs did not include or incorporate by reference any policies and procedures for the oversight of service providers in order to ensure their activities were conducted in accordance with reasonable identity theft policies and procedures. The JPMorgan order also found that the firm failed to exercise appropriate and effective oversight of service provider arrangements in that JP Morgan did not follow its own policies and procedures to assess all service providers annually and to ensure that all the relevant service provider agreements had the required red flags contractual language.
- Updating Policies and Procedures in Light of Developments – The UBS and TradeStation orders noted that despite significant changes in external cybersecurity risks related to identity theft, there had been no material changes to the firms' program for significant periods. UBS did not make material changes to the program after the Red Flags Rule went into effect in May 2013. While TradeStation's Program provided that the firm would periodically review and update the program, as necessary, to reflect changes in risks from identity theft, the firm's program failed to sufficiently identify red flags relevant to the firm's business and the covered accounts it managed over time. The firm's program did not provide that it would be reviewed on a periodic basis, the process for how the program would be updated, or factors that would necessitate an update to the program.
- Specific and Customized Practices and Procedures – The orders noted that the firms' programs did not include specific procedures or practices to ensure compliance with the Red Flags Rule or policies. The JP Morgan programs did not incorporate policies or procedures describing how identity theft red flags were to be identified or appropriately responded to once they were detected. The JP Morgan programs "merely restated the general legal requirements", "listed verbatim all the illustrative examples of identity theft red flags" provided in an appendix to the Red Flags Rule, and "listed various firmwide policies and business procedures that were incorporated into the [p]rograms." Further, the programs did not explain how to respond to red flags in order to prevent and mitigate identity theft. The order also noted that although JP Morgan did take "actions to detect and respond to potential and actual incidents of identity theft, the procedures describing those actions were not included or incorporated by reference in either [p]rogram."

  TradeStation "did not consider factors applicable to the firm in order to identify relevant red flags tailored to its particular business," only identified those red flags that were provided as non-comprehensive examples in a supplement to an appendix of the Red Flags Rule and did not identify certain red flags relevant to its business and the nature and scope of its brokerage activities. TradeStation's program did not contain any policies or procedures regarding specific steps TradeStation employees should actually undertake when performing any due diligence, the scope of the due diligence to be performed, or which persons to contact in connection with any such due diligence. The program did not contain other potentially appropriate responses to the detection of red flags, such as not opening a new account or notifying law enforcement.

> The UBS order was particularly illustrative. UBS only listed general categories of activities that their procedures should address, did not identify any relevant red flags of which employees should be aware or include, incorporate, or reference any procedures addressing the detection of red flags. The UBS program provided no policies or procedures for identifying covered accounts, including new types of covered accounts offered by the firm. The program "only provided that UBS and other covered affiliates would identify red flags based on the types of covered accounts at the firm, the firm's previous experience with identify theft, and applicable regulatory guidance." The UBS program provided no further information for relevant red flags tailored to UBS's business and the nature and scope of its brokerage and advisory activities. The written program characterized all client accounts as "covered accounts," but UBS did not conduct any risk assessments or other evaluations of these accounts to determine the types of covered accounts it offered or maintained and thus did not identify red flags based on those types of covered accounts.

The details in each order and overarching themes are instructive to investment advisers, in designing, establishing, and updating not only those policies, procedures and practices designed to comply with the Red Flags Rule, but overall, as part of an effective compliance program.

SEC Press Release – https://www.sec.gov/news/press-release/2022-131

Sixteen Wall Street Firms Electronic Recordkeeping Failures (September 27, 2022)

In a compendium of cases stemming from the same investigation that led to an earlier enforcement action against J.P. Morgan for recordkeeping failures, the SEC staff's investigation uncovered pervasive off-channel communications and brought actions against sixteen firms in September 2022, including one investment adviser. The firms cooperated with the investigation by gathering communications from the personal devices of a sample of the firms' personnel. These personnel included senior and junior investment bankers and debt and equity traders.

In sum, the orders alleged that from January 2018 through September 2021, the firms' employees routinely communicated about business matters using text messaging applications on their personal devices. The firms did not maintain or preserve the substantial majority of these off-channel communications, in violation of federal securities laws. By failing to maintain and preserve required records relating to their businesses, the firms' actions likely deprived the SEC of these communications in various SEC investigations. The failings occurred across all of the 16 firms and involved employees at multiple levels of authority, including supervisors and senior executives. In addition, the CFTC issued separate settlements with some firms on the same facts.

DWS Investment Management Americas, Inc., the investment adviser, was charged with violating certain recordkeeping provisions of the Advisers Act and with failing reasonably to supervise with a view to preventing and detecting those violations. Although DWS was a broker-dealer affiliate (of Deutsche Bank), reports of investment adviser sweeps and inquiries have surfaced. See Exam Developments, below, for additional details.

The SEC made it clear the violations had the potential to disqualify firms from relying on Reg D and other offering exemptions (though the SEC ultimately decided to waive disqualification, presumably for the good of the investors).

Many of the remediation methods agreed to by the sixteen firms track prior recommendations surrounding electronic communications issued by the Exam Division, including:

- Updating policies, procedures, and training for supervised persons and supervisors (specifically for text, WhatsApp, personal email and chats and other "off-channel" communications);
- Implementing a quarterly certification by personnel that they have complied with electronic records preservation requirements;
- Periodically assessing:

- The likelihood personnel will use the technology solutions the firm is or has implemented to meet recordkeeping requirements; and
- The effectiveness of the measures employed to track new technological solutions.

As previously noted, all communications "related to" an advisers' making recommendations or giving securities advice must be retained. Thus, advisers should keep unapproved system communications carve-outs to a minimum (*e.g.*, logistics). DWS, the adviser in this group, actually had an annual self-attestation but did not follow up to confirm or test that people were reasonably following the policies.

The effect of not retaining required records can be cumulative. DWS did not produce the "off-channel" communications in response to earlier subpoenas and records requests relating to other matters, so the SEC also faulted them for "delaying commission matters," pointing to their failure to retain required records.

SEC Press Release – https://www.sec.gov/news/press-release/2022-174

Custody & Audit Failures

Deloitte Chinese Affiliate Audit Clients Asked to Conduct Own Audit Work (September 29, 2022)

In a matter involving execution of foundational U.S. auditing requirements, the SEC charged Deloitte Touche Tohmatsu Certified Public Accountants LLP (***Deloitte-China***) with failing to comply with U.S. auditing requirements in its audits of U.S. issuers and foreign companies listed on U.S. exchanges.

The SEC found that in numerous audits, Deloitte-China personnel asked clients to select their own samples for testing and to prepare audit documentation purporting to show that Deloitte-China has obtained and assessed the supporting evidence from accounting entries. This created the appearance that Deloitte-China had conducted required testing of clients' financial statements and internal controls when it had not been done. According to the SEC, this action underscores the need for the Public Company Accounting Oversight Board (***PCAOB***) to be able to inspect Chinese audit firms, since a goal of the PCAOB is to "identify weaknesses in the firms' quality control processes."

According to the Enforcement Division Director, Deloitte-China auditors failed to "meet profession standards, exercise independence and fulfill their role as gatekeepers." The order found misconduct involving lack of supervision by audit partners and failure to adhere to PCAOB auditing standards, including due professional care of audit evidence, sampling, documentation, internal control over financial reporting, audit supervision, and quality control.

Deloitte-China settled the charges by paying a $20 million penalty. In addition to the financial penalty, the order censured Deloitte-China and required the firm to complete a review and assessment of its policies and procedures by an independent consultant, implement a plan to address deficiencies identified by the independent consultant, undergo additional annual reviews, and provide further training for all audit professionals who serve U.S. public company audit clients. When hiring U.S.-based Big 4 and other reputable accounting firms, private funds often are able to take for granted compliance with U.S. accounting standards and other regulatory requirements. However, when using foreign offices of U.S. accounting firms, clients need to be particularly diligent to confirm the PCAOB registration and examination status of such firms and ensure compliance with applicable U.S. accounting standards and regulatory requirements.

SEC Litigation Release – https://www.sec.gov/news/press-release/2022-176

Custody Rule Violations Sweep (September 9, 2022)

In an enforcement sweep involving nine investment advisers and private fund managers with collective penalties totaling over $1 million, the SEC brought charges against several firms for violations of Rule 206(4)-2 (the ***Custody Rule***) under the Advisers Act. The SEC has brought actions in the past for repeated and egregious failures to obtain timely audits of financial statements within 120 days after fiscal year-end (or 180 days for fund of funds), as required by the Custody Rule, and a number of the firms in the current sweep were charged with failing to deliver audits timely for multiple consecutive years. However, certain firms in the current sweep were charged with seemingly less egregious violations. For example, the charges against one firm noted simply that in the Form ADV filed on March 30, 2021, the firm responded to a question in Section 7.B.(1) noting that the audit report for each of two funds was “Not Yet Received.” The case further noted the firm received the audit reports on March 31, 2021 (presumably within the 120-day deadline) but simply failed to file an amendment to Form ADV, as required promptly after receipt of the audit report to update such response. Another firm was charged with a single late audit for 2019, presumably resulting from unforeseen delays during the Covid-19 pandemic, and failing to promptly update the Form ADV response after audit reports were received in two other years. Each of the cases noted that the firms failed to comply with the surprise exam and other requirements of the Custody Rule when audits were not delivered timely and were therefore unable to rely on the audit exception under the rule. The SEC has previously noted in its Custody Rule FAQ that it would not recommend enforcement action for a violation of the Custody Rule against an adviser that is relying on the audit exception (Rule 206(4)-2(b)(4)) and reasonably believed that the fund's audited financial statements would be distributed within the 120-day or other relevant deadline but failed to have them distributed in time under certain unforeseeable circumstances. Nevertheless, we have advised clients for 2022 and future audits to be vigilant in confirming with auditors throughout the audit process that audits will be completed and delivered timely. In the event a firm learns that the audit will not be delivered timely, it should immediately consider whether other actions are needed in order to comply with the Custody Rule provisions.

SEC Press Release – https://www.sec.gov/news/press-release/2022-156

Real Estate

WDC Holdings Commercial Real Estate Developer Securities Fraud (August 22, 2022)

On August 22, the SEC brought chargers against Denver real estate developer WDC Holdings LLC, doing business as Northstar Commercial Partners (***Northstar***), and its owner and CEO R. Brian Watson alleging misrepresentation regarding their own investments in securities offerings to fund ten separate real estate projects. The projects included office buildings and light industrial properties which were often distressed or vacant properties in need of improvement. According to the SEC's complaint, from April 2017 to August 2019 Northstar and Mr. Watson “raised approximately $49.5 million from at least 350 investors through sales of securities to fund commercial real estate projects across the country” and told investors they would personally invest 4% to 5% of the equity needed for these projects (approximately $2.8 million). They actually invested only a small fraction of this amount, thus misrepresenting their stake in the projects. Such "skin in the game" would create a significant monetary incentive for the defendants to “maximize profits and avoid losses on each project that would align with investors’ own financial interest in the projects,” according to the complaint.

Mr. Watson and Northstar, directly or indirectly, received fees from the real estate projects which included property management fees and debt guarantee fees. Watson took distributions from Northstar and “purchased a private jet, a multi-million-dollar mansion, and a multi-million-dollar house on a ranch.” During the period, Northstar was consistently short of cash and, as a result, “Watson repeatedly contributed money back to Northstar to make payroll and cover operating expenses that Northstar could not otherwise pay.”

According to the complaint, Northstar “followed an industry-standard debt financed transaction model when structuring each project.” Northstar’s financial planning team developed a model that incorporated the cost of planned improvements for a project and the targeted return on the investment. Then "[B]ased on these inputs, the model calculated a total project price, and Watson and Northstar determined a debt-to-equity ratio they believed the capital markets would support.” The primary marketing material for each project was a 10- to 20-page document called an Executive Investment Summary (***Summary***) that described the asset, its surrounding market, and plan for development and improvement of the asset. The Summary also included a financial model showing the debt and equity structure, projected returns, and waterfall schedule for disposition of proceeds from the eventual sale of the asset.

Northstar and Watson had a contact list of potential investors based on past projects, professional connections, and Watson's personal network to which they sent marketing emails and private placement memoranda for the projects through Northstar's online investor portal. Watson also sent blast marketing emails for projects indicating that Northstar was "currently accepting co-capital partners, alongside of my personal funds." Brochures stated that Watson "invests his personal capital in every acquisition of the company" and that "Such personal commitment in the investment process helps align the interests of the company with the long-term profit objectives of outside capital partners." Watson approved these and similar marketing materials. In addition, Watson personally called potential investors to solicit investments in projects. Through these means Northstar and Watson apparently misrepresented the degree of their own investments in the projects.

According to the complaint, Watson and Northstar "established a deliberate pattern and practice in offerings by disseminating documents with similar false and misleading statements made with similar language, all in a similar context, in each offering." They engaged in this "course of conduct over years as they continued to pledge that they would invest in each project, despite their failure to do so in prior projects." Apparently, Mr. Watson and Northstar never disclosed to investors that they did not invest in a specific project and never gave investors the opportunity to rescind their investments in light of that fact. The SEC seeks permanent injunctions, disgorgement with prejudgment interest, and civil penalties.

SEC Litigation Release – https://www.sec.gov/litigation/litreleases/2022/lr25480.htm

Angel Oak Capital Misleading Fix-and-Flip Statements (August 10, 2022)

On August 10, 2022, the SEC charged Atlanta-based registered investment adviser Angel Oak Capital Advisors, LLC (***Angel Oak***) and its portfolio manager Ashish Negandhi for misleading investors about the firm's "fix-and-flip" loan securitization's delinquency rates. Angel Oak securitized loans made to borrowers for the purpose of purchasing, renovating, and selling residential properties, a practice known as "fix-and-flip", raising $90 million in March 2018. The loans were originated by an Angel Oak-affiliated entity, and the associated deal included an early repayment trigger "that would accelerate Angel Oak's obligation to return funds to certain investors if delinquencies reached a pre-defined threshold." This early repayment trigger was designed to protect noteholders against losses.

Shortly after the deal closed, loan delinquency rates increased unexpectedly. Angel Oak and Mr. Negandhi artificially reduced such rates, in contravention of disclosures to investors, by "improperly diverting funds ostensibly held to reimburse borrowers for renovations made to the mortgaged properties" to "instead pay down outstanding loan balances." This was done in order to avoid reputational and financial harm resulting from an early repayment, which would have otherwise occurred in November 2018. Given Angel Oak's failure to disclose these actions, the performance data disseminated to investors "provided an inaccurate view of the actual delinquency rates on the mortgages in the securitization pool as well as the securitization's compliance with the early repayment trigger." In addition, Angel Oak was concerned regarding "the adverse financial impact of an early amortization on Angel Oak-managed private funds, which owned the junior tranche of the securitization notes." Angel Oak failed to inform the board of directors for a private fund for which it served as investment adviser of its improper use of funds. Angel Oak and Mr. Negandhi agreed to settle charges and pay penalties of $1.75 million and $75,000, respectively.

SEC Press Release – https://www.sec.gov/news/press-release/2022-140

FCPA Violations

Oracle Slush Fund Bribery Charges (September 27, 2022)

The SEC announced settled charges requiring Oracle Corporation, a Texas-headquartered technology company, to pay more than $23 million to resolve charges of anti-bribery, books and records, and internal accounting controls violations under the Foreign Corrupt Practices Act (***FCPA***) when subsidiaries in Turkey, the United Arab Emirates, and India created and used slush funds to bribe foreign officials in return for business.

Regulatory Updates and Enforcement

From at least 2014 through 2019, employees at Oracle subsidiaries used both excessive discounts and sham marketing reimbursement payments to create off-book slush funds via an indirect sales model involving value-add distributors and resellers. Such slush funds were routinely used to both bribe foreign officials and pay for the travel and accommodation expenses of end-user customers, including foreign officials, to attend annual technology conferences in the subsidiary's local country and the United States, including Oracle's own annual technology conference. In some instances, these funds were also used to pay for the travel and accommodation expenses of foreign officials' spouses and children, as well as for side trips to Los Angeles and Napa Valley. Local management reportedly either looked the other way or actively participated in such schemes.

The SEC previously sanctioned Oracle in 2012 in connection with the creation of slush funds, in which millions of dollars of side funds by Oracle India were generated, creating the risk that those funds could be used for illicit purposes.

Without admitting or denying the SEC's findings, Oracle agreed to cease and desist from committing violations of the anti-bribery, books and records, and internal accounting controls provisions of the FCPA and to pay approximately $8 million in disgorgement and a $15 million penalty.

SEC Press Release – https://www.sec.gov/news/press-release/2022-173

SEC Charges Brazil's Second Largest Airline, with FCPA Violations (September 15, 2022)

The SEC in September 2022 charged Brazil's second largest domestic airline, GOL Linhas Aéreas Inteligentes (***Gol***), for violating the FCPA. The São Paulo-based company, whose shares are listed on the NYSE, agreed to pay $70 million to settle the SEC charges and also agreed to enter into a deferred prosecution agreement with the U.S. Department of Justice and to pay more than $87 million to settle criminal charges.

The proceedings arose out of a scheme to bribe government officials in Brazil in exchange for certain payroll tax and fuel tax reductions that financially benefited Gol, along with other airlines. The bribe scheme took place against a backdrop of insufficient internal accounting controls, which allowed Gol's books and records to characterize the bribes as legitimate business expenses. As a result, Gol violated the anti-bribery, books and records, and internal accounting controls provisions of the FCPA.

The scheme arose in 2011 when the Brazilian government proposed an economic stimulus program that consisted, in part, of tax cuts and incentives to boost domestic employment. Among other things, the new law reduced payroll taxes for labor-intensive industries by introducing an alternative payroll tax that allowed companies operating in certain industries to pay a 1% to 3% tax on revenues rather than the standard 20% tax on payroll. Around this time, a Gol director committed to pay the approximate equivalent of $5.4 million in bribes to Brazilian politicians, including a then influential and high-ranking Brazilian legislator (***Brazilian Official***) and other politicians, to lower certain taxes that financially benefitted Gol, along with other airlines, and to benefit other companies the Gol director owned. By the end of June 2012, following pressure and intervention from the Brazilian Official and others, the Brazilian legislature expanded the new law to include the air transport industry (an industry not explicitly named in the original draft of the new law) at an attributed 1% tax rate, the lowest rate in the range of possible tax impositions under the new law.

In many cases, bribes to the Brazilian Official and other politicians were paid to accounts at or via U.S. banks or to foreign accounts belonging to U.S.-based companies.

The bribery scheme provided Gol with an improper financial benefit in the form of reduced tax costs and expenses. During the same period, Gol claimed publicly, including in SEC filings, that it was positioned as one of the lowest cost airlines in the world.

While corporate policy required that Gol select all vendors based on competitive pricing, a lack of sufficient internal accounting controls resulted in the payment of vendors who were given sole source contracts outside of the supply department. Additionally, Gol paid the vendors involved in the scheme even though most of the vendors' purported services were never rendered. Moreover, the procurement process did not include an effective review of the documentation submitted before or after the disbursement of funds to monitor compliance with GoI's purchase policy. The insufficiency and ineffectiveness of the internal accounting controls resulted in a procurement process that relied primarily on the GoI director for authorization and verification of these services with little oversight or review.

As a result of the conduct described above, GoI violated Section 30A of the Exchange Act, which prohibits any issuer, or any officer, director, employee, or agent acting on its behalf, from using interstate commerce corruptly in furtherance of an effort to pay or offer to pay anything of value to foreign officials for the purpose of influencing their official decision-making, in order to assist in obtaining or retaining business.

Due to GoI's demonstrated financial condition and inability to pay the fines in full, the SEC and the Department of Justice (***DOJ***) waived payment of all but $24.5 million and $17 million of GoI's payment obligations, respectively. GoI will pay approximately $3.4 million in additional penalties or restitution to Brazilian authorities.

SEC Press Release – https://www.sec.gov/news/press-release/2022-164

Miscellaneous Enforcement

TBG Holdings Venture Capital Unregistered Broker-Dealer (September 13, 2022)

The SEC charged a venture capital firm with unregistered broker-dealer activity during its raising of approximately $3 million from more than 200 investors. The firm held itself out as "the Venture Capital Firm for the Masses" and purportedly identified and offered investment opportunities to accredited investors at a discount. The firm hired unregistered sales agents who had been previously suspended and/or permanently barred by financial industry regulatory organizations. The sales agents provided sales materials and press releases, sales pitches, subscription agreements and offering materials to investors. The agents worked together as "fronters" and "closers" and used lead lists to actively contact potential investors through phone call and emails, using aggressive tactics such as describing the opportunity as a time-sensitive offer. The sales agents were paid $500,000 in transaction-based compensation in the form of bonuses based on a percentage of investor proceeds. The SEC also brought charges against the unregistered sales agents. This case highlights violative activities characterized as venture capital, which can result in additional regulatory focus on that business model. In addition, the case emphasizes the SEC's continued focus on transaction-based compensation and other activities that require broker-dealer registration. Private funds should continue to prohibit such practices to avoid the need to register as a broker-dealer.

SEC Litigation Release – https://www.sec.gov/litigation/litreleases/2022/lr25504.htm

Perceptive Advisors Failure to Disclose SPAC-Related Conflicts (September 6, 2022)

The SEC charged an investment adviser and private fund manager, Perceptive Advisors LLC (***Perceptive***), with failing to disclose conflicts of interest regarding its personnel's ownership of sponsors of special purpose acquisition companies (***SPACs***) into which it advised clients to invest. According to the SEC's order, in 2020, Perceptive formed multiple SPACs whose sponsors were owned both by Perceptive personnel and by a private fund that Perceptive advised. The Perceptive personnel were entitled to a portion of the compensation the SPAC sponsors received upon completion of the SPACs' business combinations. The SEC's order found that Perceptive repeatedly invested assets of a private fund it advised in certain transactions that helped complete the SPACs' business combinations but did not timely disclose these conflicts. As a Cayman Islands private fund, the managed fund had a board of directors. Although the board routinely held quarterly meetings that Perceptive attended, the adviser did not discuss the shared ownership of the SPAC sponsors with the board until after they had consummated an initial public offering and, in some cases, completed or announced a business combination transaction and participated or subscribed to a related private investment in public equity (***PIPE***) transaction.

The SEC's order also found that Perceptive failed to timely file a required report on Schedule 13D concerning its beneficial ownership of stock in a public company. During the lapse in filing, through a private fund it advised, Perceptive improperly acquired beneficial ownership of additional stock in the public company.

SEC Press Release – https://www.sec.gov/news/press-release/2022-155

Regulatory Updates and Enforcement

Other Regulatory Developments

Anti-Money Laundering & Sanctions Developments

Sweeping Defense Authorization Bill Imposing Bank Secrecy Act Regulations on Lawyers, Accountants, and Other Gatekeepers

In the U.S. currently, Anti-Money Laundering (***AML***) and Know-Your-Customer (***KYC***) laws under the Bank Secrecy Act apply solely to entities defined as financial institutions, such as banks and brokerage firms. Earlier this year, however, the U.S. House of Representatives passed legislation that, if approved by the Senate and signed into law, could impose certain AML requirements on those involved in specified “gatekeeping” activities within the U.S. financial system, including legal and accounting services, as well as those involved in:

- managing, advising, or consulting with respect to money or other assets; and
- the sourcing, pooling, organization, or management of capital in association with the formation, operation, or management of, or investment in, a corporation, limited liability company, trust, foundation, limited liability partnership, partnership, or similar entity.

Lawmakers have included the proposed legislation, dubbed the ENABLERS Act, in the National Defense Authorization Act for Fiscal Year 2023, a vital bill historically passed by Congress each year. The ENABLERS Act was originally intended to require full AML programs for seven clearly outlined groups, including: investment advisers; dealers in art, antiquities, and collectibles; lawyers “involved in financial activity on behalf of another person;” trust or company service providers; accountants; public relations firms that “provide another person with anonymity or deniability’” and third-party payment providers. The language ultimately passed by the House in July, however, removed investment advisers, art dealers, and PR firms from its scope, but included a list of gatekeeping-type services that the U.S. Treasury’s AML bureau, the U.S. Treasury’s Financial Crimes Enforcement Network (***FinCEN***), would be required to target when enforcing the new regulations. Despite the removal of investment advisers from the list of targeted professions, the gatekeeping services added to the list suggest that investment advisers would be obliged to enact AML measures of some undefined sort—ranging from establishing full AML programs and suspicious activity reporting regimes, to less onerous obligations, such as creating due diligence procedures—if the law is approved in the Senate.

Fund Manager Responsibilities

In an effort to deter instances of money laundering and other illegal activities generally, it is currently best practice for U.S. fund managers to maintain a risk-based AML program and subject investors to KYC practices and due diligence, which typically includes the following:

- Verifying the identity of an individual or legal entity investor;
- Understanding the source of an investor’s funds;
- Identifying the ultimate controller(s) and beneficial owners of an investor; and
- Understanding the connections between an investor and potential high-risk geographies, industries, or individuals.

Counterparties and others may expect, or even require, that fund managers periodically screen their investors and underlying beneficial owners and controllers against negative news lists. Should an investor or an investor-related party be deemed to be of higher risk, enhanced due diligence is recommended.

CORE will continue to follow the progression of the proposed legislation and is available to assist fund managers in all AML and KYC compliance matters.

Regulatory Updates and Enforcement

FinCEN Beneficial Ownership Reporting Requirements (September 29, 2022)

On January 1, 2021, Congress passed the Anti-Money Laundering Act of 2020 (***AMLA***), the most comprehensive set of reforms to AML laws in the United States since the USA PATRIOT Act was passed in 2001. The AMLA was designed to reform and modernize AML and counter-financing of terrorism (***CFT***) laws, improve coordination among government and industry stakeholders, and emphasize the importance of risk-based AML/CFT programs. Among its key reforms was adoption of the Corporate Transparency Act (***CTA***) and the subsequent requirement to create a national registry tracking the beneficial ownership information of certain entities. Acting upon this, in September 2022, FinCEN issued a final rule establishing a beneficial ownership information reporting requirement, pursuant to the bipartisan CTA. The rule will require most corporations, limited liability companies, and other entities created in or registered to do business in the United States to report information about their beneficial owners—the persons who ultimately own or control the company, to FinCEN. Designed to protect U.S. national security and strengthen the integrity and transparency of the U.S. financial system, the rule is intended to help stop criminal actors, including oligarchs, kleptocrats, drug traffickers, human traffickers, and those who would use anonymous shell companies to hide their illicit proceeds.

Reporting Companies

The final rule, like the proposed rule, defines "reporting companies" to include both U.S. domestic companies and foreign companies registered to do business in any U.S. state or tribal jurisdiction.

Reporting companies will be required to provide FinCEN with beneficial ownership information on (i) the reporting company itself; (ii) each "beneficial owner" of the reporting company; and (iii) the reporting company's "company applicant(s)." The rule defines "beneficial owner" as any individual who, directly or indirectly, either exercises "substantial control" over the reporting company or owns or controls at least 25% of its "ownership interests." Unlike FinCEN's Customer Due Diligence Rule, which requires that only one individual with significant control be identified, this rule requires reporting on every individual with substantial control, defined as an individual who:

- serves as a senior officer of the company;
- has authority over appointment or removal of any senior officer or a majority of the board of directors of the company;
- directs, determines, or has substantial influence over important decisions by the company (*e.g.*, the nature, scope and attributes of the business; reorganization, dissolution or merger of the company; major expenditures or investments, issuances of equity, incurrence of significant debt); or
- has any other form of substantial control.

A reporting company must report its full legal name, any alternative names through which it engages in business, its business street address, jurisdiction of formation or registration, and Taxpayer Identification Number (***TIN***). Foreign reporting companies that lack a U.S. TIN will be permitted to provide instead a foreign tax identification number with the name of the relevant jurisdiction.

For each beneficial owner and company applicant, reporting companies must disclose the individual's full legal name, date of birth, current residential or business street address, a unique identifying number from an acceptable identification document (*e.g.*, a valid U.S. passport, U.S. identification document or U.S. driver's license, and, if none of these are available, a valid non-U.S. passport), as well as a scanned copy of the identification document from which the unique identifying number of the beneficial owner or company applicant is obtained.

The rule includes a provision regarding the ability of an individual to use a FinCEN identifier—a unique identifying number assigned by FinCEN to a person—in lieu of providing detailed beneficial ownership information to a reporting company for submission to FinCEN. An individual may obtain a FinCEN identifier by submitting an application containing the information about themselves that would be required in a report filed by a reporting company. A reporting company will similarly be permitted to obtain a FinCEN identifier by submitting an application to FinCEN, but only at or after the time that the entity submits an initial report to FinCEN.

Regulatory Updates and Enforcement

Exemptions from Beneficial Ownership Information Reporting

SEC-registered investment advisers, venture capital fund advisers filed as exempt reporting advisers with the SEC, pooled investment vehicles, and subsidiaries of certain exempt entities (including general partners and managing members of pooled investment vehicles), are among the 23 categories of entities specifically exempted from beneficial ownership information reporting requirements. State-registered advisers and non-venture exempt reporting advisers with the SEC are expected to comply with the new reporting requirements.

Other notable exemptions to reporting requirements include “large operating companies,” which applies to companies that employ more than 20 employees on a full-time basis in the U.S., maintain an operating presence at a physical office in the U.S., and filed a U.S. federal income tax return for the previous year showing more than $5 million in gross receipt or sales from operations in the U.S.

Exempt entities will have no obligation to affirmatively claim an exemption; however, if an exempt entity ceases to qualify for an exemption, it will have 30 calendar days to file its applicable beneficial ownership information with FinCEN.

Effective Date

The rule is effective January 1, 2024. Reporting companies created or registered before January 1, 2024, will have one year (until January 1, 2025) to file their initial reports, while reporting companies created or registered after January 1, 2024, will have 30 days after creation or registration to file their initial reports. Once the initial report has been filed, both existing and new reporting companies will have to file updates within 30 days of a change in their beneficial ownership information.

The CTA lays out civil and criminal penalties for persons who “willfully provide, or attempt to provide, false or fraudulent beneficial ownership information...to FinCEN'” or “willfully fail to report complete or updated beneficial ownership information to FinCEN.” The CTA establishes civil penalties of up to $500 for each day a violation continues or has not been remedied. Persons that criminally violate the CTA may be fined up to $10,000, imprisoned for up to two years, or both.

The reporting rule is one of three rulemakings planned to implement the CTA. FinCEN is expected to engage in additional rulemakings to: (i) establish rules for who may access beneficial ownership information, for what purposes, and what safeguards will be required to ensure that the information is secured and protected; and (ii) revise FinCEN’s customer due diligence rule.

CORE expects that FinCEN will publish guidance to clarify aspects of the final rule before its effective date.

FinCEN Proposes No-Action Letter Process (June 2022)

In June 2022, FinCEN issued an Advance Notice of Proposed Rulemaking to solicit public comment on questions relating to the implementation of a no-action letter process at FinCEN, similar to established processes at the SEC. A no-action letter is generally understood to be a form of enforcement discretion where an agency states by letter that it will not take an enforcement action against the submitting party for the specific conduct presented to the agency. If implemented, FinCEN would issue such letters in response to inquiries concerning whether and how anti-money laundering or countering the financing of terrorism laws and regulations apply to specific conduct. The no-action letter process is intended to supplement the existing forms of regulatory guidance and relief that third parties may request from FinCEN, including administrative rulings and exceptive or exemptive relief.

The comment period for the proposed rulemaking ended August 5, with commenters apparently generally in favor of the process, assuming FinCEN could provide a no-action letter that is accepted by all relevant regulators so as to truly provide the assurance institutions need to proceed with a covered activity. The need for FinCEN to further contemplate whether and how to provide for the public release of no-action letters and the inherently confidential information contained within was mentioned by more than one respondent.

Regulatory Updates and Enforcement

Privacy Developments

California Consumer Privacy Act (***CCPA***) Enforcement

California Attorney General Rob Bonta announced a settlement with Sephora, Inc. in August 2022, and gave a statement on his offices' efforts in enforcing the CCPA, previewing a wide-reaching investigative sweep of retail businesses for failures to process online opt-out requests. Bonta noted in the statement that his office has issued an array of deficiency notices alleging noncompliance with the CCPA to corporations in the tech, healthcare, and data brokerage industries, among others, giving the businesses 30 days to cure non-compliance. Under scrutiny are businesses' loyalty programs, confusing or incomplete privacy disclosures, and broken "do not sell my personal information" website links.

Although the current enforcement is focused on retail businesses, the Attorney General's statement underscores the office's commitment to enforcement and desire to "send a strong message" that it is prepared to enforce against non-compliant businesses, and that it is casting a wide net by targeting businesses in and outside of California. Where the private information of California residents is concerned, arrangements giving any vendors or third-parties access should be carefully scrutinized to confirm necessary CCPA conditions are met, and privacy notices are consistent with actual practices. Further, if the failure to comply with opt-out notices is actionable and under scrutiny, there is reason to suspect the same of similar provisions that may be applicable to private fund managers, albeit on a limited basis. Advisers should ensure all requests under the CCPA are handled timely and appropriately. For example, a request from a California investor to delete personal information should be promptly addressed and documented.

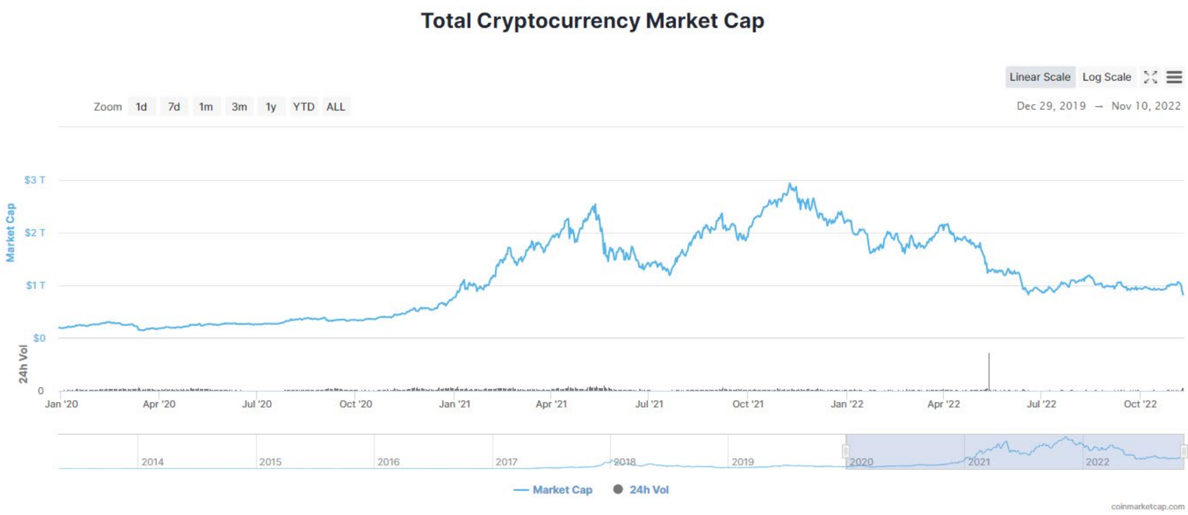
Attorney General Statement – https://oag.ca.gov/news/press-releases/attorney-general-bonta-announces-settlement-sephora-part-ongoing-enforcement

Digital Asset Developments

Not-So-Cryptic Reasons Behind the Fall of Crypto

The crypto market continues to decline as recession fears spread globally. The two largest cryptocurrencies, Bitcoin and Ether, have declined 70% and 75% respectively since reaching their all-time highs in November of last year. Crypto markets face many headwinds, including various government regulations and bans worldwide; investor shift from speculative assets into less risky and volatile investments; and investor realization that, despite being marketed as such, assets like Bitcoin and Ether are not an inflation hedge. In spite of the indisputable slowdown of the crypto boom, regulators are still focused on introducing new laws or applying existing laws to this market and its participants. Certain countries (Indonesia, China, and Thailand) took very decisive steps, opting for complete prohibitions on cryptocurrency trading. Domestically, Gary Gensler, the Chair of the SEC, considers the question settled as to whether crypto assets fall under the SEC's jurisdiction. On September 13, SEC Chair Gensler responded to a question regarding whether crypto assets were securities as follows: "They don't just resemble securities, they are securities. The vast number of these thousands of tokens – without prejudging any one of them – meet the standard of being a security…" Importantly, Gensler further added that existing securities laws already fit the crypto markets. The compliance industry has long been waiting for a new piece of regulation that would target crypto specifically. However, Gensler's statement appears to promote an application of existing securities laws instead of inventing new crypto-specific regulations.

In contrast to Mr. Gensler's statement, SEC Commissioner Mark T. Uyeda suggested in a September 9th speech that whether crypto assets constitute security is not a settled question. Uyeda effectively asked, if crypto assets are securities, how do market participants comply with the federal securities laws and the SEC's rules? He noted that the SEC's views on crypto assets "have been more often expressed through enforcement action" rather than regulation specifically saying that crypto assets and related services are absent from the SEC's regulatory agenda. Mr. Uyeda noted that market participants have expressed significant concerns regarding the lack of regulatory guidance regarding crypto assets and that the SEC is unable to consider their perspectives in developing an appropriate regulatory framework. He suggested that the lack of predictability with regard to crypto asset regulation in the United States may encourage crypto firms to relocate to other jurisdictions. Unlike Chair Gensler, who finds existing securities laws already suited to the crypto markets, Commissioner Uyeda's speech reads "[t]o the extent that crypto assets raise unique issues not otherwise addressed in the current rule book, the Commission should consider proposing rules or issuing interpretive releases."



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SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action

In July, the SEC brought insider trading charges against a former Coinbase product manager, his brother, and his friend for misusing material, non-public information for personal benefit. The plaintiffs engaged in trading ahead of multiple announcements regarding certain crypto assets that would be made available for trading on the Coinbase platform.

While employed at Coinbase, Ishan Wahi helped to coordinate the platform's public listing announcements including those regarding which crypto assets would be made available for trading. According to the SEC's complaint, Coinbase treated such information as confidential and warned its employees not to trade on the basis of, or tip others with, that information. However, between June 2021 and April 2022, in breach of his duties, Ishan repeatedly tipped the timing and content of upcoming listing announcements to his brother and his friend. Consequently, the tippees purchased at least 25 crypto assets, a portion of which were securities, and then typically sold them shortly after the announcements for a profit. The long-running insider trading scheme generated illicit profits totaling more than $1.1 million.

Gurbir Grewal, Director of the Enforcement Division stated: "In this case, those realities affirm that a number of the crypto assets at issue were securities, and, as alleged, the defendants engaged in typical insider trading ahead of their listing on Coinbase. Rest assured, we'll continue to ensure a level playing field for investors, regardless of the label placed on the securities involved." Carolyn M. Welshhans, Acting Chief of the Enforcement Division's Crypto Assets and Cyber Unit added: "As today's case demonstrates, whether in equities, options, crypto assets, or other securities, we will vindicate our mission by identifying and combatting insider trading in securities wherever we see it." Consistent with those statements and with Chair Gensler's public statements, the complaint in this case repeatedly uses the term "digital asset securities" and reads, in part, "A digital token or crypto asset is a crypto asset security if it meets the definition of a security which the Securities Act defines to include 'investment contract,' *i.e.*, if it constitutes an investment of money, in a common enterprise, with a reasonable expectation of profit derived from the efforts of others." The complaint details the SEC's argument as to why these digital assets are securities concluding that "hallmarks of the definition of a security continue to be true for the nine crypto asset securities that are the subject of the trading in this complaint."

This is a good example of the SEC bringing a case against an employee of a firm while not penalizing the firm itself due to existing internal controls addressing the type of violative activity in question. As CORE often stresses to its clients, a crime like insider trading cannot always be prevented, but conducting training and having policies and procedures in place presents a good layer of protection for the firm, potentially sparing the firm of being named in an enforcement action and facing costly reputational and monetary penalties.

The SEC seeks permanent injunctive relief, disgorgement with prejudgment interest, and civil penalties. In a parallel action, the U.S. Attorney's Office for the Southern District of New York announced criminal charges against all three individuals.

SEC Press Release – https://www.sec.gov/news/press-release/2022-127

SEC Charges Eleven Individuals in $300 Million Crypto Pyramid Scheme

The SEC charged 11 individuals for creating and promoting a fraudulent crypto Ponzi scheme and pyramid scheme, known as Forsage, that raised over $300 million from investors in several countries, including the United States. The scheme claimed to be a decentralized smart contract platform, and it allowed millions of investors to enter transactions on various blockchains, including Ethereum, Tron, and Binance. The founders actively promoted Forsage online including through social media outlets such as YouTube, Facebook, Instagram, and Telegram. The plaintiffs allegedly used assets from new investors to pay earlier investors in a typical Ponzi structure and operated it as a pyramid scheme for more than two years during which investors earned profits by recruiting others into the scheme. Both international and individual state regulators brought cease-and-desist actions against Forsage for operating as a fraud. Despite those actions, the defendants allegedly continued to promote the scheme and publicly denied the claims. Four of the founders' whereabouts are unknown with last-known locations of Indonesia, Russia and the Republic of Georgia. The 11 individuals violated the registration and anti-fraud provisions of the federal securities laws. The SEC's complaint seeks injunctive relief, disgorgement, and civil penalties.

SEC Press Release – https://www.sec.gov/news/press-release/2022-134

SEC Charges Kim Kardashian for Unlawfully Touting Crypto Security

In a celebrity enforcement case, the SEC announced charges against Kim Kardashian for touting on social media a crypto asset security offered and sold by EthereumMax without disclosing the payment she received for the promotion. Kardashian agreed to settle the charges, pay $1.26 million in penalties, disgorgement, and interest. The SEC penalized Kardashian for failure to disclose that she was paid $250,000 to publish a post on her Instagram about EMAX tokens, the crypto asset security being offered by EthereumMax. Kardashian's post contained a link to the EthereumMax website, which provided instructions for potential investors to purchase EMAX tokens.

"This case is a reminder that, when celebrities or influencers endorse investment opportunities, including crypto asset securities, it doesn't mean that those investment products are right for all investors," said SEC Chair Gary Gensler. "Ms. Kardashian's case also serves as a reminder to celebrities and others that the law requires them to disclose to the public when and how much they are paid to promote investing in securities," Gensler added.

The SEC has previously published a statement urging caution regarding potentially unlawful celebrity-backed crypto asset offerings. Chair Gensler has been actively warning investors not to make investment decisions based solely on the recommendations of a celebrity or influencer.

SEC Press Release – https://www.sec.gov/news/press-release/2022-183

Regulatory Updates and Enforcement

Other Developments

Department of Justice Amends Prosecution Guidelines – Impact to Compliance Programs

The DOJ issued a memorandum amending its prosecution guidelines on September 15, 2022, reiterating and expanding on several factors indicative of an effective corporate compliance department, such as the tone-at-the-top, and specifically noting the importance of policies governing the use of personal devices and third-party applications as part of an effective program.

Echoing the U.S. Federal Sentencing Guidelines, and its June 2020 memorandum "Evaluating Corporate Compliance Programs," the September memorandum provides a similar framework for evaluating corporate compliance programs, outlining or expanding upon factors to consider. Again, adequate resources and empowering the compliance staff, and whether the program is working in practice, are all indicative of an effective compliance program. The memorandum highlights additional, similar areas to consider, such as recidivism and past misconduct, and compliance culture across the organization, particularly in its management, as well as risk assessments, reviews, and testing to prevent, deter and detect misconduct.

Notably, in delineating its compliance program controls and testing as a factor, the DOJ echoes the SEC's September electronic communication failure enforcement actions. It discusses management's lack of commitment to compliance and oversight as a direct indicator of broader weaknesses in a company's compliance culture or practices and specifically states that an effective compliance program should have policies, procedures governing the use of personal devices and third-party applications, clear training on such policies, and enforcement when policies are violated.

In evaluating the compliance culture, the memo instructs prosecutors to consider how an organization has incentivized employees, whether the company took steps to remediate known misconduct, including employee discipline, compensation clawbacks, restitution, and compliance program upgrades, and whether senior leaders have "through their words and actions, encouraged or discouraged compliance." It lists a number of ways companies can promote a culture of compliance by aligning compensation, job performance and compliance-adherence, and it directs reviewers to look not only in written policies, but also at whether the policies are followed in practice.

Prompt, voluntary self-disclosure, made prior to imminent threat of disclosure or government investigation, is also noted by the DOJ as a factor in considering whether to prosecute. The memorandum directs its internal departments to review their policies on self-disclosure and ensure they set forth the relevant department's expectations as to the benefits an organization can expect to receive if it meets the standards set forth in such policy.

Voluntary self-reporting is encouraged by SEC. Though it has its downsides (for example, a self-report could result in a targeted examination by the SEC), the DOJ memorandum is a reminder that in the best-case scenario, a compliance program should serve as a defense to prosecution and could potentially help avoid an SEC referral to the DOJ.

DOJ Remarks – https://www.justice.gov/opa/speech/deputy-attorney-general-lisa-o-monaco-delivers-remarks-corporate-criminal-enforcement

DOJ Memorandum – https://www.justice.gov/opa/speech/file/1535301/download