Ethical Issues In Securities Enforcement Proceedings

Erik A. Christiansen
Parsons Behle & Latimer
echristiansen@parsonsbehle.com

The opinions expressed herein are my own personal opinions, and do not necessarily reflect the opinions of the Utah State Securities Commission or Parsons Behle & Latimer.

Section 926 of Dodd-Frank Wall Street Reform and Consumer Protection Act

--required SEC to adopt rules that disqualify securities offerings involving certain felons and other bad actors from reliance on Rule 506 of Regulation D.

--the SEC adopted final rules on July 10, 2013

--The disqualification provisions are found in Rule 506(d).

--**The disqualification provisions cover the following "covered persons"**:

- The issuer and any predecessor of the issuer or affiliated issuer;
- Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
- Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- Any investment manager to an issuer that is a pooled investment fund and any director, executive officer, other officer participating in the offering, general partner or managing member of any investment manager, as well as any director, executive officer or officer participating in the offering of any such general partner or managing member;
- Any promoter (as defined in Rule 405) connected with the issuer in any capacity at the time of the sale;
- Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sales of securities in the offering (i.e., a compensated solicitor); and
- Any director, executive officer, other officer participating in the offering, general partner, or managing member of any such compensated solicitor.

- Executive officers. The term "executive officer" means a company's president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions.

- Officers who participate in the offering. The term "officer" means a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, as well as any person who routinely performs corresponding functions. Participation in an offering would have to be more than transitory or incidental involvement, and could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents, and communication with the issuer, prospective investors or other offering participants.

- Promoters: The category of "promoter" is broad. Securities Act Rule 405 defines a promoter as any person—individual or legal entity—that either alone or with others, directly or indirectly takes initiative in founding the business or enterprise of the issuer, or, in connection with such founding or organization, directly or indirectly receives 10% or more of any class of issuer securities or 10% or more of the proceeds from the sale of any class of issuer securities (other than securities received solely as underwriting commissions or solely in exchange for property). The test considers activities "alone or together with others, directly or indirectly"; therefore, the result does not change if there are other legal entities (which may themselves be promoters) in the chain between that person and the issuer.

--**The following events are disqualifying events if a covered person**:

- Has been convicted, within 10 years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:
    - In connection with the purchase or sale of any security;
    - Involving the making of any false filing with the Commission; or
    - Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities; or

- Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice;
    - In connection with the purchase or sale of any security;
    - Involving the making of any false filing with the Commission; or
    - Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities; or
- Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; FINRA, an SRO, or the National Credit Union Administration that:
    - At the time of such sale, bars the person from:
        - Association with an entity regulated by such commission, authority, agency or officer;
        - Engaging in the business of securities, insurance or banking; or
        - Engaging in savings association or credit union activities; or
    - Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within 10 years before such sale; or
- Is subject to an order of the SEC entered pursuant to section 15(b) and 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b) or 78o-4(c)) or section 203(e) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(e) or (f)) that, at the time of such sale:
    - Suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;
    - Places limitations on the activities, functions or operations or such person; or
    - Bars such person from being associated with any entity or from participating in the offering of any penny stock; or

- Is subject to any order of the SEC entered within 5 years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of:

    - Any scienter-based anti-fraud provision of the federal securities laws, including without limitation section 17(a)(1) of the Securities Act of 1933 (15 USC 77q(a)(1)), section 10(b) of the Securities Exchange Act of 1934 (15 USC 78j(b)) and 17 CFR 240,10b-5, section 15(c)(1) of the Securities Exchange Act of 1934 (15 USC 78o(c)(1) and section 206(1) of the Investment Advisers Act of 1940 (15 USC 80b-6(1)), or any other rule or regulation thereunder; or Section 5 of the Securities Act of 1933 (15 USC 77e); or

- Is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade; or

- Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within 5 years before such sale, was the subject or a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or

- Is subject to a United States Postal Service false representation order entered within 5 years before such sale, or is, at the time of such sale, subject to a TRO or preliminary injunction with respect to conduct alleged to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

- **SEC disciplinary orders:** Disqualification is triggered by Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons under Section 15(b) or 15B(c) of the Securities Exchange Act, or Section 203(e) or (f) of the Investment Advisers Act that:

    suspend or revoke the person's registration as a broker, dealer, municipal securities dealer or investment adviser
    place limitations on the person's activities, functions or operations
    bar the person from being associated with any entity or from participating in the offering of any penny stock

    Disqualification continues only for as long as some act is prohibited or required to be performed pursuant to the order. As a result, censures and orders to pay civil money penalties, assuming the penalties are paid in accordance with the order, are

not disqualifying, and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires.

- **SEC cease-and-desist orders:** Commission orders to cease and desist from violations and future violations of

  the scienter-based anti-fraud provisions of the federal securities laws, including, for example

  Section 17(a)(1) of the Securities Act
  Section 10(b) of the Securities Exchange Act and Rule 10b-5
  Section 15(c)(1) of the Securities Exchange Act
  Section 206(1) of the Investment Advisers Act
  Section 5 of the Securities Act

  Disqualification applies to cease-and-desist orders that were issued within five years before the proposed sale of securities and remain in effect.

Disclosure of Pre-Existing Events:

Disqualification will not arise as a result of disqualifying events that occurred before September 23, 2013, the effective date of the rule amendments. Matters that existed before the effective date of the rule and would otherwise be disqualifying are, however, required to be disclosed in writing to investors. Issuers must furnish this written description to purchasers a reasonable time before the Rule 506 sale. Rule 506 is unavailable to an issuer that fails to provide the required disclosure, unless the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a disqualifying event was required to be disclosed.

Determining whether disclosure is required. The rule looks to the timing of the triggering event (*e.g.*, a criminal conviction or court or regulatory order) and not the timing of the underlying conduct. A triggering event that occurs after effectiveness of the rule amendments will result in disqualification, even if the underlying conduct occurred before effectiveness.

Form of disclosure. The Commission expects that issuers will give reasonable prominence to the disclosure to ensure that information about pre-existing bad actor events is appropriately presented in the total mix of information available to investors.

Reasonable Care Exception:

The Rule 506 exemption is still available if the issuer establishes that it did not know and/or in the exercise of reasonable care, could not have known that a disqualification existed under the bad actor provision.

Issuers will have to conduct due diligence, including with questionnaires and c certifications.

Waivers:

The SEC can provide a waiver upon a showing of good cause if.

A waiver also can be granted by the court or regulatory authority that entered the relevant order.

S.E.C. Release 2013-249: Curt Kramer; Mazuma Corporation; Mazuma Funding Corporation; Mazuma Holding Corporation.

--Settlement for selling unregistered securities

--Disgorgement of $1,067,367, interest of $128,611 and penalty of $273,000

--Consent decree for violation of Sections 5(a) and 5(c) of the Securities Act of 1933

--"Entry of the order will constitute a disqualifying event for Kramer and the Mazuma firms under the recently enacted bad actor disqualification provisions of Rule 506."

Procedural Unfairness in Administrative Proceedings:

Remarks at the SEC Speaks Conference 2015; A Fair, Orderly, and Efficient SEC by Commissioner Michael S. Piwowar:

"Our enforcement program could also benefit from a look through the lens of fairness. In order to ensure that the Commission does not engage in arbitrary or capricious conduct in enforcement matters, the Commission should formulate and adhere to a consistent set of guidelines when conducting our enforcement proceedings.

Commission staff has recently indicated that they will recommend instituting more enforcement matters, including insider trading cases, through administrative proceedings rather than going through the federal district courts. Announcement of this plan to increase the use of administrative proceedings in insider trading cases followed the Commission's loss in two insider trading cases in federal district courts. Regardless of whether these circumstances are linked, this change has the appearance of the Commission looking to improve its chances of success by moving cases to its in-house administrative system.

Even prior to the staff announcement, more cases were being brought in administrative proceedings as a result of the enactment in 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Prior to the Dodd-Frank Act, the Commission only had the authority to seek monetary penalties in administrative proceedings against regulated entities and would have needed to file an action in federal court to obtain a monetary penalty against any other person.

In administrative proceedings, there is no jury and cases are presented to administrative law judges that are employees of the Commission. In addition, discovery available to defendants is more limited. The Commission has an extremely high success rate when litigating through administrative proceedings. One Article III federal judge has stated that in fiscal year 2014 the SEC won 61 percent of federal court trials but was successful in 100 percent of its administrative proceedings. To avoid the perception that the Commission is taking its tougher cases to its in-house judges, and to ensure that all are treated fairly and equally, the Commission should set out and implement guidelines for determining which cases are brought in administrative proceedings and which in federal courts.

"A similar concern exists in the termination of whether to issue waivers. Certain violations of securities regulations result in the automatic disqualification of the violator or related entities from participating in certain aspects of the securities industry or from relying on certain exemptions in the securities regulations. Frequently, the violator and its affiliates will apply to the Commission or Commission staff for relief from the disqualification. For many of these waiver requests, guidelines and policies have been developed by the staff to determine if the applicants should be granted a waiver from the applicable disqualification.

However, recently and with increasing frequency, Commissioners have been ignoring the established staff guidelines and staff's efforts to apply them. Although the Commission is not bound to staff guidelines, nevertheless it is important that there be an established policy or guidelines that would allow a party to determine if it would be eligible for applicable waivers."

--The rich and powerful frequently get waivers, i.e., the Bank of America's, UBS's, and Oppenheimer's etc…. of the world.

--Rep. Maxine Waters, Democrat from California, is proposing draft legislation that if passed would make it harder for the SEC to grant waivers. Why? Waters said that the "SEC has been grating waivers automatically – and disproportionately for large financial firms." "I have been disappointed with the seemingly reflexive granting of waivers to bad actors, which can enshrine a policy of too-big-to bar."

The Utah Securities Commission:

Members of the Commission:

1. Five members;
2. Two from securities brokerage community;
3. One from securities section of Utah state bar;
4. One public at large member; and
5. One business member who does not work at a public company.
6. Appointed for 4-year terms:
7. We are uncompensated.

The duties of the Commission: Utah Code Ann. 61-1-18.5

1. Formulate and make recommendations to the director regarding policy and budgetary matters;
2. Submit recommendations regarding registration requirements;
3. Formulate and make recommendations to the director regarding the establishment of reasonable fees;
4. Act in an advisory capacity to the director with respect to the exercise of the director's duties, powers, and responsibilities;
5. Conduct an administrative hearing that is not:
    a. Delegated by the commission to an administrative law judge or the division relating to a violation; or
    b. Expressly delegated to the division under this chapter.
6. Impose sanctions.
7. Review rules made by the division for purposes of concurrence; and
8. Perform other duties as the statute provides.

9. The Commission may:

    a. Issue orders to show cause;

    b. Issue cease and desist orders;

    c. Impose fines;

    d. Bar or suspend people from being associated with a broker-dealer or investment adviser;

    e. Make whistleblower awards.

10. In considering penalties, the Commission shall consider whether:

    a. The person against whom the sanction is to be imposed exercised undue influence; or

    b. The person against whom the sanction is imposed knows or should know that an investor in the investment that is the grounds for the sanction is a vulnerable adult.

11. The Commission is governed by Administrative Procedures Act.

<u>Appeals</u>:

1. To the executive director of the department of commerce;

2. Then to the courts.

Operation Choke Point:

1. Numerous agencies involved including Department of Justice, the FDIC, the Consumer Financial Protection Bureau, Department of Treasury, and the SEC.

2. Policy originated in the executive branch as a result of hostility to payday lenders.

3. Targets industries that the Obama Administration considers high risk for illegal activities:

    a. Payday lenders;

    b. Guns;

    c. Smoke shops;

    d. Fireworks;

    e. Pawn shops;

    f. Pornography;

    g. Coin dealers;

    h. Dating services;

    i. Debt consolidation companies;

    j. Escort services;

    k. Money transfer networks;

    l. On-line gambling;

    m. Ponzi schemes.

    n. Get rich schemes.

4. Banks are told to close accounts behind the scenes. The result has been that banks are existing high risk lines of business.

5. No notice to affected individuals. No due process.

6. Congressional hearings have been held.

7. I know of two cases after S.E.C. settlements.

Omnicare, Inc. v. Laborers District Council Construction Industry (March 24, 2015)

--The U.S. Supreme Court ruled that an issuer cannot be liable under §11 of the Securities Act for statements of opinion in a registration statement that turn out to be wrong unless the speaker did not genuinely hold the stated opinion.

--"[A] sincere statement of pure opinion is not an untrue statement of material fact, regardless of whether an investor can ultimately prove the belief wrong."

--Section 11 provides that:

> "In case any part of the registration statement, when such pat become effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . [may] sue."

The case involved two statements:

> "We believe our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state law."
>
> "We believe that our contracts with pharmaceutical manufacturers are legally and economically valid arrangements that bring value to the healthcare system and the patients that we serve."

The Federal Government later alleged that the company violated anti-kickback laws.

The plaintiffs alleged that one of the company's lawyers had warned it that a particular contract carried a heighted risk of liability under anti-kick back laws.