CORE COMPLIANCE & LEGAL SERVICES, INC.

Risk Management Update
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THE DANGERS OF RECIDIVIST DEFICIENCIES AND THE SEC'S COMPLIANCE PROGRAM INITIATIVE

The SEC Takes a Stance against Recidivism

In the past few years, the Securities and Exchange Commission ("SEC") has taken a tougher stance against recidivist behavior by registered investment advisory firms ("RIAs"). Recidivism refers to occurrences where an RIA has not corrected deficiencies noted in previous regulatory examinations. The SEC is focusing on recidivist behavior through its "Compliance Program Initiative", which seeks to identify firms who have failed to correct such deficiencies.

This initiative was first brought to full light in November 2011, when the SEC issued a press release announcing enforcement actions against three investment advisory firms.[1] The release stated, "The cases stem from an initiative within the SEC Enforcement Division's Asset Management Unit to proactively prevent investor harm by working closely with agency examiners to ensure that viable compliance programs are in place at firms. Investment advisers are required by law to adopt and implement written compliance policies and procedures. When SEC examiners identify deficiencies in a firm's compliance program, those deficiencies need to be corrected before they lead to other securities law violations that could harm investors. Investment advisers that essentially ignore SEC examination warnings risk being the subject of SEC enforcement actions."

The SEC continues to demonstrate its growing impatience with recidivist behavior through public speeches by Commissioners and enforcement actions that carry severe penalties and consequences for recidivist offenders, including being permanently ban from working in the industry. The SEC also has dedicated resources for utilizing technology as part of their initiative, which was opined upon in a speech given by SEC Commissioner Daniel Gallagher[2], wherein he stated "I am pleased to report that in recent years, the agency has made great strides in developing programmatic and technological tools aimed at efficiently ferreting out the most egregious misconduct and identifying those individuals and firms most likely to be recidivists."

Enforcement Actions

There have been many enforcement actions in the last decade for recidivist activity and lack of adequate compliance programs. Below is a summary of some of the more recent cases.

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[1] See press release 2011-248 issued November 28, 2011 "SEC Penalizes Investment Advisers for Compliance Failures" at http://www.sec.gov/news/press/2011/2011-248.htm

[2] Remarks at the 46th Annual Rocky Mountain Securities Conference, Denver Colorado (May 9, 2014) http://www.sec.gov/News/Speech/Detail/Speech/1370541779229#.VJdVTF4AAA

In the Matter of Modern Portfolio Management, Inc., G. Thomas Damasco II, and Bryan F. Ohm (IA Release No. 3702/October 23, 2013)[3]

Summary: The SEC found that Modern Portfolio Management, Inc. ("MPM"), and its owners G. Thomas Damasco II and Bryan Ohm had failed to correct ongoing compliance violations at the firm despite prior warnings from SEC examiners. In particular, they failed to complete annual compliance reviews in 2006 and 2009 and made misleading statements on MPM's website and investor brochure.

Penalties: MPM, Damasco, and Ohm agreed to be censured and pay a total of $175,000 in penalties. Damasco and Ohm must complete 30 hours of compliance training, and MPM has agreed to designate someone other than Damasco or Ohm to be its chief compliance officer. MPM, which is based in Holland, Ohio, must retain a compliance consultant for three years.

In the Matter of Equitas Capital Advisors, LLC, Equitas Partners, LLC, David S. Thomas, Jr, and Susan Christina, (IA Release No. 3704/October 23, 2013)[4]

Summary: The SEC found that Equitas Capital Partners, LLC ("Equitas") had over billed and under billed certain clients and negligently made false and misleading disclosures to clients and potential clients about the firm's historical performance, compensation, conflicts of interest, and prior examination deficiencies. They said that Equitas also violated the compliance-related rules under the Investment Advisers Act of 1940, as did Equitas Partners, LLC ("Equitas Partners"), a registered investment adviser under common control with Equitas, by failing to implement and maintain written policies and procedures reasonable designed to prevent violations of the Advisers Act and conduct the required annual compliance reviews. The SEC found that their principal and chief executive officer ("CEO"), David Thomas, aided, abetted, and caused the advertising violations, while he and the firms' chief compliance officer ("CCO"), Susan Christina, aided, abetted, and caused the compliance-related violations. These violations occurred despite warnings by the staff of the SEC's Office of Compliance Inspections and Examinations ("OCIE") in connection with its examinations of Equitas and Equitas Partners in 2005, 2008, and 2011.

Penalties: Equitas Capital Advisers and Crescent were required to reimbursed all overcharged clients, and Equitas Capital Advisers, Thomas, and Gisclair were fined a total of $225,000 in additional penalties. Both Equitas firms agreed to censures and to hire independent compliance consultants. The two Equitas firms, along with Gisclair are required to provide their clients with written notice of the SEC enforcement actions.

Take Action Now to Correct Noted Violations

A large number of examinations result in a deficiency letter being issued by regulators, which outlines the items of concern and violations an examination team found during their exam. When responding to a deficiency letter, firms should carefully address the deficiencies noted by

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[3] *See* http://www.sec.gov/litigation/admin/2013/ia-3702.pdf
[4] *See* http://www.sec.gov/litigation/admin/2013/34-70743.pdf

providing a detailed description of the action they have or will be taking to correct each deficiency. When addressing items that will be corrected through future action, firms should be careful not to outline corrective actions that are not within their capabilities.

Once a firm has responded to the SEC's deficiency letter, the CCO should take steps to ensure the corrective actions described in the response are carried out, and in a timely manner. The CCO may want to consider taking the following additional steps to help prevent recidivist deficiencies:

- Implement a heighten review and testing program for the area(s) noted for non-compliance. For example, if a deficiency was issued for not adhering to a certain part of a rule, take steps to ensure that not only has the deficiency been corrected, but other requirements under the same rule are being followed and applicable procedures are reasonably designed to prevent future violations.
- Ensure the annual compliance review process includes a review of all prior deficiency letters from regulators and confirm that corrective actions continue to be in place. If any are no longer applicable, (for instance if there had been a change in the firm's business practices) then documentation should be maintained summarizing the changes, including when such change took place.
- Provide compliance training to new employees upon hire and current employees at least annually to help ensure they understand all compliance requirements.

Conclusion

In this current regulatory environment, firms that continue to have lax compliance programs, especially after being found deficient by the SEC (or state regulator) run the risk of enforcement action and costly penalties that could include termination of a firm's registration. Senior management should confirm that adequate resources are focused toward ensuring that the firm's compliance program is robust and appropriately designed to prevent any future violations.

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