

SEC Enforcement: A Review of 3Q21

Introduction

The new Director of the Enforcement Division, Gurbir Grewal, assumed his position during the Third Quarter of 2021. Even if he hits the ground running it typically takes time to adjust to the environment. Mr. Grewal brings a substantial amount of experience to the position, having served as the Attorney General of New Jersey and as an Assistant U.S. Attorney in the Eastern District of New York. At the same time, the Commission is not a prosecutor, it is a regulator, a very different function.

In his first public remarks Mr. Grewal focused on key points for crafting an effective enforcement program that trace to the earliest days of the Division: Corporate responsibility; gatekeeper accountability; and effective remedies. Each point has been a theme running through the program since the creation of the Division in the early 1970s first under Irv Pollock and then Stan Sporkin. These comments reflect a thoughtful approach.

Other points in the new Director's comments, however, suggest what may become a more hard-edged approach. For example, the statement that the Division will return to the practice of requiring admissions and expand the use of officer/director bars may suggest a harsher approach than has been used in recent years. The blend of those points with key themes from the history of the Division, however, will ultimately be key.

The Statistics

During the third quarter of 2021 – the final quarter of the government fiscal year – the Division significantly picked up the pace at which new cases were filed. During the quarter 144 new actions were filed. That compares to a total of 123 for the first two quarters of 2021.

Related Capabilities

- Securities & Financial Services Litigation & Enforcement

The overall mix of cases filed in the third quarter differed significantly from earlier periods. The mix was much more diverse. While a few categories of actions constitute the largest groups of cases, they were much smaller than in the past. The following table depicts the largest groups of cases and shows the percentage each group represents of the total number of actions.

Investment advisers 5%

Insider trading 4.8%

Microcap fraud 4.8%

Unregistered brokers 3.4%

These numbers contrast sharply with those from the second quarter. During the latter period 31% of the cases were offering frauds and 18% involved investment advisers. Yet during the third quarter the Division filed a much larger number of cases – 144 in the third quarter compared to the 75 new cases filed in the second quarter.

The difference reflects the fact that a larger array of cases were filed in the third quarter. During that period, for example, actions were initiated involving conflicts, false statements, financial fraud, investment controls, municipal bonds, the short tender rule, crypto rules, auditor independence and the safeguard rule, among others. While this suggests that the Division may be expanding its reach and presence in the market-place which should facilitate investor confidence in the markets, the longer term effect will have to be carefully evaluated.

Below is a selection of cases filed during the quarter. The first group centers on actions that fall into the largest groupings cited above. A second group of significant actions follows.

Select cases from leading categories

Investment adviser

Actions involving investment advisers have been one of the leading categories of cases brought by the division in recent years. The action below centered on one of the key charges involved, a failure to properly implement policies and procedures. Another key area involves undisclosed conflicts. The case also reflects a current concern of the agency – the use of complex products that may not be fully understood.

In the Matter of UBS Financial Services Inc., Adm. Proc. File No. 3-20401 (July 19, 2021) is an action which names as a respondent the dual registered broker-dealer investment adviser. These proceedings center on the failure of the firm to properly implement policies and procedures with respect to the VXX product as used in its discretionary Portfolio Management Program or PMP. Beginning in 2016 firm financial advisers put clients involved in the PMP program into the VXX. This product is typically built on short

term futures products. Here the firm had policies and procedures in place to effectively prevent holding the VXX for long periods. Those policies and procedures did not, however, apply to the PMP program. When financial advisers put PMP clients into the VXX they failed to ensure that it was only held for the short term. Indeed, about 1,882 clients were involved with the product that was in hundreds of accounts. Those accounts held the product beyond the short term – many held the VXX for over a year. Accordingly, clients suffered losses. In resolving this matter, the firm took remedial steps. The Order alleges violations of Advisers Act Section 206(4) and Rule 206(4)-7. Respondent resolved the proceedings, consenting to the entry of a cease-and-desist order based on the Section and Rule cited in the Order and to a censure. The firm will also pay disgorgement of \$96,344, prejudgment interest of \$15,15,930 and a penalty of \$8 million. A fair fund will be established.

Insider trading

Insider trading has long been a key focus for the Division. This case reflects a current approach used in settling many of these settling – not seeking disgorgement in favor of a penalty that is two times the amount of the trading profits, adopted after the Supreme Court's decision in *Liu v. SEC*, 581 U.S. – June 22, 2020).

In the Matter of Zorayr Mikael Manukyan-Zakaryan, Adm. Proc. File No. 3-20457 (August 10, 2021) is an action which ultimately involved trading in the stock of AveXs, Inc. prior to an April 9, 2018 announcement that the firm had agreed to be acquired by Novartis AG. Respondent was Senior Director, Biostatistics for Pfizer, Inc. AveXis initially was in discussions about a potential deal with Novartis and Pfizer. During discussions Respondent was asked to participate in the transaction by reviewing certain research. During that work he learned of the discussions. The Pfizer transaction was not completed. After that, however, the AveXis – Novartis deal was consummated. Prior to the deal announcement Respondent traded in the shares of AveXis, reaping over \$20,000 in trading profits. The Order alleges violations of Exchange Act Section 10(b). To resolve the matter Respondent consented to the entry of a cease-and-desist order based on the Section cited in the Order. He also agreed to pay a penalty in the amount of \$40,997.26.

Conflicts

Undisclosed conflicts of interest are a key area of focus for market professionals such as the dual registered investment adviser and broker-dealer here. It is also a key area for the Division of Inspections.

In the Matter of TIAA-Cref Individual & Institutional Services, LLC, Adm. Proc. File No. 3-20392 (July 13, 2021) is a proceeding which names the registered investment adviser and broker-dealer as Respondent. The proceedings center on a failure to adequately disclose conflicts of interest and the distribution of false statements in connection with recommendations that clients invest in Teachers Insurance and Annuity Association of America (TIAA) record-kept employer-sponsored retirement plans or ESP roll over retirement assets into a managed account program called Portfolio Advisor. Over a five-

year period, beginning in January 2013, Respondent created positive incentives and negative pressures for its Wealth Management Advisors to roll over ESP assets into Portfolio Advisor. In connection with this process Respondent and WMAs also made misleading statements to induce clients to execute the rollover. Respondent also failed to properly disclose related conflicts resulting from incentive compensation and failed to properly implement its applicable policies and procedures. The Order alleges violations of Securities Act Sections 17(a)(2) and (3). In resolving the matter Respondent took certain remedial acts. The firm also consented to the entry of a cease-and-desist order based on the Sections cited in the Order and to a censure. In addition, Respondent will pay disgorgement of \$73,985,572, prejudgment interest of \$14,014,428 and a penalty of \$9 million. A fair fund is created for the penalties. The Order also states that the disgorgement and prejudgment interest does not exceed Respondent's net profits from the violations.

Additional select cases

Crypto

While this is an area that is much talked about, only two cases were brought during the period. The second action, however, is the first DiFi case.

SEC v. Uulala, Inc., Civil Action No. 5:21-cv-01307 (C.D. Ca. Filed August 4, 2021) is an action against the firm and its co-founders, defendants Oscar Garcia and Matthew Loughran. Beginning in December 2017, and continuing for the next two years, Defendants raised over \$9 million from over one thousand investors through a ICO using a coin called the Uulala. The tokens were sold as securities which were not registered. The white paper used to solicit investors contained claims about the technology underlying the coins, alleging it was patented and had proprietary micro-credit algorithms. The claims were false. Beginning in 2019 Defendants Uulala, Inc. and Garcia raised an additional \$500,000 from four U.S. investors through the sale of its Convertible Notes. A slide deck was used to affect the sales that contained false financial information about the Uulala. The complaint alleges violations of Securities Act Sections 5 and 17(a) and Exchange Act Section 10(b). Each Defendant consented to the entry of a permanent injunction based on the Sections cited in the complaint. In addition, the coins will be disabled and the company will pay a penalty of \$300,000 while Mr. Garcia will pay \$192,768 and Mr. Loughran will pay \$50,000. See Lit Rel. No. 25157 (August 4, 2021).

In the Matter of Blockchain Credit Partners, Adm. Proc. File No. 3-20453 (August 6, 2021). The action names as Respondents the firm, also known as DeFi Money Market or DMM which owned DMG tokens when they were created and obtained the proceeds from sales; Gregory Keough, a founder of DMM and owner of 50% of Blockchain Credit Partners; and Derek Acree, also a founder of Blockchain Partners and 50% owner of Blockchain Credit. Over a period of about one year, beginning in early 2020, Messrs. Keough and Acree, along with Blockchain Credit, operated DeFi Money Market. DMM offered investors 6.2% interest on digital assets. The funds were to come from what were called "real world assets" otherwise known as car loans. Two types of digital assets were available, the mToken and the DMG token. The former paid 5.25% interest. The latter

were marked as “governance tokens.” Those tokens gave purchasers certain voting rights, a share of excess profits and the ability to profit from DMG resales in the secondary market. Overall, in excess of \$17million in mTokens were sold and \$13.9 million in DMG tokens. The DMM business was built by programmers who created the architecture underlying the smart contracts and tokens. They also identified assets that could generate interest for mTokens and surplus profits for the DMG token holders. The mTokens were securities, according to the Order. In fact, they were notes offered and sold as investment contracts. Purchasers were led to believe that the profits they would receive would come from the efforts of Respondents from managing DMM. That included the auto loans which were purchased. While those assets were acquired, they remained in a separate entity – ownership was not transferred. The DMG tokens were also securities. They were offered and sold as investment contracts. The reasonable expectation of profits came from the claim that DMG would use the proceeds to operate and develop the business and then share the profits with investors. The Order alleges violations of Securities Act Sections 5(a), 5(c) and 17(a) and Exchange Act Section 10(b). To resolve the matter, Respondents agreed to certain undertakings. Those included an agreement to assist mToken holders with redemption. In addition, Respondents Keough and Acree will refrain for five years from directly or indirectly participating in an offering of a digital asset security, excluding any personal transactions. Respondent DMM will also refrain from participating in any offering of digital assets. Respondents consented to the entry of cease-and-desist orders based on the Sections cited in the Order. In addition, Messrs. Keough and Acree will be prohibited for five years from serving as an officer or director of any issuer. Respondents will also pay disgorgement of \$12,849,354, and prejudgment interest of \$258,052. Respondents Keough and Acree will each pay a penalty of \$125,000.

False statements

False statements is a long standing, traditional area of focus for enforcement. The case below is a typical example of these actions.

SEC v. Prallax Health Sciences, Inc., Civil Action No. 1:22-cv-05812 (S.D.N.Y. Filed July 7, 2021) is an action which names as defendants the firm, Paul R. Arena, its CEO, and Nathaniel T. Bradley, its CTO. In a period of approximately one month, beginning on March 11, 2020, the health care company issued a series of press releases to capitalize on the COVID pandemic. The releases claimed, for example, that the firm was developing a screening test that would be available shortly and had other medical equipment available such as ventilators. The firm’s CEO oversaw the preparation of the releases which were primarily penned by its CTO. In fact, the claims were false. The company was nearly bankrupt and did not have the FDA registrations required to support such products. The complaint alleges violations of Securities Act Sections 17(a)(1) and (3) and Exchange Act Section 10(b). Defendants resolved the matter by each consenting to the entry of a permanent injunction based on the Sections cited in the complaint. In addition, the company, along with CEO Arena and CTO Bradley will pay penalties in the amount of \$100,000, \$45,000 and \$40,000 respectively. Finally, Messrs. Arena and Bradley each consented to the entry of a penny stock bar for, respectively, five years and

three years. See Lit. Rel. No. 25137 July 7, 2021).

Financial fraud

Financial fraud is another long-standing area of focus for the Division. Below are examples of the cases brought during the last quarter. These examples also suggest that the Division is keying in this area and may in some instances be using data analytics to identify cases, a trend that traces to perhaps this time last year.

SEC v. Palleschi, Civil Action No. 2:21-cv-00530 (M.D. Fla. Filed July 15, 2021) is an action which names as defendants Michael Palleschi and David Lethem. Each defendant is a senior executive at FTE Networks, Inc., a Naples-based public company that provides network infrastructure to the technology and telecommunications industries. Over a three-year period, beginning in 2016, the two executives engaged in three fraudulent schemes. First, they issued about \$22.7 million in complex convertible notes. Since the conversion feature which permitted the notes to convert to stock was so complex, Defendants concealed it. Second, Defendant inflated FTE's revenues by inventing about \$12.5 million in revenue purportedly from completed construction projects that had not yet been billed but for with the company supposedly had completed the work. The claims were false since the work had not been done. Third, Defendants misappropriated about \$5.4 million from the company for their personal use. Eventually the fraudulent acts were uncovered by an independent director. FTE was required to restate its financial statements. The complaint alleges violations of each provision of Securities Act Section 17(a) and Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), 13(b)-5, 14(a) and SOX Section 304 along with related rules. The case is pending. See Lit. Rel. No. 25141 (July 15, 2021).

In the Matter of Paul L. Chancey, Jr. CPA, Adm. Proc. File No. 4225 (July 13, 2021) is a proceeding which names as a respondent Mr. Chancey, a certified public accountant, and a partner in the Georgia firm of Cherry Bekaert, LLP. During the audits of MiMedxGroup, Inc. for 2015 and 2016 Respondent became aware that portions of the firm's revenue was contingent. For 2015 Respondent also learned from the controller that revenue was recognized prematurely; for 2016 he learned the same fact with regard to the revenue from a vendor. In both instances Mr. Chancey ignored the warnings. His opinion incorrectly stated that the audits had been done in accord with PCAOB standards. The Order alleges violations of Rule 102(e). The proceedings will be set for hearing.

In the Matter of Tandy Leather Factory, Inc., Adm. Proc. File No. 3-20403 (July 21, 2021). Tandy is the world's largest specialty leather firm. Also named as a Respondent is Shannon Greene, CPA, the firm's CFO. Beginning in 2016 the firm failed to implement and maintain proper internal and disclosure controls. First, its inventory system failed to properly implement the firm's FIFO inventory controls. When prices were changed, for example, it failed to maintain the historical costs for earlier purchases. This resulted from inadequate controls. Second, the firm also failed to properly implement its disclosure controls. Ultimately these failures resulted in a multi-year restatement. The firm did undertake remedial efforts. The Order alleges violations of Exchange Act Sections 13(a),

13(b)(2)(A) and 13(b)(2)(B). To resolve the proceedings each Respondent consented to the entry of a cease-and-desist order based on the Sections cited in the Order. The firm will pay a penalty of \$200,000. Respondent Greene will pay a penalty of \$25,000.

In the Matter of The Kraft Heinz Co., Adm. Proc. File No. 3-20523 (September 3, 2021). The proceeding names as respondents the firm, a well-known Chicago based food and beverage firm, and Eduardo Pelleissone, then the firm's Global Head of Operations and Chief Operating Officer. This proceeding centers on a scheme to inflate reported pre-EBITDA revenue (earnings before interest, taxes, depreciation and amortization) beginning in the last quarter of 2014 and continuing through the end of 2018. During that period the firm negotiated upfront cash payments and discounts in exchange for future commitments to be undertaken by the company. Those payments were not properly documented, causing the firm to overstate its pre-EBITDA earnings over the period. Under GAAP, if upfront cash and discounts are tied to future commitments, the savings must be recognized over the period the obligations are satisfied. The procurement personnel for Kraft, however, negotiated and maintained false supplier contracts which made it appear that the expense savings were provided in exchange for past or same-year events performed by the company. In reality, the payments were tied to future performance.

During the period 59 transactions were improperly documented and recorded. If the items were properly accounted for, the cost of goods sold for Kraft would have been about \$50 million higher. The improper practices ultimately led to a restatement in 2019. That restatement involved the financial statements for years 2015 through 2018. It corrected a total of \$208 million in cost savings from 295 transactions. Mr. Pelleissone was presented with several warning signs indicating that expenses were being managed through the manipulation of supplier agreements. Similarly, an executive that reported to Mr. Pelleissone, and who managed the procurement section, approved certain contracts and suppliers. That executive also had sub-certification responsibilities in 2018 was confronted with several signs that should have alerted him to the issue. They did not. The Order alleges violations of Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and the related rules. To resolve the proceedings the firm consented to the entry of a cease-and-desist order based on the Sections cited in the Order. The firm will also pay a penalty of \$62 million. Mr. Pelleissone consented to the entry of a cease-and-desist order based on the same Sections and, in addition, Exchange Act Section 13b-5. He also agreed to pay disgorgement in the amount of \$12,500, prejudgment interest in the amount of \$1,711.31 and a penalty of \$300,000. *See also SEC v. Hofmann*, Civil Action No. 1:21-cv-07407 (S.D.N.Y. Filed September 3, 2021)(action against Klaus Hofmann, then global head of procurement and chief procurement officer of Kraft based on essentially the same allegations as above; the case is in litigation). *See Lit. No. 25199* (September 8, 2021).

Misrepresentations

The action below is typical of cases brought in this area during the last quarter.

In the Matter of App Annie Inc., Adm. Proc. File No. 3-20549 (September 14, 2021) is an

action which names as respondents the firm and Bertrand Schmitt, respectively, a leading provider of data on apps and its founder. App Annie is one of the largest sellers of market data on how apps on mobile devices perform. Trading firms call the data Alternative Data. Many trading firms pay for subscriptions and use it to make investment decisions. App Annie provides a free analytics product called Connect to companies that offer apps. It enables those firms to track how their apps are performing. App Annie assured users it aggregates the data and uses only an anonymized form to generate its estimates. Those representations were false. The firm also assured users it had comprehensive compliance policies and procedures to make sure the data collected was used properly. Those procedures, like the representations about data use, facilitated sales. The claims were false. The Order alleges violations of Exchange Act Section 10(b). To resolve the proceedings Respondents consented to the entry of a cease-and-desist order based on the Section cited in the Order. The firm will also pay a \$10 million penalty. Mr. Schmitt will pay a penalty in the amount of \$300,000.

Muni bonds

Muni bonds appears to be another area of focus for the Division. In recent months another of actions have been brought in this area.

In the Matter of Hilltop Securities, Inc., Adm. Proc. File No. 3-20389 (July 9, 2021) is a proceeding which names as respondents the firm, a registered broker-dealer, investment adviser and municipal advisor, and Daniel Tracy, a registered representative at the firm. The proceeding centered on violations of rules of the Municipal Securities Rulemaking Board regarding priorities in muni bond offerings and Hilltop's supervisory failures. Specifically, over a two year period, beginning in 2016, the firm failed to give first priority to retail orders as required by the rules and permitted "stock" orders – those from the firms that are rarely filled — to obtain bonds. While Mr. Tracy knew that Hilltop and other stock orders did not qualify to be filled, but in fact they were. This resulted in violations of MSRB Rule G-17. To resolve the matter Respondent Hilltop took certain remedial steps and consented to the entry of a cease-and-desist order based on Exchange Act Section 15B(c)(1) and MSRB Rules G-17 and 27 and to a censure. Mr. Tracy's activities were limited in certain specific matters tied to future offerings. The firm will pay disgorgement of \$206,606, prejudgment interest of \$48,587 and a penalty of \$85,000. Mr. Tracy will pay a penalty of \$25,000.

Manipulation

The action below is a variation of the kind of cases typically brought in this area which usually center on pump-and-dump cases involving microcap issuers.

SEC v. Fassari, Civil Action No. 8:21-cv-0403 (C.D. Cal.) is a previously filed action which named as defendant Andrew Fassari. Defendant is alleged to have posted false statements on Twitter and another social media site while buying and selling securities. Specifically, Mr. Fassari began purchasing over 41 million shares of Arcis Resources securities shortly before tweeting false information about the company. The share price skyrocketed, rising over 400%. To resolve the action, Mr. Fassari consented to the entry

of permanent injunctions based on Exchange Act Section 10(b) and Securities Act Section 17(a). In addition, he will pay disgorgement of \$457,110, prejudgment interest of \$8,007 and a penalty of \$195,047. Defendant also agreed to the entry of a penny stock bar. See Lit. Rel. No. 25185 (August 27, 2021).

Safeguard rule

The Safeguard rule, with its focus on privacy and security of client data may well become a focus of the Division in the future along with cybersecurity actions. The case below is a good illustration.

In the Matter of Cetera Advisors Networks, LLC, Adm. Proc. File No. 3-20490 (August 30, 2021) is a proceeding which names the registered investment advisor and broker-dealer, along with four of its affiliates that are wholly owned and controlled subsidiaries as respondents. Those firms are Cetera Advisor Networks LLC, Cetera Investment Services LLC, Cetera Financial Specialists LLC, Cetera Advisors LLC and Cetera Investment Advisers LLC. The case centers on a failure to properly implement the Safeguard Rule. That Rule has three purposes: 1) To protect the security and confidentiality of client information; 2) to protect customer information against hazards; and 3) to protect against hacks. Over a three-year period, beginning in 2017, about 60 Cetera Entities' personnel were taken over by unauthorized third parties resulting in the exposure of over four thousand customers. At the time none of the accounts had multi-factor authentication turned on, although firm policy did require it whenever possible. None of the accounts appear to have engaged in unauthorized transactions. The firm failed to properly implement the Rule. During the period Respondents had in place policies and procedures regarding certain aspects of the Rule, but they were not reasonably designed and properly implemented. The firm also had a number of tools available to it to implement controls that would mitigate higher risks. The Order alleges violations of Advisers Act Section 206(4). In resolving the matter, Respondents undertook remedial acts. They also consented to the entry of cease-and-desist orders based on the Section cited in the Order and the related Rule and to a censure. Respondents will pay a civil penalty of \$300,000. See also *In the Matter of Cambridge Investment Research*, Adm. Proc. File No. 3-20496 (August 30, 2021)(names the firm and an affiliate as respondents; also based on the Safeguard Rule on similar facts; resolved with a cease-and-desist order to same Section and Rule cited above, a censure, and the payment of a \$250,000 penalty); *In the Matter of KMS Financial Services, Inc.*, Adm. Proc. File No. 3-20495 (August 30, 2021)(action naming the firm, a registered investment advisor and broker-dealer as a Respondent; based on similar facts as the cases cited above; resolved with a consent to the entry of a cease-and-desist order based on the same sections and a censure; also a penalty in the amount of \$200,000).

Conclusion

The cases cited above provide a good overview of the work by the Enforcement Division over the last quarter. Not only were more cases brought during that quarter than in the first half of 2021, collectively they are very diverse and not concentrated in just a few

areas. Collectively, the cases also represent the dedication of the Division staff, working under difficult circumstances through the pandemic and without any permanent Director since last year.

Finally, the cases provide insight into the potential path of enforcement. For example, the increased diversity of the cases brought during the period clearly suggests that the Division is taking a broader view of areas in which to focus. Nevertheless, investment advisers and conflicts which arise in that area, continue to be key. In addition, a new settlement approach is clearly emerging in insider trading cases where the agency appears to be focusing solely on penalties and dropping claims for disgorgement. This approach may fit well with the new Division director's comments on sanctions as part of an effort to bolster confidence in the markets. And, the Safeguard rule, with its focus on privacy is a ready complement to the focus on cybersecurity that has emerged recently, suggesting areas that investment advisers, brokers and dealers as well as others should carefully review to ensure effective and fully implemented policies and procedures are in place.