Schulte Roth & Zabel

Securities Enforcement Quarterly

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New Administration / New Quarterly Update

The first quarter of 2021 marked the beginning of the Biden Administration and new leadership at the U.S. Securities and Exchange Commission. Gary Gensler's appointment as the new Chair of the SEC likely heralds an aggressive enforcement agenda comparable to his time as the Chair of the Commodity Futures Trading Commission. We expect similar appointments at the top ranks of the SEC, CFTC and Department of Justice reflecting the priorities of the Biden Administration.

This inaugural edition of Schulte Roth & Zabel's Securities Enforcement Quarterly explores recent SEC statements articulating its current priorities, including its recent focus on Environmental, Social and Governance-driven investment strategies, and certain significant charging decisions that frame the current enforcement environment. This update goes on to describe significant cases the SEC brought in the first quarter of 2021 that highlight key enforcement issues under the new administration.

Recently Announced Priorities

A. ESG Disclosures

Even prior to Chair Gensler's swearing in on April 17, 2021, the SEC had repeatedly signaled its "enhanced focus" on developing a regulatory framework for Environmental, Social and Governance ("ESG") driven investment strategies. On March 15, 2021, the SEC sought public comment on a new ESG-disclosure framework in order to put "all hands on deck" in an effort to deliver ESG information sought by investors.[1]

The SEC will closely scrutinize what private fund managers say and do with respect to ESG-driven strategies. In seeking public comment related to ESG disclosures, Acting Chair Allison Herren Lee noted that "actual portfolio management practices of investment advisers and funds should be consistent with their disclosed ESG investing processes or investment goals."[2] This message is consistent with how the SEC views any publicly touted investment strategy — making sure the disclosures are consistent with the actual practice. The SEC formed an enforcement task force on ESG and identified it as a focus area for its examinations. This will require enhanced scrutiny and regulatory risk for managers who market ESG strategies to investors and have deficiencies in related portfolio management, advertising and compliance practices.

[1] Securities and Exchange Commission, Acting Chair Allison Herren Lee, *A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC*, March 15, 2021, available here.

[2] Securities and Exchange Commission, Division of Examinations, Risk Alert, *The Division of Examinations' Review of ESG Investing*, April 9, 2021, available here.

More specifically, in an April 9, 2021 Risk Alert, the SEC Division of Examinations announced that the staff would "continue to examine firms to evaluate whether they are accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures, and practices that accord with their ESG-related disclosures."[3] The Division also offered specific examples from its observations during exams of areas where programs were deficient as well as those that were particularly effective.

Based on deficiencies and internal control weaknesses identified by the exam staff, managers should consider:

- *Portfolio Management Practices.* Are portfolio management practices consistent with the firm's ESG-related disclosures and investor-facing statements?
- *Inadequate Controls for ESG-Related Policies.* Do policies and procedures adequately provide for implementation and monitoring of investors' ESG-related directives, in particular for implementing and tracking negative screens?
- *Inconsistencies with Proxy Voting and ESG-Related Policies.* Are the firm's ESG-related proxy voting claims consistent with internal proxy voting practices? Because firms generally structure their proxy voting practices to align with the best interests of their clients, this could result in different votes on behalf of different clients if one client is pursuing an ESG-related investment strategy and another is not.
- *Unsubstantiated or Misleading Claims.* Are the firm's marketing materials and disclosure documents making unsubstantiated or misleading claims regarding ESG investing?
- *Inadequate Controls to Ensure the Consistency of ESG-Related Disclosures.* Where a firm is making ESG-related disclosures in marketing materials and investor-facing statements, what controls are in place to review disclosures and identify inconsistencies?
- *Inadequacy of Compliance Programs in Addressing ESG-Related Issues.* If a firm engages in ESG investing, are there adequate policies and procedures to address the firm's ESG investing analysis and decision-making process and to provide for compliance review and oversight? Relatedly, do compliance personnel have sufficient knowledge of, and oversight over, ESG-related disclosures and marketing decisions?

On April 12, 2021, Commissioner Hester M. Peirce issued a statement clarifying that the SEC will approach ESG-related regulation in the same manner in which it approaches other regulatory initiatives. The Commission will not, Commissioner Peirce stated, adopt the position of being a "merit regulator[]. The SEC's role is not to assess whether any particular strategy is a good one, but to ensure that investors know what they are getting when they choose a particular adviser, fund, strategy, or product."[4] Because of this, Commissioner Peirce made clear her view that firms do not need special policies and procedures specifically addressing ESG. Rather, "a firm's disclosures about its personnel should match the reality."[5]

Per Commissioner Peirce's statement, the SEC's focus on ESG is based on examining and policing existing rules and regulations. Going forward, however, the SEC appears to be exploring potential rule changes that would further impact fund managers. Accordingly, we expect to see continued activity from the SEC in the ESG space. Private fund managers currently marketing ESG-related investment strategies, or interested in pursuing such strategies, should

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[3] *Id.*

[4] Securities and Exchange Commission, Public Statement from Commissioner Hester M. Peirce, *Statement on the Staff ESG Risk Alert*, April 12, 2021, available here.

[5] *Id.*

consider whether their public-facing statements about ESG investing harmonize with their actual investment programs.

B. 2021 Examination Priorities

The SEC Division of Examinations released its 2021 Examination Priorities ("Exam Priorities") on March 3, 2021.[6] These Exam Priorities, in addition to ESG, include conflict of interest disclosures, digital assets, alternative data, structured products and the strength of advisers' compliance programs.

With respect to evaluating compliance programs, the examination staff will continue to ensure that "policies and procedures are reasonably designed, implemented, and maintained." The Exam Priorities specifically identified the following areas for compliance assessment: "portfolio management practices, custody and safekeeping of client assets, best execution, fees and expenses, business continuity plans, and valuation of client assets for consistency and appropriateness of methodology." The Division of Examinations also emphasized that it expects chief compliance officers to not only implement robust compliance programs, but also be equipped to enforce their policies and procedures.

With respect to digital assets, the Exam Priorities identified the following areas of focus: due diligence; alignment of firms' treatment of digital assets with its fiduciary duties; maintaining appropriate books and records; custody and safekeeping; disclosure related to the "technical, legal, market, and operational risks" of digital assets; and valuation methodologies.

The Exam Priorities reiterated the Division's focus on conflicts of interest, noting a particular focus on the preferential treatment of certain investors, the impact of valuation on advisory fees, cross trade disclosures, principal investments or distressed sales and conflicts surrounding fund restructurings led by investment advisors.

With regard to the use of alternative data, the Exam Priorities stated that their focus will include "whether firms are implementing appropriate controls and compliance around the creation, receipt, and use of such information."

The Exam Priorities also included a section related to private funds that hold a high concentration of structured products such as collateralized loan obligations and mortgage-backed securities. The exam staff will seek to determine whether funds holding these investments are at a "higher risk for holding non-performing loans and having loans with higher default risk than that disclosed to investors."

These Exam Priorities reflect a combination of long standing SEC priorities in addition to relatively new initiatives. We expect the SEC's enforcement actions under the new administration to reflect this mix of old and new priorities.

[6] *See* Securities and Exchange Commission, Press Release, *SEC Division of Examinations Announces 2021 Examination Priorities*, March 3, 2021, available here; *see also*, "SEC Examinations Update: 2021 Examination Priorities," *SRZ Alert,* March 4, 2021, available here.

C. Special Purpose Acquisition Companies

Throughout 2020 and into 2021, there has been exponential increase in the use of Special Purpose Acquisition Companies ("SPACs") as an alternative to more traditional initial public offering ("IPOs") and direct listings.[7] The number of SPACs going public continued to accelerate, with approximately $100 billion raised in the first quarter of 2021. However, the SPAC ecosystem is facing myriad headwinds, including increased scrutiny from regulators and the plaintiffs' bar. While we expect SPACs to remain a popular vehicle with enormous potential to reshape the way private companies enter the public markets, the importance of ensuring that SPAC deals are properly structured and that participants have adequate legal and compliance resources has never been greater.

Specifically, on April 8, 2021, John Coates, acting director of the SEC Division of Corporation Finance, issued the first of two statements signaling that the SEC intends to apply an unprecedented level of scrutiny to disclosures accompanying either the initial issuance of the SPAC securities or a follow-on transaction funded — at least in part — by a SPAC structure.[8] On April 12, 2021, Acting Director Coates and Acting Chief Accountant Paul Munter, issued a second statement questioning whether the near ubiquitous practice of treating SPAC-issued warrants as equity instruments is appropriate.[9] These SEC statements came on the coattails of a near-constant stream of investor alerts, bulletins and other warnings from the Commission that began in late 2020.

Indeed, we are already seeing an increased proliferation of civil lawsuits relating to SPACs and de-SPAC transactions and a precipitous decline in the number of new SPAC IPOs following the SEC statements as market participants work to better understand these developments.[10] For example, in *Zuod v. Lordstown Motors,*[11] plaintiffs alleged that a SPAC target company, Lordstown Motors, misled SPAC investors into approving a combination by, among other things, including fictitious pre-orders, making false claims concerning time-to-market and failing to disclose the CEO's termination for misconduct and mismanagement from the separate company developing Lordstown's electric truck. While the plaintiff's civil allegations against Lordstown have yet to be adjudicated, Lordstown disclosed during a March 17, 2021 conference call that the company had also received a request for information from the SEC.

Given the flurry of new SPACs in early 2021 and the recent comments from Acting Director Coates and Acting Chief Accountant Munter, we expect to see many more such suits filed against sponsors and directors. While the recent unprecedented interest by investors in SPACs provides enormous potential to capital market participants, the structure can present complicated conflicts and other novel issues and has become an attractive target for securities regulators and the plaintiffs' bar. Recent developments reflecting aggressive enforcement by the SEC and securities industry SROs, likely suggests that if 2020 was the "Year of the SPAC," then 2021 may well be a year of unprecedented regulatory scrutiny and private securities litigation against SPAC sponsors, targets, advisors and their affiliates.

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[7] *See also*, "SPAC Litigation Alert: SEC Cautions SPAC Participants that Claims of Reduced Liability Exposure Are Overstated," *SRZ Alert*, April 13, 2021, available here.

[8] Securities and Exchange Commission, Acting Director of Division of Corporation Finance, *SPACS, IPOs, and Liability Risk Under the Securities Laws*, April 8, 2021, available here.

[9] Securities and Exchange Commission, Office of the Chief Accountant and Division of Corporation Finance, *Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACS"),* April 12, 2021, available here.

[10] *See,* Yun Li, *SPAC Transactions Come to a Halt Amid SEC Crackdown, Cooling Retail Investor Interest*, CNBC, April 21, 2021, available here.

[11] Complaint, *Zuod v. Lordstown Motors Corp. et al*, Docket No. 4:21-cv-00720 (N.D. Ohio filed Apr. 02, 2021).

Recent Enforcement Actions

A. The Return Of Reg FD: SEC Charges AT&T with Selective Disclosure

On March 5, 2021, the SEC charged AT&T with violation of Regulation FD ("Reg FD") in connection with the selective disclosure of material nonpublic information to certain research analysts. This is a significant development for all investment professionals — as the SEC has rarely invoked Reg FD in enforcement actions since it was enacted in 2000, only bringing a handful of enforcement actions related to fair disclosure violations over the past 20 years.[12]

Reg FD prohibits issuers and certain persons acting on their behalf from disclosing material non-public information ("MNPI") to certain third parties without disclosing that same information to the general public. It was enacted in 2000 to prevent public companies from selectively sharing nonpublic earnings information to securities analysts and favored shareholders. The goal of Reg FD was to level the playing field between retail investors and large institutional investors and professionals following consistent reports that the latter group were reaping profit in advance of corporate earnings announcements.[13]

According to the SEC's complaint, AT&T experienced an unanticipated decline in smartphone sales in the first quarter of 2016. To avoid falling short of analyst consensus revenue estimates, the SEC alleged that AT&T investor relations executives called equity analysts at approximately 20 sell-side firms privately and disclosed disappointing sales data. According to the SEC's allegations, those calls were made in an effort to lower Wall Street's expectations and avoid missing a consensus revenue estimate for its third consecutive quarter.

The fact that the SEC brought a Reg FD enforcement action against AT&T in the first quarter of 2021 serves as an important reminder — investment professionals cannot and should not assume that corporate executives understand and have compliance programs in place to educate their employees and officers on Reg FD. Fund managers and broker-dealers need to take it upon themselves to have policies and procedures in place that take this specific risk into consideration every time their employees meet with corporate executives.

While investment professionals should be thoroughly trained to recognize MNPI and their responsibilities to ensure they are not using it improperly, other protective measures, such as review of meeting materials by compliance professionals, should be employed as deemed appropriate.

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[12] *See also*, "SEC Brings Rare Regulation FD Enforcement Case — Implications for Private Fund Managers and Broker-Dealers," *SRZ Alert*, March 9, 2021, available here.

[13] Final Rule: Selective Disclosure and Insider Trading, Exchange Act Rel. No. 43154, 65 Fed. Reg. 51, 721, Aug. 15, 2000, available here.

B. SEC Focuses on Foreign Bribery with Charges Against Deutsche Bank

On Jan. 8, 2021, the SEC filed an administrative proceeding action against Deutsche Bank AG ("Deutsche Bank").[14] The SEC alleged that, from at least 2009 through 2016, Deutsche Bank improperly used third-party intermediaries, business development consultants and finders (collectively "BDCs") to obtain and retain global business. Hundreds of BDCs were used during this timeframe, and their use was approved by past members of Deutsche Bank's senior management and various regional committees. Among those engaged were foreign officials, their relatives and associates in circumstances where bribery risks were neither assessed nor sufficient steps taken to mitigate bribery risks posed by such engagements.

The order alleges that Deutsche Bank lacked sufficient internal accounting controls related to the use and payment of BDCs during the relevant time period, resulting in payments to BDCs that were actually bribe payments as well as payments made for unknown, undocumented or unauthorized services. Those payments were inaccurately recorded as business expenses in Deutsche Bank's books and records, and involved the preparation of invoices and documents that the SEC alleges was falsified by Deutsche Bank employees.

The SEC also alleged that former Deutsche Bank officers were aware that these internal accounting controls were insufficient to provide reasonable assurance that payments were accurately recorded in Deutsche Bank's books and records. Deutsche Bank is alleged to have failed to take steps to address and remediate these known internal accounting control failures until 2016.

Deutsche Bank has entered into a Deferred Prosecution Agreement with the Department of Justice that acknowledges responsibility for criminal conduct relating to certain findings in the order.

While this matter has now been fully settled, it represents a significant development. The Deutsche Bank case signals that, moving forward, the SEC will be scrutinizing potential violations of the foreign bribery laws through the lens of internal controls and compliance programs. All financial services firms should ensure that their compliance programs are adequately monitoring and scrutinizing any payments to foreign third parties. Employees who are responsible for overseeing these payments should receive routine training in the laws governing foreign bribery, including the Foreign Corrupt Practices Act. Finally, employee responsible for accounting, financial reporting and internal controls should be trained to identify possible problematic payments so that these can be quickly identified, stopped and, if necessary, self-reported.

[14] *Deutsche Bank AG*, Exchange Act Release No. 90875 (SEC Jan. 8, 2021), available here.

C. Digital Asset Enforcement — SEC Roils Crypto Regulation Outlook with Suit Against Ripple Labs Inc.

On Dec. 22, 2020, the SEC filed a civil action against Ripple Labs Inc. ("Ripple"), Ripple's Chief Executive Officer, Christian Larsen and its Chief Information Officer, Bradley Garlinghouse in the U.S. District Court for the Southern District of New York.[15] The Commission alleged that the Ripple defendants had collectively raised over $1.3 billion through the unregistered public offering of the cryptocurrency XRP.

The SEC's case relies principally on its allegation that XRP is an "investment contract" under Section 2(a)(1) of the Securities Act and the definition of a security under the so-called "Howey Test" outlined by the U.S. Supreme Court in *SEC v. W.J. Howey Co.*[16] Pursuant to the Howey Test, an investment contract qualifies as a security if it represents (1) an investment in, (2) a common enterprise made with, (3) the expectation of profits (4) based on the efforts of others.

Specifically, the SEC has alleged that Ripple conflating the relationship between itself and XRP by publicly referring to XRP as "Ripple Credits," leading to investors in the crypto space to refer to the token as "Ripples." Indeed, the SEC uncovered that Ripple was advised by its own lawyers that XRP could be deemed an investment contract subject to the federal securities laws based on the way Ripple promoted and marketed XRP to potential purchasers in combination with its knowledge of those potential purchasers' motivations.

Additionally, the SEC has alleged that the Ripple defendants viewed the increased distribution and sale of XRP as a method for achieving network growth for Ripple and to raise funds for Ripple's ongoing operations. These goals were accomplished, according to the Commission, by Ripple's direct distribution of XRP to third parties as compensation and by Ripple's decision to "list" XRP on digital asset trading platforms. The SEC has alleged that, following the wide distribution of XRP, the Ripple defendants sought to control XRP's liquidity and price. Ripple allegedly sought to make investors aware of its efforts to manage the price of XRP, stating to investors that it would engage in efforts to "develop and fosters 'uses' for XRP[.]"

The Ripple defendants are aggressively contesting the case with a number of arguments contained within motions to dismiss that were filed, respectively, on April 12, 2021.[17] They contend that they never sold XRP as an investment, that XRP holders have no ownership interest in or control over Ripple Labs Inc., and that XRP holders are not entitled to any profits generated by Ripple Labs Inc. Additionally, they have argued that the XRP blockchain ledger is decentralized and is neither owned nor controlled by the defendants, that XRP functions as an alternative currency, and that the price of XRP rises and falls in correlation with the price of cryptocurrencies in general and is not dependent on actions taken Ripple Labs Inc. The Ripple defendants have also pointed to what they characterize as the Commission's inaction and lack of regulatory guidance, and have argued that the SEC should be precluded from bringing this case as a result.

[15] SEC Press Release 2020-338, *SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering*, Dec. 22, 2020, available here.

[16] 328 U.S. 293 (1946).

[17] *See SEC v. Ripple Labs, Inc*, Case No. 1:20-cv-10832-AT-SN, ECF Nos. 105-111 (S.D.N.Y. April 12, 2021).

While this litigation is ongoing and not expected to be resolved in the near future, it represents a significant development in the regulation of digital assets. An outcome in either party's favor could have a substantial impact on the way that digital assets are regulated in the U.S. The case could also lead to specific SEC guidance or legislation aimed at providing clarity to market. Any market participants involved with digital assets should consider the regulatory risks associated with their investments. Similarly, private funds should review their risk disclosures to ensure that they reflect the regulatory uncertainty regarding digital assets and the possibility that they may be considered unregistered securities.

D. SEC Tags Former Morningstar Credit Rating Unit for Alleged Undisclosed Model Adjustments

On Feb. 16, 2021, after investigating the underlying conduct for over five years, the SEC filed a civil action in U.S. District Court for the Southern District of New York against the former Morningstar Credit Ratings LLC.[18] The complaint alleges that, in 30 transactions from 2015-2016, totaling approximately $30 billion, Morningstar analysts made undisclosed adjustments to its model for rating commercial mortgage-backed securities ("CMBS") and failed to implement and maintain appropriate controls to monitor these adjustment processes used in its ratings model.

According to the complaint, Morningstar analysts adjusted issuer ratings to reduce CMBS stresses, which had the impact of favorably improving credit ratings for issuers that had hired Morningstar. The alleged undisclosed adjustments to its model benefited issuers by reducing interest rates on credit for their CMBS. The SEC has alleged that these adjustments were at odds with Morningstar's publicly touted methodology, which claimed that it focused on loan-specific, bottom-up quantitative analysis of loans and corresponding properties, and each loan's net cash flow and capitalization rate from its underwriting process.

The SEC has additionally alleged that Morningstar, at times, used this ratings model on a firm-wide portfolio basis that covered 100 loans in its CMBS portfolio, which the SEC charges was inconsient with Morningstar's claim that the adjustments were "loan specific."

The SEC's complaint, which the defendant is contesting, charges Morningstar with violating Sections 15E(b)(2)(A) and 15E(c)(3)(A), and Rules 17g-1(f) and 17g-7(a)(1)(ii)(B) of the Securities Exchange Act of 1934, which are disclosure and internal control provisions applicable to credit rating agencies. The SEC seeks injunctive relief, disgorgement plus prejudgment interest, and civil penalties.

Interestingly, according to Morningstar's Motion to Dismiss filed on April 19, 2021, the SEC's allegations were made after the SEC abandoned the initial legal theory that served as the basis for its Wells notice issued to Morningstar. According to Morningstar, upon realizing the flaws in its initial theory as to why the analyst adjustments at issue did not constitute violations, the SEC filed the existing complaint without providing Morningstar an updated Wells notice based on the SEC's new legal theory.[19] In the more aggressive enforcement environment expected under Chair Gensler, this potential change in approach merits watching.

[18] SEC Litigation Release No. 25030, *SEC Charges Ratings Agency with Disclosure and Internal Controls Failures Relating to Undisclosed Model Adjustments*, Feb. 17, 2021, available here.

[19] *SEC v. Morningstar Credit Ratings, LLC*, Case No. 1:21-cv-01359-RA, ECF No. 21 at 1, S.D.N.Y., April 19, 2021.

Investment Adviser Enforcement Actions

A. Failed Policies and Procedures: *In re Advanced Practice Advisors, LLC et al.*; *SEC v. Sztrom et al.*; *SEC v. Glick*

A recent set of SEC enforcement actions is demonstrative of the Commission's view that compliance failures can lead to organization-wide fraud. On Jan. 14 and 15, 2021, the SEC filed a series of actions relating to deceptive and fraudulent activities by Advanced Practice Advisors, LLC ("APA") and a number of its associates.

In re Advanced Practice Advisors, LLC et al. First, on Jan. 14, 2021, in a settled administrative proceeding action brought against APA and its founder and Chief Executive Officer, Paul C. Spitzer, the SEC alleged that APA and Spitzer failed to make certain disclosures which allowed advisory clients to be deceived by an APA investment adviser representative, David Sztrom, and that APA and Spitzer failed reasonably to supervise David Sztrom.[20] Specifically, David Sztrom allegedly deceived advisory clients by allowing his father, Michael Sztrom, through Sztrom Wealth Management Inc. to advise APA clients even though Michael Sztrom was not formally associated with APA. APA and Spitzer allegedly knew that David Sztrom had no real experience, no clients of his own, and that Michael Sztrom, who had previously worked as an investment adviser representative at another firm, wanted to continue advising his clients and shared an office with his son. The SEC charged that Spitzer, and therefore APA, knew or should have known that Michael Sztrom was advising APA clients under the guise of his inexperienced son's association with APA. APA and Spitzer failed to disclose to advisory clients that Michael Sztrom was not formally associated with APA. Additionally, the SEC charged that APA failed to implement certain compliance policies and procedures, including those designed to prevent clients from being misled. APA has withdrawn its registration as an investment adviser with both the SEC and with the state of California.

Upon its filing, this administrative proceeding was fully settled by APA and Spitzer. APA was censured by the SEC and both APA and Spitzer were ordered to cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder. The SEC ordered Spitzer to pay a civil money penalty in the amount of $20,000, and barred him from acting in a supervisory capacity with any broker, dealer or investment adviser (among other market participants). Finally, APA and Spitzer were ordered to comply with certain undertakings provided in the order, including cooperation with the SEC's ongoing investigation and supplemental compliance training by Spitzer.

SEC v. Sztrom et al. On Jan. 15, 2021, the SEC also filed a contested action in the U.S. District Court for the Southern District of California against Michael Sztrom, David Sztrom, and Sztrom Wealth Management Inc. ("SWM") for their activities related to APA.[21] The complaint alleges that, from November 2015 through March 2018, David and Michael Sztrom provided investment advice to clients of APA through SWM. As alleged, David and Michael Sztrom participated in concealing from APA clients that Michael Sztrom was not associated with APA or any registered investment adviser and was not subject to compliance oversight by APA or any other firm. David Sztrom is charged with failing to disclose that his father was not affiliated with APA while allowing Michael Sztrom to use APA's clearing broker for client transactions. According to the SEC, the defendants breached their fiduciary duties to their

[20] *Advanced Practice Advisors et al.*, Investment Advisers Act Release No. 5670, SEC, Jan. 14, 2021, available here.

[21] SEC Litigation Release No. 25010, *SEC Charges Father and Son Investment Advisers with Fraud*, Jan. 19, 2021, available here.

clients through a variety of deceptive activities, including Michael Sztrom impersonating David Sztrom on telephone calls with the APA's clearing broker, and accessing confidential information of APA's clients.

The SEC's complaint, which the defendants are contesting, charges Michael Sztrom, David Sztrom and SWM with violating the antifraud provisions of Sections 206(1) and (2) of the Investment Advisers Act of 1940. The complaint further charges Davis Sztrom with aiding and abetting APA's books and records violations of Section 204(a) of the Advisers Act and Rule 204-2(a)(7) thereunder. The SEC seeks permanent injunctions and civil money penalties against all defendants.

SEC v. Glick. Finally, on Jan. 15, 2021, the SEC filed yet another APA-related action in the U.S. District Court for the District of Arizona against Jacob C. Glick.[22] As with the SEC's allegations against the Sztrom defendants, this case is being contested by Glick. The SEC's complaint alleges that from mid-2016 through mid-2018, Glick defrauded his advisory clients in three different ways. First, Glick allegedly placed the majority of his clients, many of whom had moderate or conservative risk tolerances, in unsuitably risky investments that resulted in substantial losses, and failed to disclose the risks involved in these investments to clients. Second, the SEC alleges that Glick defrauded two advisory clients by representing that he would use their money for a real estate investment, while instead misappropriating his clients' money and using it for his own options trading and to pay the clients purported interest payments on their investment. Third, the SEC alleges that, following his termination by APA in June 2017, Glick misappropriated $355,000 from an elderly widow who was a longtime advisory client and used those funds for his personal benefit, including paying his credit card bills and reimbursing other defrauded clients.

The SEC's complaint, which the defendant is contesting, charges Glick with violating the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940. The complaint further charges Glick with aiding and abetting APA's books and records violations under Section 204(a) of the Advisers Act and Rule 204-2(a)(7) thereunder. The SEC seeks permanent injunctions, disgorgement and civil penalties against Glick.

B. Inflated Assets: *In re Daniel Investment Associates, LLC et al.*

In a recent enforcement action, the SEC settled charges related to the negligent failure to disclose adverse financial information related to an investment. On Jan. 29, 2021, the SEC filed a settled administrative proceeding against registered investment adviser Daniel Investment Associates, LLC ("DIA") and its principal Gregory D. Van Wyk.[23] The order alleges that DIA and Van Wyk negligently failed to disclose material information regarding promissory notes issued by Essex Capital Corporation ("Essex Capital") and its principal, Ralph Ianelli. The order alleges that in early 2018, DIA and Van Wyk negligently withheld material adverse financial information about Essex Capital from trustees who had inherited responsibility for an investment account and who were evaluating whether to maintain an investment in $1.25 million worth of Essex Capital promissory notes. During meetings with the trustees, Van Wyk recommended that the trustees remain invested in the Essex Capital promissory notes while withholding adverse information in his possession about Essex Capital, negligently misleading the trustees about the reliability of the investment in the notes. The trustees did not learn of Essex Capital's financial problems until the SEC brought an

[22] SEC Litigation Release No. 25011, *SEC Charges Former Investment Adviser for Making Unsuitable Investments, Misleading Clients, and Misappropriating Client Funds*, Jan. 19, 2021, available here.

[23] *Daniel Investment Associates, LLC et al.*, Investment Advisers Act Release No. 5675, SEC, Jan. 29, 2021, at here.

action against Essex Capital for operating an offering fraud. As a result of Essex Capital's fraud, the trustees may be unable to recover the full $1.25-million principal amount of the notes.

In settling this matter, DIA and Van Wyk agreed to be censured and to cease and desist from committing or causing any violations and future violations of Section 206(2) of the Advisers Act. The SEC also ordered DIA to pay a nominal amount of disgorgement and prejudgment interest, and ordered Van Wyk to pay a civil money penalty of $75,000.

C. Misrepresentations: *SEC v. GPB Capital Holdings, et al.*

The SEC has continued to pursue charges wherever it uncovers falsified financial information, and in a case brought in the first quarter of 2021 focused on the fact that an investment adviser had sought to silence potential whistleblowers. On Feb. 4, 2021, the SEC filed a contested civil action in the U.S. District Court for the Eastern District of New York against GPB Capital Holdings, LLC, Ascendant Capital, LLC, Ascendant Alternative Strategies, LLC (AAS), David Gentile, Jeffry Schneider, and Jeffrey Lash for conducting a Ponzi scheme that included the issuance of over $1.7 billion in securities through an asset management firm and registered investment adviser that they owned and controlled.[24]

The SEC's complaint describes a fraudulent scheme perpetrated by Gentile and Schneider, and aided and abetted by Lash, through GPB Capital, a registered investment adviser, and AAS, a registered broker-dealer and its branch office Ascendant Capital, which were owned and managed by Gentile and Schneider respectively. According to the complaint, the defendants falsely touted the success of GPB as an alternative asset management firm and the limited partnership funds that it managed, and based on these misrepresentations raised in excess of $1.7 billion from over 17,000 retail investors nationwide since 2013. The complaint alleges that defendants misrepresented the viability and profitability of the funds, manipulated the funds financial statements, and misrepresented the fees and other compensation paid to Gentile, Schneider and Ascendant Capital. Defendants concealed the fraud by failing to deliver audited financial statements to investors for over four years and failed to properly register two of the funds with the SEC. According to the complaint, GPB Capital suspended all investors redemptions in 2018, and its assets are well below its obligations to its investors. Finally, GPB Capital included language in agreements with former employees that limited their ability to communicate with the SEC in violation of its whistleblower statute, and GPB (through its officers and directors) retaliated against a former employee that it knew to be an SEC whistleblower.

The SEC's complaint, which the defendants are contesting, charges Gentile, Schneider, GPB Capital, AAS and Ascendant Capital with violating the antifraud provisions of Section 17(a) the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and charges Lash with aiding and abetting certain of those violations. The complaint also charges GPB Capital with violating the antifraud provisions of Sections 206(1), 206(2) and 206(4) of the Investment Advisers Act of 1940 and Rules 206(4)-2 and 206(4)-7 thereunder, and violating the registration and anti-retaliation provisions of Sections 12(g) and 21F of the Exchange Act and Rule 21F-17(a) thereunder. Finally, the complaint charges Gentile with violating the antifraud provisions of Sections 206(1) and 206(2) of the Advisers Act. From each of the defendants, the complaint seeks an injunction, disgorgement of ill-gotten gains plus prejudgment interest and penalties.

[24] SEC Press Release 2021-24, *SEC Charges Investment Adviser and Others With Defrauding Over 17,000 Retail Investors*, Feb. 4, 2021, available here.

D. Unregistered Advisor/Offering Fraud: *SEC v. Moleski, et al.*

On Feb. 5, 2021, the SEC filed a contested civil action in the U.S. District Court for the Central District of California against Stephen Scott Moleski (a/k/a Steve Scott), David Michael and Erik Michael Jones for fraud in connection with an investment adviser and private fund enterprise that they managed.[25]

Among other things, defendants Moleski and Michael are alleged to have acted as unregistered investment advisers for three private investment funds that they had created, and offered and sold investments in such funds to unsuspecting investors. As alleged in the complaint, very few of the assets were invested; instead defendants Moleski and Michael allegedly misappropriated the money and used it to pay personal and business expenses, including sales commissions to agents such as defendant Jones. The complaint also alleges that the defendants defrauded investors by soliciting money in the purchase of unregistered securities in unaffiliated companies. Defendants, who were not registered as brokers or dealers, paid themselves approximately 30% of the funds obtained for the purchase of securities in the form of commissions.

The SEC's complaint, which the defendants are contesting, charges Moleski and Michael with violating the antifraud provisions of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 and 206(4)-8 thereunder. The complaint also charges Moleski, Michael and Jones with violating the registration provisions of Sections 5(a) and 5(c) of the Securities Act and the broker-dealer registration provisions of Section 15(a)(1) of the Securities Exchange Act. The SEC seeks permanent injunctions, disgorgement plus prejudgment interest and civil penalties against all defendants, and also seeks disgorgement plus prejudgment interest from certain named relief defendants.

E. Theft of Assets: *SEC v. Goodman*

The SEC continues to coordinate with the Department of Justice in charging criminal acts of fraud and asset theft. On Feb. 8, 2021, the SEC filed a contested civil action in the U.S. District Court for the District of Minnesota against Isaiah L. Goodman for having defrauded his investment advisory clients and having stolen $2.25 million.[26] Doing business through Becoming Financial Advisory Services, LLC, Goodman falsely represented to these clients that he would invest their retirement and investment accounts in mutual funds and individual securities. Instead, Goodman allegedly misappropriated his clients' money for his personal and business expenses. Goodman is alleged to have furthered the fraud by providing his clients with fake account statements and computer screenshots purporting to show that their funds were appropriately invested and their accounts had appreciated in value, and by using the assets of certain clients to replace money stolen from other client accounts.

The SEC's complaint, which the defendant is contesting, charges Goodman with violating the antifraud provisions of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, and seeks injunctive relief, disgorgement with pre-judgment interest, and civil penalties. In conjunction with the filing of the SEC's civil action, the U.S. Attorney's Office for the District of Minnesota filed criminal charges against Goodman on the same day.

[25] SEC Litigation Release No. 25025, *SEC Files Fraud and Other Charges in Connection with a Fraudulent Investment Adviser and Private Fund Enterprise*, Feb. 5, 2021, available here.

[26] SEC Litigation Release No. 25026, *SEC Charges Former Minneapolis-Area Investment Adviser with Fraud for Misappropriating Client Funds*, Feb. 9, 2021, available here.

F. Fictitious Performance: *SEC v. Heckler*

The first quarter of 2021 saw the SEC pursue charges in relation to a Ponzi-like scheme designed to disguise losses from investors. On March 9, 2021, the SEC filed a partially settled civil action in the U.S. District Court for the District of New Jersey against George Heckler for conducting a long-running investment adviser fraud through two private hedge funds that Heckler used to conceal losses incurred by a previously established private fund that he controlled.[27] The complaint alleges that Heckler, the manager of a private fund that had suffered massive losses, created two new funds into which he transferred the first fund's poorly performing assets and then misrepresented the new funds' objectives and performance to those funds' investors. Between 2009 and 2019, Heckler raised at least $90 million for the new funds by falsely telling investors that the new funds were generating positive returns through very short-term equity trading, when in fact he was misappropriating their funds to prop up the failing fund, making over $32 million in Ponzi-like payments to prior investors.

The SEC's complaint charged Heckler with violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1), 206(2), 206(4) and Rule 206(4)-8 of the Investment Advisers Act of 1940. In coordination with the filing of the SEC's civil action, the U.S. Attorney's Office for the District of New Jersey filed criminal charges against Heckler on the same day, to which Heckler has pled guilty. Accordingly, Heckler has agreed to a partial settlement of the SEC's civil action in which he consented to the entry of an injunction prohibiting future violations and barring him from the securities industry. The SEC's claims for disgorgement of ill-gotten gains and a civil monetary penalty will be separately adjudicated.

G. Offering Fraud: *SEC v. Haarman et al.*

Investment Advisers must take care when describing their own industry-specific experience and the risk profile of certain investments — the SEC carefully scrutinizes such representations for accuracy. On March 11, 2021, the SEC filed a contested civil action in the U.S. District Court for the Western District of Texas against a Texas-based investment adviser, APEG Energy GP, LLC, and its owners Paul W. Haarman and Patrick E. Duke, for fraudulently raising $17 million for an oil-and-gas investment fund.[28]

The complaint alleges that Haarman and Duke lured investors to buy limited partnership interests in their fund by making numerous false and misleading statements concerning the risks of investing in the fund, management fees, their experience in the oil and gas industry and the measures in place to prevent losses. Defendants Haarman and Duke allegedly also took nearly $2.7 million in the form of purported "acquisition fees" linked to asset purchases for the fund, which were not disclosed to investors and violated the funds' governing documents and the managers' fiduciary duties.

The SEC's complaint, which the defendants are contesting, charges Haarman, Duke and APEG Energy GP with violating the antifraud provisions of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Investment Advisers Act of

[27] SEC Litigation Release No. 25047, *SEC Charges Unregistered Investment Adviser with Misleading Investors in Decade-Long Fraud*, March 11, 2021, available here.

[28] SEC Litigation Release No. 25051, *SEC Charges Texas Investment Adviser and Two Executives in Connection with $17 Million Energy Fund Fraud*, March 12, 2021, available here.

1940. The SEC seeks permanent injunctions against the named individuals from violating the federal securities laws, disgorgement of ill-gotten gains with prejudgment interest and civil penalties against each defendant.

Closing Thoughts

Throughout early 2021, the SEC's new leadership has strongly signaled that what was old is now new. The SEC has put all regulated firms on notice with its Reg FD and FCPA-related enforcement actions and has continued its standard practice of aggressively charging investment adviser fraud wherever it is uncovered. We anticipate that the SEC will continue scrutinizing market participants to ensure the existence of robust regulatory controls and compliance programs, and will blend that focus with newer priorities such as ESG. Firms would be well served to continue investing in their compliance function and to facilitate ongoing dialogue between their investment and legal teams as the new administration continues to define its enforcement priorities in this space going forward.

About Schulte Roth & Zabel

SRZ's Securities Enforcement Group represents public and private companies, financial institutions, broker-dealers, private funds and their senior executives in securities-related enforcement proceedings and government investigations involving the full range of federal and state law enforcement and regulatory authorities. With numerous former federal prosecutors from U.S. Attorneys' offices, including chiefs of the Appeals and Major Crimes Units, and former U.S. Securities and Exchange Commission officials, our deep bench of lawyers offers guidance on matters ranging from informal inquiries and formal or grand jury investigations to administrative proceedings and cases brought in federal and state courts.

SRZ lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the SRZ lawyer with whom you usually work, the authors or any of the following members of the Securities Enforcement practice group:

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