

ACA Insight

The weekly news source for investment management legal and compliance professionals

“If they can muster a proposal by the second quarter, that would be quick work indeed.”

SEC May Propose Its Own Fiduciary Rule by Second Quarter

It's an ambitious target, but the SEC is reportedly planning to propose a Fiduciary Rule that would cover all brokers – not just those selling retirement accounts – by the second quarter of this year. That could mean that there will be a proposed rule in about 10 weeks, but it could also mean in about five months, depending on whether “by the second quarter” means the beginning or the end of that quarter.

Whichever interpretation proves to be correct, it would appear that the SEC is indeed [continued on page 2](#)

SEC Charges Gatekeepers in Federal Court with Aiding and Abetting Fraud

Don't expect the crackdown on “gatekeepers” – attorneys, accountants, consultants and other third parties that work with advisory firms – to let up any time soon, even with a new SEC chairman at the helm. The agency recently filed charges in U.S. District Court against an attorney and an accountant for allowing, if not enabling, an adviser's alleged misappropriation of more than \$9 million from a charitable foundation.

The SEC on December 22 filed a complaint¹ in U.S. District Court for the Southern District of New York against attorney **Robert Gaughran** and accountant **Kevin Clune**. [continued on page 3](#)

Multiple and Repeated Compliance Problems Likely to Draw SEC Action

Compliance is more than simply taking steps to satisfy regulators. If followed in spirit, with an eye toward ethics, compliance should be part of a culture where advisory firms do the right thing simply because it is right. In doing so, they will probably find that they are more likely to satisfy SEC requirements and thereby head off potential enforcement actions.

Advisers should consider their own culture of compliance in the wake of a January 3 SEC settlement² with an advisory firm, Phoenix-based **LKL Investment Counsel** and **Mark Love**, its president and CCO. Among other things, the settlement resolved [continued on page 6](#)

SEC May Propose

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accelerating its work on an agency Fiduciary Rule, as reported by the *Wall Street Journal* January 10. While a broad-based rule that affects all brokers might resolve some of the concerns about the existing Department of Labor Fiduciary Rule, it raises some new questions, as well.

The SEC's work would also possibly include a ban on brokers calling themselves "financial advisers" unless they first accept a strict duty of loyalty to clients, the *Journal* said.

SEC chairman **Jay Clayton** has, since taking office, said that producing a Fiduciary Rule is a priority. The agency also recently included it in its near-term agenda list of planned priorities for 2018 (*ACA Insight*, 1/1/18⁶). The SEC declined to comment on whether it plans to propose a rule by the second quarter.

"You have two new commissioners, Clayton is still relatively new, there is a new assistant secretary of labor who will be directly involved, the SEC is still reviewing responses from a call for comments, plus it will need regular communication with both the DOL and the states."

"We're also hearing that the SEC is looking to propose a rule in the first half of the year," said **Investment Adviser Association** president and chief executive officer **Karen Barr**, adding that expecting it by the beginning of the second quarter might not be realistic. The IAA has long been concerned about brokers holding themselves out as fiduciaries, including by using the term "financial adviser." As currently used, Barr said, the term muddies the distinction between true investment advisers – who are fiduciaries – and other financial professionals who are not.

The IAA's official position on an SEC fiduciary action is that it wants the agency to keep its existing fiduciary standard for advisers, while creating a separate, "equally robust" standard for brokers, she said (*ACA Insight*, 9/18/17⁶).

"If they can muster a proposal by the second quarter, that would be quick work indeed," said **Willkie Farr** partner and former SEC deputy chief of staff **James Burns**. "The complexity surrounding the issue hasn't really subsided in the years since Dodd-Frank advanced the issue front and center. In the meantime, various constituencies have sharpened their arguments – and there is the overlay of the DOL Fiduciary Rule that adds complexity to the substance as well as the economic analysis. Finally, the Commission itself will be adding two new members to its number and we have yet to see what they will insist should be included in such a proposal merely to allow it to leave the exit terminal."

"All that said," he added, "the issue is ripe – overdue in fact – for progress. It would be a great accomplishment and testament to the chairman, commissioners and SEC staff if they can successfully advance the ball this year."

There remains some skepticism about whether a proposed rule could be issued even within the first half of the year. "Any notion of the first half of the year may be somewhat ambitious," said **Stradley Ronon** counsel **George Michael Gerstein**. "You have two new commissioners, Clayton is still relatively new, there is a new assistant secretary of labor who will be directly involved, the SEC is still reviewing responses from a call for comments, plus it will need regular communication with both the DOL and the states."

The states, in fact, are the new concern, Gerstein said. Nevada, New York, New Jersey and others, he said, are currently considering laws and/or regulations that address some aspect of fiduciary duty for brokers, and they will need to be at the table with the SEC and the DOL. "There's a triangulation of regulations among these three which has created a very dynamic situation. The states are going to have to be part of the discussion. The last thing anyone wants is for there to be a patchwork of regulations. "

That said, Clayton and DOL secretary **Alexander Acosta** appear to be moving in the same direction, with both commenting in recent months that they want the SEC and the DOL to cooperate in resolving the situation (*ACA Insight*, 10/2/17⁶).

How it will all work out, and how long it will take, even once the SEC issues its proposal, remains to be seen. One possibility, Gerstein said, is that the SEC might issue a uniform standard that effectively contains most, if not all, of the conditions of a related DOL prohibited transaction exemption, which would mean that satisfaction of one could help satisfy the other.

While the existing DOL Rule is in effect, the DOL is currently not enforcing certain key exemptions, such as the Best Interest Contract Exemption, that are tied to it, and won't until July 2019. That might allow the SEC time to issue its own proposal and work with the DOL and the states to resolve the entire matter.

Unless, of course, as has proved the case, resolving the matter requires still more time. ☞

SEC Charges Gatekeepers

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The complaint argues that the two gatekeepers aided and abetted New York City-based investment adviser **Train, Babcock Advisors** (TBA) and its former principal, **John Rogicki**, in their alleged theft against the foundation.

"While serving as a trustee of the foundation, Gaughran allegedly accepted outsized fees and ignored glaring signs of Rogicki's theft that were apparent from the foundation's brokerage statements and other documents that he regularly reviewed," the SEC said in a statement. "Gaughran also drafted the trust and estate papers that put Rogicki in charge of the charitable foundation and knew the size of the estate that should have flowed to the charitable foundation, but for Rogicki's misappropriation of \$9 million of its assets."

As for Clune, who performed tax work for both the estate that created the foundation and for the foundation itself, he "ignored multiple and repeated red flags

revealing Rogicki's and TBA's fraudulent scheme," the agency said.

In addition, the SEC said, "both Gaughran and Clune were actively involved in concealing the theft by providing false information to an outside audit firm during a surprise examination of the charitable foundation that was conducted in 2014."

"If you accept the allegations in the complaint, the gatekeepers were doing far more than just providing one-off advice to the bad actors," said **Faegre Baker Daniels** partner **Jeffrey Blumberg**. "They were allegedly deeply entrenched in the situation and actively assisted in misleading other gatekeepers (like the outside audit firm) in connection with the fraudulent scheme. As a gatekeeper myself, these cases are a reminder to me that I cannot turn a blind eye to issues that present themselves when assisting my clients."

That the attorney and the accountant were allegedly participating in the fraud, rather than simply being negligent in not calling it out, is a distinction that needs to be made, said **Shearman & Sterling** partner **Jay Baris**. "The fact that they were gatekeepers is secondary to their participation in the alleged fraud."

"The complaint is a clear sign that, where lapses are viewed as sufficiently egregious, the SEC will continue to pursue gatekeepers who allow investment advisers to commit fraud under their watch," said **Shearman & Sterling** partner **Mark Lanpher**.

Violations and what's next

In its complaint to the court, the agency charged both Gaughran and Clune with aiding and abetting Rogicki's and TBA's violations of Advisers Act Sections 206(1) and (2), both of which prohibit fraud; and Exchange Act Section 10(b) and its Rule 10b-5(a) and (c), which also prohibit fraud.

The SEC asks the court to permanently restrain and enjoin Gaughran and Clune from future violations, order them to disgorge all ill-gotten gains from the alleged violations, and pay civil money penalties. The defendants demanded a jury trial, and, barring a settlement between the parties, it may be months before a

judgment is reached. Clune, when reached, chose not to comment.

An attorney for Gaughran said that his client cares deeply about the foundation in question and its philanthropic mission. “He too was a victim of Rogicki’s criminal fraud on the foundation and its trustees,” the attorney said. “Gaughran certainly did not ‘aid and abet’ Rogicki’s fraud and he never would. The SEC’s allegations will be vigorously defended.”

Advisory firm consequences

TBA separately reached its own settlement with the SEC on the same day that the agency’s complaint against the gatekeepers was filed. As a result of that settlement, the firm was censured, ordered to pay a civil money penalty of approximately \$1.34 million, and disgorgement and prejudgment interest of approximately \$365,000.

“The complaint is a clear sign that, where lapses are viewed as sufficiently egregious, the SEC will continue to pursue gatekeepers who allow investment advisers to commit fraud under their watch.”

That’s just from the advisory firm’s administrative settlement with the agency. In October 2017, in response to criminal charges brought against him by the Manhattan District Attorney, Rogicki pleaded guilty and, in December, was sentenced to serve 30 to 90 months in prison and ordered to pay approximately \$6.73 million to the foundation, of which he forfeited \$2.5 million with his criminal plea, the SEC said. The agency also filed a civil injunctive action against Rogicki in October.

TBA, according to the administrative order, is in the process of “selling its assets and winding down any remaining business.” The firm, which had registered with the SEC as an investment adviser in 1975, managed more than \$100 million in assets, it said.

In a statement issued after the settlement was reached, an attorney representing TBA noted that TBA had conducted an internal review of Rogicki’s client accounts. “During the course of this review, serious discrepancies were identified in one account. Train Babcock immediately engaged professional advice and further investigated the account. Additionally, the SEC was promptly informed of the matter. Throughout the past year, TBA has fully cooperated with law enforcement and regulatory authorities, including the SEC, in the investigation of this matter.”

Rogicki, “in addition to his gross personal misconduct and criminal activity,” the attorney said, “betrayed the trust and confidence of everyone at Train Babcock. His scheme, with the alleged assistance of two other non-Train Babcock persons, a second co-trustee and a certified public accountant, was an abhorrent abuse of his fiduciary responsibility to the Foundation as well as to the company.”

“Mr. Rogicki has accepted full responsibility for his actions,” said an attorney with the law firm representing him. “We think this is a sensible resolution of the matter and serves the interests of justice.”

The underlying case

TBA provided advisory services to individuals, investment companies, pension and profit sharing plans and business entities, as well as to accounts of charitable organizations, trusts and estates, the SEC said. For these latter services, a TBA employee would take part in an arrangement in which he or she would serve as a trustee of these client accounts.

The non-profit charitable foundation involved in this case was established in 1991 by “a wealthy elderly woman” who later died. She is identified by the SEC in its court complaint and administrative order only as “Decedent Z.”

“Rogicki, who had befriended Decedent Z near the end of her life, served as the president and a trustee of the foundation,” the agency said. “Gaughran, Decedent Z’s lawyer before her death, served as the secretary and a trustee of the foundation,” which Decedent Z funded

during her lifetime and to which she left the remainder of what the SEC called her “sizable” estate. She also named Rogicki as the estate’s executor.

After Decedent Z died in 2001, Rogicki and Gaughran named TBA as the foundation’s investment adviser, “with the understanding that Rogicki would be the individual at TBA responsible for overseeing the account.”

What happened, unfortunately, was that “in this fiduciary role, Rogicki funneled money to himself that had been intended for the foundation to distribute to charities,” the SEC said. The agency said that this “scheme” had three parts. Specifically, it said, Rogicki:

1. Liquidated positions in the foundation’s TBA advisory account,
2. Wired the cash proceeds from the foundation’s account to a bank account set up for the Decedent Z estate, and
3. Transferred those funds from the Z estate to his own personal bank account.

“Between 2008 and 2016, more than 150 of these improper transfers – in amounts ranging from \$15,000 to \$385,000 – were made from the foundation’s TBA advisory account to Decedent Z’s estate account,” the SEC said. “From approximately 2004 through April 2016, Rogicki misappropriated more than \$9 million from the TAB advisory client account of the foundation.”

The attorney’s role

The court complaint notes that Gaughran became Decedent Z’s estate counsel when she was 95, drafted the documents appointing Rogicki as a trustee of her trust and as executor of her estate, served in a fiduciary role as a director and one of the trustees of the foundation since 2001, and at times performed legal work for the foundation.

“In his positions as counsel for the Z estate and a trustee for the foundation, Gaughran knew or was reckless in not knowing that significantly less money was in the foundation account than should have been there and that Rogicki was misappropriating assets,” the SEC said. “Despite knowing about these red flags that

either must have or should have alerted him to Rogicki’s and TBA’s misappropriation, Gaughran made no effort to stop it. By failing to take any affirmative steps to stop Rogicki’s and TBA’s misappropriation, Gaughran allowed the fraud to continue.”

The agency’s complaint points out that the foundation’s monthly brokerage account statements “showed consistently large withdrawals every month throughout the year,” and that the portfolio appraisals “also showed large amounts being withdrawn from the account prior to year-end – in other words, at times where no charitable disbursements or other significant foundation payments should have been made.”

In addition, the SEC said, when the year-end brokerage account statements and portfolio appraisals were compared to the foundation’s annual tax forms, it was “clear that an excessive amount of money was being withdrawn. . . It should have been an immediate red flag to Gaughran that the total amount of withdrawals reflected in the year-end brokerage account statements far exceeded that shown in the tax forms.”

The agency alleged that Gaughran also provided a “fabricated number” to the foundation’s outside auditor that “significantly understated the foundation’s outlays” when he was specifically asked to obtain and certify the withdrawal figures in connection with a 2014 surprise examination by TBA of the foundation.

Assuming that what the SEC charges are true, why did Gaughran take these actions? He “had incentive to ignore all of these red flags, mislead the auditor, and allow Rogicki’s and TBA’s misappropriation to continue,” the agency said. Specifically, according to the complaint, Gaughran “received exorbitant compensation each year from the foundation. In his capacity as a trustee, Gaughran collected more than \$90,000 annually for his limited work on behalf of the foundation. In addition, Gaughran was paid in certain years as the foundation’s counsel, at times for doing exactly the same work that he performed as a trustee.”

The accountant’s role

Clune, who served as the tax accountant for both the foundation and the Decedent Z estate, “knew how much

money was in the estate on at least a year-end basis, and how much money should have gone to the foundation,” the SEC said. “Clune also received the brokerage account statements for the foundation, which made the misappropriation scheme immediately apparent.”

Beyond not taking action on red flags, the SEC alleged that Clune “directly contributed to the misleading withdrawal figures that were provided to TBA and the auditor in connection with the surprise examination.” He did so by providing Gaughran with the number that did not include Rogicki’s and TAB’s misappropriations, “thus understating the foundations actual outlays by roughly \$800,000,” according to the complaint.

Clune’s incentive in this matter, the agency argued, was that Rogicki and the foundation were his solo practice’s primary source of income for many years. “Clune also inflated the number of hours worked on his annual invoice to the foundation to ensure that he continued receiving these exorbitant fees,” the SEC said. “Total payments from the foundation and Decedent Z’s estate alone earned Clune more than \$500,000. And through Rogicki’s introduction to TBA, Clune came to serve as the tax accountant to 12 TBA clients.”

Multiple and Repeated

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agency allegations that the firm made multiple misrepresentations on its Forms ADV, failed to produce documents requested by agency examiners, and failed to have written policies and procedures in place regarding how advisory fees would be charged.

These actions, the SEC said in its administrative order instituting the settlement, were in relation to Love’s recommendations to certain LKL clients that they invest in private funds in which he held managerial interests and would receive fees and a share of investment profits. Although the agency said that the clients who invested knew of Love’s involvement with the funds, it alleged that LKL nonetheless stated on its Forms ADV that he had “no outside financial industry activities or affiliations, and no interests in client transactions.”

“Every adviser must carefully understand the nature

of its own business and its disclosure requirements or face the possibility of being sanctioned severely,” said **Scarinci Hollenbeck** partner **Paul Lieberman**.

“These violations were accompanied by compliance breakdowns – LKL did not conduct requisite annual reviews and failed to implement its policies requiring full disclosure of Love’s outside activities in LKL’s Forms ADV,” the SEC said. “Moreover, LKL failed to adopt policies related to advisory fees and made errors in charging and refunding advisory fees totaling approximately \$8,500.”

“The SEC’s Enforcement staff recently indicated that it plans to pursue more message cases in its effort to regulate the financial industry. The LKL matter appears to be such a case,” said **Paul Hastings** partner **John Nowak**. “It should serve as a reminder to advisers of the SEC’s expectation during the examination process that the examination staff’s requests should be met with complete and candid responses. Moreover, it should be used to remind advisers to involve counsel directly or indirectly during the examination process on the more sensitive issues.”

The settlement

As part of the settlement, Love was barred from engaging in a compliance capacity for the indefinite future. LKL was charged with, among other things, willfully violating Advisers Act Sections 204(a) and its Rule 204-3, which require advisers to deliver to clients within 120 days of the end of their fiscal year either a current Form ADV, Part 2A brochure or summary of material changes to the brochure; Section 206(4) and its Rule 206(4)-7, the Compliance Program Rule, for failing to adopt and implement reasonable written compliance policies and procedures; and Section 207, for making untrue statements of material fact in any registration application or reports filed with the Commission. The firm was censured and ordered to pay a civil money penalty of \$100,000. It withdrew its registration with the agency as an adviser in July 2017.

Love was also charged with willfully violating Section 207, as well as willfully aiding, abetting and causing LKL’s other violations. He was barred from acting in a

compliance capacity for the indefinite future. He was censured and ordered to pay a civil money penalty of \$50,000. Attorneys representing LKL and Love did not respond to an email or voice mail seeking comment.

Form ADV problems

Following is a rundown of LKL's compliance and disclosure violations as alleged by the SEC:

- Financial activities and affiliations.** "None of LKL's Forms ADV filed between March 2010 and March 2015 disclosed Love's affiliated private funds, and each affirmatively misrepresented that LKL and Love had no outside business activities," the SEC said. It noted that LKL never checked the box required if any of an adviser's related persons serve as a sponsor, general partner, managing member or equivalent of a pooled investment vehicle. Further, the agency said, on Form ADV, Part 2A, the brochure falsely stated that "[t]he firm and its management personnel do not engage in or maintain any financial industry activities or affiliations." While LKL's Part 2B brochure supplement for Love "stated that he maintained an insurance license, [it] then misleadingly stated that Love 'may engage in other business activities that are unrelated to the investment industry,'" the SEC said. "This response

omitted to state that Love was actively managing private funds, which is an investment industry activity."

- Undisclosed interest.** The agency also alleged that LKL's Forms ADV "provided false information about Love's financial interests in client transactions." The adviser's responses "omitted information regarding Love's private funds and the accompanying financial interests that he had in LKL client transactions," it said.
- Assets under management.** According to the settlement, Love admitted to SEC examiners that the advisory firm's AUM on its Forms ADV "was incorrect and inflated," the agency said. "The degree to which LKL's AUM was erroneous varied across the different Forms ADV, but LKL admitted that in certain Forms ADV it overstated its AUM by more than \$30 million," the SEC said. Further, it alleged, while LKL admitted that the amount of the overstatement was a material change (from \$130 million to around \$101 million), it never properly amended its Form ADV Part 2A brochure, or summary of the material change, to clients within 120 days of the end of the adviser's fiscal year. "Such delivery never occurred despite LKL and Love being informed of the obliga-

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tion by a compliance consultant," the agency said. If an advisory firm hires a compliance consultant, said Lieberman, "follow its recommendations or document that you disagree with the recommendations and the reasons why."

- **Refunding advisory fees.** The advisory firm, according to the settlement, "falsely stated" in its Part 2A brochure that when its services are terminated prior to the end of a calendar quarter, pro-rated fees would be refunded to the client. "This statement was false because . . . LKL failed to refund a pro rata share of pre-paid advisory fees for multiple client accounts that were closed mid-quarter until after Commission examination staff sent LKL a deficiency letter and Commission enforcement staff started an investigation," the SEC said.
- **Continuing misrepresentations.** "LKL's Form ADV misrepresentations continued even after Commission examination staff confronted Love about certain affiliated private funds in early 2016,"

the agency said. While LKL then "belatedly disclosed" that Love served as a managing member of entities meeting the SEC's definition of pooled investment vehicles, it "identified only two such funds, . . . and failed to disclose multiple other funds that Love managed and into which certain LKL client money was invested."

Examination staff

The settlement also focuses on Love's alleged failure to provide records to examiners, beginning with how he "initially represented to Commission examination staff that he had not participated in or had any interest in any other businesses or joint ventures in the past 10 years."

Further, the SEC charged, " when Commission examination staff asked Love about certain funds that [they had] independently identified, Love provided only partial disclosure of the activities of those funds and failed to disclose the existence of other funds that he managed and into which LKL clients had invested money at his recommendation." ❧

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