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"Luke, I am your father." (Or not.) Collective False Memory and SEC and FINRA Enforcement Issues from November and December 2020

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Often, there are quotes, spellings, symbols, events, or experiences that many of us "know" occurred, but which did not actually happen. This phenomenon is known as the "Mandela Effect," or "collective false memory." Its name derives from the false recollection of many people that Nelson Mandela died in the 1980s in prison when, in fact, he lived until 2013.[2] It was recently reintroduced to American society through the current hit HBO comedy docuseries called "How To with John Wilson."[3]

One example of such a false memory is the iconic quote, "Luke, I am your father," which Darth Vader proclaimed to his son, Luke Skywalker, in the 1980 classic film "Star Wars: Episode V—The Empire Strikes Back." Many of us remember that quote and, if we breathe deeply enough, and reach into the bottom of our soul, we can imitate the famous James Earl Jones line. However, that line was never uttered. The correct quote is, "No. I am your father."[4] (If you don't believe us, let's go to the videotape.[5]) (It's okay. We'll wait.)

To be clear, we don't think the securities regulators have false collective memories—other than, possibly, believing this line: "It's easy for you to produce that information to us. You can just push a button." And we don't think the securities industry has such false memories either—other than possibly believing that the SEC sanctioned firms for using the word "may." (Wait. That really did happen.[6]) Nonetheless, we thought it would be fun to explore this phenomenon and see how it fits with enforcement matters. After all, it's important to examine ourselves and our surroundings to better understand what happened and why. Wasn't it the Queen in Snow White who said, "*Mirror, mirror*, on the wall, who's the fairest of them all?" Well, actually . . . . (You know where this is going, right?) She really said, "*Magic* mirror on the wall. Who is the fairest one of all."[7] (Emphasis added.) Who knew?[8]

Spelling matters. And so do words.

Which of the following is correctly spelled?

1. The air freshener
   a. Febreeze
   b. Febreze

2. The Warner Brothers animated comedy series
   a. Looney Toons
   b. Looney Tunes

3. The children's literature series
   a. The Berenstein Bears
   b. The Berenstain Bears

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1. The authors represented some firms that participated in FINRA's 529 plan initiative, discussed below.
2. False memory - Wikipedia.
3. How to With John Wilson (hbo.com).
4. Darth Vader: Obi-Wan never told you what happened to your father.
   Luke: He told me enough. He told me you killed him.
   Darth Vader: No. I am your father.
   11 Misquoted Movie Lines (newser.com).
5. Star wars original 1980 i am your father HD - YouTube (at 1:54).
6. Legal Alert: The SEC's litigation against a firm for allegedly inadequate disclosure of shareholder service fees and 12b-1 fees – Eversheds Sutherland (eversheds-sutherland.com); Legal Alert: DC Circuit finds negligent but not willful fraud for inadequate disclosures – Eversheds Sutherland (eversheds-sutherland.com).
7. https://youtu.be/mqmIMvWnIV8 (at 23).
8. For other articles exploring the intersection between popular culture and securities enforcement, feel free to peruse our prior articles. "Back to the Future, But SEC and FINRA Enforcement Issues from the Present (October 2020)," *Currents* (November 2020); "Not Dead Yet: Just Flesh Wounds, Suspensions, and Fines (SEC, CFTC and FINRA Enforcement Actions in September 2020)," *Currents* (October 2020); "The Show, er, um, Article About Nothing (other than SEC, CFTC, FINRA, and State Securities Enforcement Actions in August 2020)," *Currents* (September 2020); "Just When You Thought It Was Safe to Go Back in the Office (Or at Least Think About It): SEC and FINRA Examinations and Enforcement Actions in July 2020," *Currents* (August 2020); "Curb Your Enforcementism: SEC and FINRA Enforcement Cases in June 2020," *Currents* (July 2020); "Killing Eve (all others are fined or suspended): SEC and FINRA Enforcement Cases in May 2020," *Currents* (June 2020); "The Last Dance (But not the Last Enforcement Action): SEC and FINRA Enforcement Actions in April 2020," Currents (May 2020); "Tiger King: Murder, Mayhem and March 2020 Enforcement Matters," Currents (May 2020).

4. The delicious, sugary cereal
   a. Froot Loops
   b. Fruit Loops

If you answered, b, b, b, and a, you are correct (and you're probably a very lonely person, but we're sure your parents are very proud). If you got any wrong, congratulations, you're just like the rest of us. And, believe it or not, each of these examples has been chalked up to the Mandela Effect.[9]

Incorrect Valuations of DPPs and REITs

While regulators (generally) don't sanction firms or individuals for misspellings, they do impose sanctions for using the wrong words and numbers. For example, in November 2020, through a Letter of Acceptance, Waiver, and Consent (AWC), FINRA fined a firm $300,000 for distributing account statements with incorrect valuations.[10] For approximately seven months, the firm distributed 6,851 account statements to more than 2,300 customers containing noncompliant valuations relating to Direct Participation Programs (DPPs) or Real Estate Investment Trusts (REITs). The valuations did not comply with the requirements of NASD Rule 2340(c). Beginning with amendments that took effect on April 11, 2016, NASD Rule 2340(c) required FINRA members to use either of two approved methodologies when providing per-share estimated values for DPP and unlisted REIT securities on customer account statements.

During the first few months of 2016, the firm obtained much of its valuation data regarding DPP and REIT securities from third-party vendors. But when one of its vendors could not provide rule-compliant, estimated values for certain securities—as it told the firm in a letter—it sent zeros as valuations. Those zeros fed directly into the firm's system used to generate customer-account statements. When the firm created its customer account statements at the end of the month, however, the firm's security pricing team manually overrode the zeros that the firm's third-party valuation vendor had provided, and instead populated the statements with the valuations that the vendor supplied for those positions the previous month—i.e., before the rule change. Thus, rather than learning that compliant valuations were not available, customers received account statements showing outdated valuations for those holdings.

Takeaways:

- First, firms cannot rely on vendors to fulfill their own compliance obligations—especially when a vendor informs a firm that it cannot support the firm's compliance obligations. Firms need to be diligent about what a vendor can and cannot do.
- Second, this appears to be the case where different parts of the firm were not adequately communicating. The AWC doesn't explain what happened, but it is not likely that Legal or Compliance were involved when the zero valuations were changed to the prior month's valuations.
- Third, when rules change, firms need to review how they are handling new requirements. It's not just "set it and forget it." Rule changes can require self-examination of old processes and require the adoption of new processes. Those new processes, however, should be tested for compliance with newly created obligations before those obligations go into effect, as well as afterwards to determine how the firm is complying with the changes.

9. 14 Mandela Effect Examples That Will Mess With Your Brain (theodysseyonline.com).
10. 2016051352401 First Clearing LLC nka Wells Fargo Clearing Services BD 19616 AWC va.pdf (finra.org).

Unsuitable sales of volatility-linked exchange-traded products

In November 2020, the SEC filed settled actions against three investment advisory firms and two dually-registered firms for violations related to unsuitable sales of volatility-linked exchange-traded products to retail investors, occurring between January 2016 and April 2020.[11] According to the SEC, the offering documents made clear that these products were intended for holding short-term and that the products were more likely to experience a decline in value when held over a longer period. The SEC found that, contrary to these warnings, and without understanding the products, representatives of the firms recommended their customers and clients buy and hold the products for longer periods, including, in some circumstances, for months and years. The SEC further found that the firms failed to adopt or implement policies and procedures regarding suitability and volatility-linked exchange-traded products.

The sanctions included an aggregate of $3 million in disgorgement and nearly $3 million in penalties, ranging from $500,000 for one firm to $650,000 for two other firms. These actions are the first arising from investigations generated by the SEC's Exchange-Traded Products Initiative, which used trading data analytics to uncover the potential unsuitable sales.

Takeaways:

- First, firms should have reasonable systems in place to train their representatives for all products, but especially complex ones, such as volatility-linked exchange-traded products.
- Second, firms should consider implementing systems to identify if products are not traded or held as intended.
- Finally, the SEC's big data analytics to monitor market wrongdoing is running full steam ahead, and we will likely see other enforcement actions stemming from this market review.

Misleading Statements and Best Execution Failures

In December 2020, the SEC settled with a firm and assessed a $65 million penalty for repeatedly failing to disclose the firm's receipt of payments from trading firms for routing customer orders to them, and for failing to satisfy its best execution obligation and seek the best reasonably available terms to execute customer orders.[12] Through an online application, the firm let customers transfer money from their bank accounts to brokerage accounts and then start buying and selling stocks for free. According to the SEC's order, between 2015 and late 2018, the firm made misleading statements and omissions in customer communications, including in Frequently Asked Questions pages on its website, about its largest revenue source when describing how it made money—namely, that the firm received payments from trading firms in exchange for the firm sending customer orders to those firms for execution, also known as "payment for order flow."

As the SEC's order found, one of the firm's selling points to customers was that trading was "commission free," but due in large part to its unusually high payment for order flow rates, the firm's customers' orders were executed at prices that were inferior to other brokers' prices. Despite this, according to the SEC's order, the firm incorrectly claimed in a website FAQ between October 2018 and June 2019 that its execution quality matched or beat that of its competitors.

The order found that the firm provided inferior trade prices that in aggregate deprived customers of $34.1 million even after taking into account the savings from not paying commissions.

As part of the settlement, and in addition to paying the $65 million penalty, the firm also agreed to retain an independent consultant to review its policies and procedures relating to customer

11. SEC.gov | SEC Charges Investment Advisory Firms and Broker-Dealers in Connection with Sales of Complex Exchange-Traded Products.
12. https://www.sec.gov/litigation/admin/2020/33-10906.pdf

communications, payment for order flow, and best execution of customer orders, and to ensure that it is effectively following those policies and procedures.

Takeaways:

- First, firms may be sanctioned for things they said, and things they didn't say.
- Second, regulators sometime focus on firms that receive a lot of publicity. This firm became very big, very fast, becoming a "poster child" of zero-commission trades. Therefore, it was not surprising that regulators scrutinized its business.

Memories of the way we were.

Sometimes we remember something clear as clear can be. Right as rain, we think. Only to later learn that our perfect memory is—you guessed it—wrong. Wrong as . . . whatever the opposite is. Wrong as drought? Wrong as left?

Let's test you again. Do you remember the following:

- Stouffers Stove Top Stuffing?
- Jiffy peanut butter?
- Double Stuffed Oreos?
- Cup O Noodles?
- Mike 'N Ike candy?[13]

If you answered Yes to any of these "memories," sorry, your collective memory is the same as ours, and it may need some fine-tuning (possibly by watching "How To with John Wilson"). Recollections are sometimes wrong: Stouffers never made stove top stuffing (despite one of our memories a few days before Thanksgiving 2020). And the correct names are Jif peanut butter, Double Stuf Oreos, Cup Noodles, and Mike and Ike candy.

The securities laws contemplated this issue. Therefore, securities firms cannot rely on their memories. They need adequate books and records to document what happened and what didn't happen.

Email Retention and Review

Because of these "memory needs," if firms fail to retain or review emails, they can be sanctioned. In November 2020, that happened—FINRA fined a firm $150,000 for email retention failures.[14] For five years, due to a coding error, the firm failed to capture approximately six million emails from 109 employee email accounts for supervisory review. The error was not identified because the firm did not reasonably monitor and test its system to ensure that emails were properly routed to the firm's email review platform.

This technical error went unnoticed for several years because the firm did not conduct an initial test to make sure that its journaling process worked and that each new employee's emails were properly journaled to the review platform. Nor did the firm monitor the volume of email ingested into its review platform for irregularities or conduct any reconciliation of the email addresses to be monitored with the emails that were ingested.

13. Stouffers Stove Top Stuffing – Alternate Memories; 23 Food Examples Of The Mandela Effect That'll Make You Think You're In A Parallel Universe (buzzfeed.com).
14. 2019061735701 Santander Investment Securities Inc. CRD 37216 AWC va .pdf (finra.org).

Takeaways:

- First, firms can be sanctioned for inadvertent technical errors related to the retention and review of emails.
- Second, it is important that firms review technology to determine whether it is working as intended. In this case, the firm failed to test the email systems when employees joined the firm. In other cases, firms have been sanctioned where they did not analyze email retention or email review after technical upgrades.
- Third, firms may want to review whether Compliance is involved when technical changes or upgrades are performed. Other departments may not understand the compliance ramifications of their work.

Recordkeeping Obligations

In December 2020, a firm agreed to pay $1 million to settle FINRA charges that the firm failed to establish and maintain a supervisory system compliant with rules concerning its recordkeeping obligations.[15]

FINRA found that from April 2004 through 2020, the firm had failed to establish and maintain a supervisory system, including written procedures, reasonably designed to comply with its recordkeeping requirements. For example, for about five years the firm had no WSPs related to Rule 17a4-(f). And even when the relevant recordkeeping rules were added to the WSPs, the firm didn't provide any guidance to firm personnel about compliance. For example, the procedures did not: identify any system, location, or database where documents should be stored; describe any process for auditing the integrity of such documents; or identify the individuals responsible for achieving compliance with Rule 17a-4(f)'s record retention requirements.
The firm self-reported this issue to FINRA and began remediation.

Takeaways:

- First, recordkeeping matters. This firm was one of several to recently settle with FINRA, and pay large fines, for failing to establish, maintain, and enforce a supervisory system as it relates to recordkeeping. FINRA has been assessing six- and seven-figure fines for several years for similar conduct.
- Second, some procedures are better than no procedures, but just having basic written procedures, with no details, can lead to sanctions. Regulators charge firms that do not provide adequate guidance on how to implement those procedures.

AML and Regulation S-P

Another recent example related to firm records involved a firm and its President/Chief Compliance Officer (CCO), which were sanctioned for anti-money laundering (AML) and Regulation S-P issues.[16] In November 2020, FINRA fined the firm $55,000 and suspended the individual for six months.

According to the AWC, the respondents failed to develop and implement an adequate AML program. Specifically, they did not have reasonable policies and procedures tailored to the firm's business—namely, a significant customer base from high-risk jurisdictions. As such, the firm failed to detect and report suspicious activity arising from wire transfers to customer accounts, in part, because the firm had no procedures for how to address potential red flags. Additionally, the respondents failed to provide reasonable ongoing AML training to the firm's associated persons.

15. https://www.finra.org/sites/default/files/fda_documents/2018059389401%20SG%20Americas%20Securities%2C%20LLC%20CRD%20128351%20AWC%20sl.pdf.
16. 2018059545203 Southern Trust Securities, Inc. Susan Molina Escobio CRD 1062322 CRD 103781 AWC va.pdf (finra.org).

Also, they failed to conduct periodic reviews of account activity and enhanced due diligence with respect to a foreign financial institution account.

In addition to the AML violations, the respondents failed to establish, maintain, and enforce a supervisory system reasonably designed to prevent a terminated representative from continuing to access firm email, which contained customer records. The respondents also failed to recognize and investigate red flags indicating that the terminated individual may have continued to access his firm email address containing customer records.

Takeaways:

- First, FINRA continues to aggressively pursue AML violations. While AML violations can result in large, multimillion-dollar fines, FINRA has also brought smaller cases where appropriate, as here.
- Second, firms can be sanctioned if their AML systems and procedures are not (1) appropriately tailored to their business, (2) operating as intended, and (3) identifying and remediating appropriate “red flags.”
- Third, firms can be sanctioned if they do not prevent terminated representatives as well as terminated contractors or service providers from having physical or electronic access to firm systems and property, including customer records. As this case demonstrates, it does not matter if the improper access led to customer harm.

Representatives Taking Customer Information

FINRA has also sanctioned representatives when they took firm “memories” with them, leaving firms with customer information, but without customer knowledge or consent. In November 2020, FINRA fined two representatives $5,000 each and suspended them for ten days for leaving two different firms with customer information without customer knowledge or consent in violation of Regulation S-P. One representative, without his old firm’s or the customers’ knowledge or consent, printed account documents for 100 customers and hand-delivered them to a broker at his new firm before joining the new firm.[17] The other representative faxed detailed profile information on 20 clients of his old firm without their knowledge or consent to his new firm prior to his arrival there.[18] After these events came to light, both representatives were terminated by their new firms. It does not appear that the old or new firms were sanctioned for this conduct. In addition, earlier in November, FINRA fined another representative $12,500 for printing about 500 customer names, account values, and numbers in anticipation of losing his job due to a restructuring, and of selling some of the names to another broker.[19]

Takeaways:

- First, these cases underscore that FINRA views it as serious when representatives improperly take customer information with them when they move from one firm to another.
- Second, the fact that the new firms terminated the representatives after learning of these issues demonstrates firms’ growing fears of being sanctioned for aiding or abetting or causing Regulation S-P violations.
- Finally, firms may want to review their onboarding policies and procedures. Some firms distribute a transition guide to recruits to help them understand what information they may take with them, such as birthday or holiday lists, and what information they cannot take without permission or proper notification, such as date of birth or Social Security numbers. In addition, firms should be aware that they can be sanctioned if they receive certain information that a recruit or new representative should not have shared.

17. 2019062873001 Joseph D. Olheiser CRD 4543537 AWC sl.pdf (finra.org).
18. http://www.finra.org/sites/default/files/fda_documents/2018060447501%20Daniel%20Hee%20CRD%205934535%20AWC%20va.pdf.
19. https://www.finra.org/sites/default/files/fda_documents/2019062357402%20David%20Patrick%20Beston%20CRD%205296215%20AWC%20sl.pdf.

Basic Recordkeeping, Recordkeeping about Associated Persons (and the Supervision of Consolidated Reports)

Recordkeeping takes many forms. In December 2020, a firm agreed to pay $6.5 million to settle FINRA charges that the firm failed to establish and maintain a supervisory system compliant with rules concerning: (1) recordkeeping, which the firm self-reported to FINRA; (2) fingerprinting and screening of non-registered people associated with the firm; and (3) consolidated reports.[20]

The firm had multiple recordkeeping issues. First, the firm's procedures did not inform personnel that local computer drives and shared computer drives did not meet record retention requirements and should not be used for records storage. In addition, although the written procedures stated that branch managers were primarily responsible for compliance with recordkeeping requirements, the written procedures did not identify how or when branch managers, or any other personnel, including home office personnel, should monitor usage of local and shared drives as electronic storage locations.

Second, the firm failed to preserve approximately 1.5 million customer communications that a third-party vendor had contracted to retain. These communications included mutual fund switch letters, 36-Month Letters, and wire transfer confirmation.

Third, FINRA alleged that the firm failed to retain electronic records in the required format, preserve certain electronic records, and notify FINRA prior to employing electronic storage media.

Fourth, the firm failed to store required records in a form and manner reasonably designed to safeguard them from possible loss, alteration, or destruction. The firm stored electronically more than 87 million required records—including its general ledger, supervisory procedures, customer statements and onboarding documents, and notices to customers—on local and shared computer drives and on electronic storage devices, but did not store these records in a non-rewriteable, non-erasable format.

Finally, in December 2017 and December 2019, the firm failed to send 36-Month Letters to approximately one million customers because of failures related to its communications with and supervision over a vendor.

FINRA also alleged that the firm failed to fingerprint and screen more than 7,000 non-registered associated persons from January 2014 through 2020 for statutory disqualification based on criminal convictions. This particular violation led to a former registered representative, who was subject to statutory disqualification, remaining associated with the firm for two years. That representative, while not named as a respondent in the firm's AWC, was separately barred by FINRA for sending reports containing fictitious assets to several firm customers as part of a Ponzi scheme away from the firm and converting at least $1 million of customers' funds.[21] He subsequently pleaded guilty to one count of securities fraud in the Southern District of New York and was sentenced to 42 months in prison and was ordered to pay $4.97 million in forfeiture for running a Ponzi scheme.[22]

Regarding consolidated reports, the firm was previously sanctioned for not supervising those reports. After that AWC, representatives who wished to create consolidated reports could only use proprietary systems or specific, approved third-party vendors. However, from May 2015 through 2020, the firm did not review draft consolidated reports, manually added assets, and

20. https://www.finra.org/sites/default/files/fda_documents/2018059192701%20LPL%20Financial%20LLC%20CRD%206413%20AWC%20va.pdf.
21. 2019062787101 James T. Booth CRD 1906145 AWC jm (2019-1564618780231).pdf (finra.org).
22. Ex-LPL Rep to Spend 3.5 Years in Jail for Ponzi Scheme | ThinkAdvisor.

thousands of reports where third-party vendors gave representatives and customers direct access to the reports. Among the reports that were not reviewed were ones created by the former registered representative, which contained false information related to the Ponzi scheme.

In addition to the fine, the firm agreed to an undertaking to retain a consultant.

Takeaways:

- First, firms cannot lose sight of nuts-and-bolts issues like recordkeeping, screening, and fingerprinting, and complying with prior AWCs.
- Second, the case is a good example of the consequences of not properly screening for potential bad actors, both in the registered and non-registered capacity.
- Third, this case also is an example of how seemingly more benign supervisory failures in one area of a firm, like recordkeeping, may directly contribute to other, more severe violations that lead to customer harm. Here, a bad actor exploited the lack of supervision in record retention to convert $1 million in customer funds.
- Fourth, regulators assess whether firms have corrected deficiencies. Here, although the firm self-reported, the AWC required the firm to retain a consultant.

Picture this.

Close your eyes and imagine the following. Strike that. (If you close your eyes, you can't read what we are going to tell you.) Instead, please read the following and *then* visualize with your eyes open or closed. Ready?

- Picture the game Monopoly. Remember the really wealthy guy, Rich Uncle Pennybags? Did he wear a monocle?

- Picture the passenger side mirror in your car. (Remember your car? That's what you used to sit in at least a couple of times a day? Now, not so much.) Does it say, "Objects in mirror may be closer than they appear"?

The answers to both questions require that you open your eyes. Thank you!

Rich Uncle Pennybags never wore a monocle. Some have speculated that "our subconscious combined the dapper dress of Mr. Peanut with that of Mr. Pennybags, borrowing the monocle to better fit our stereotype of wealth and prestige." [23]

The second question is super controversial. Based on the best information we found, mirrors said (and say) that objects "are" closer (not "may be" closer).[24]

Red Flags and "Should Have Known" Liability

The next thing to picture is red flags. (We know you know what they look like . . . And we know that sometimes you think they are more pink than red. Although the regulators are often color blind—seeing only red.) When a supervisor sees red flags and fails to respond, that's problematic. A case recently decided by the DC Circuit Court of Appeals addressed red flags, "should have known" liability, and a CCO.[25] In this case, the CCO had been found liable by FINRA for failing to comply with a FINRA rule that requires reporting to FINRA certain conduct within a specified

23. The Top 5 Mandela Effect Examples Explained | by Jeremiah Walker | Vlipsy.
24. Mandela Effect (Side Mirrors Proof!?!) "Objects In Mirror MAY BE Closer Than They Appear": Mandela_Effect (reddit.com); Can Anybody Find A Vehicle with A Mirror Saying May Be Closer Than They Appear?: MandelaEffect (reddit.com).
25. 18-1341-1867836.pdf (uscourts.gov).

number of days after the firm “knows or should have known” about the conduct. The specific issue was a rep’s relationship with a statutorily disqualified person and the CCO’s failure to detect it. The SEC affirmed FINRA’s decision, albeit applying different standards.

The DC Circuit ruled that the SEC’s decision was “supported by substantial evidence.” However, the court failed to analyze what the FINRA rule meant when it used the phrase, “should have known.” Instead, the DC Circuit simply noted that the “Commission found a series of ‘clear red flags’ that ‘should have led [the CCO] to inquire’ about such a relationship [with the statutorily disqualified person], but he failed to do so.” The Court did this despite the fact that the DC Circuit requires analyzing what “knowledge [the] inquiry would have produced.” It is easy to see why. Sometimes following up on a red flag will yield information and sometimes it will not.

In addition, neither the court nor the SEC nor FINRA analyzed the relevant rulemaking history. In the Notice of Filing for FINRA Rule 4530, the SEC stated, “[t]he purpose of the ‘should have known’ standard is to ensure that members do not intentionally avoid becoming aware of a reportable event.” Based on the early decisions, it appears that if the court or the SEC had analyzed this issue, they would have found that the CCO did not intentionally avoid becoming aware of the underlying facts.

Unfortunately for firms and CCOs, inquiring about red flags is only part of the analysis to determine whether a firm or individual “should have known” about certain facts. In effect, the DC Circuit established a strict liability standard for failing to investigate red flags.

Takeaways:

- First, firms and individuals can be sanctioned if they are not vigilant about red flags. FINRA may treat the failure to follow up on a red flag as a strict liability offense, alleging that the person or firm knew of an issue that may have been discovered if the issue had been reviewed.
- Second, firms and individuals may want to document all responses to red flags. After the fact, it will be easier to show one’s thinking and defend actions taken (or not taken) with a contemporaneous record. Because this case dealt with Rule 4530, documentation is particularly important when assessing whether to report something to FINRA under the rule.

Trade Supervision

Trading without authorization, churning, overcharging commissions, and similar conduct are all potential red flags. In December 2020, the New Hampshire Bureau of Securities (Bureau) reached a record-setting settlement with a large broker-dealer and one of the firm’s registered representatives regarding churning.[26] The order alleged that the firm failed to adequately supervise the registered representative, who regularly traded without authorization, mismarked trade confirmations, excessively traded stocks and initial public offerings, over-charged commissions, and inappropriately traded inverse and leveraged products.

The investigation and subsequent order arose from the complaint of one high-net-worth customer of the registered representative, who lost millions of dollars on the securities strategies recommended by the registered representative. According to multiple press sources, the complaining customer was the former governor of New Hampshire.

The firm was assessed a fine of $1,750,000 plus costs of $250,000, and ordered to pay $24.2 million in restitution to the customers. In addition, the registered representative was permanently

26. https://sos.nh.gov/media/0ouim0tk/enforcorder_com2019-000.pdf.

barred from the securities business in New Hampshire. The Bureau also ordered the firm to maintain compliance undertakings put in place to address the compliance failures uncovered by the investigation.

Takeaways:

- First, firms are often sanctioned as a result of one bad registered representative. When something goes wrong at a firm, regulators want to know whether the firm's systems and procedures were reasonable, and whether there were red flags indicating the existence of a problem.
- Second, although the order isn't clear, it appears there may have been multiple times when the firm could have or should have addressed the problematic trades. For each identified issue, it is likely that the Bureau reviewed what systems the firm had in place, whether there were red flags, and if so, how the firm addressed those red flags.
- Finally, if a complaining customer is a former or current governor or other high-ranking official, firms better react quickly.

Listen up.

Who are you going to believe, us or your own ears?

Sometimes we "hear" things (or remember hearing things) even when those words didn't travel through the air (or through our AirPods) and reach our ears. Above, we cited the famous Darth Vader line. Another classic example is Humphrey Bogart's line from *Casablanca*, where we thought he said, "Play it again, Sam." In fact, he didn't really say that. Here's the actual dialogue:

> Rick: You know what I want to hear.
> Sam: No, I don't.
> Rick: You played it for her and you can play it for me.
> Sam: Well, I don't think I can remember it.
> Rick: If she can stand it, I can. Play it![27]

Interestingly, it was Ilsa, who *almost* said the famous quote:

> Ilsa: Play it once, Sam, for old time's sake.
> Sam: I don't know what you mean, Miss Ilsa.
> Ilsa: Play it, Sam. Play "As Time Goes By."

Similarly, Captain Kirk never said, "Beam me up, Scotty" on any *Star Trek* television episode or film. Instead, he said variations, including "Scotty, beam us up"; "Beam me up"; "Mr. Scott, beam us up"; and "Beam them out of there, Scotty."[28]

While it may be less important to remember exactly what our favorite heroes or villains said on the big screen or the little screen (it's all the little screen now, isn't it?), it is important to know and to try to remember what the regulators are saying.

SEC Enforcement's Annual Report

In November 2020, the SEC's Enforcement Division issued its annual report. By now, most of you have probably seen the SEC's annual Enforcement report.[29] The SEC reported that its monetary

27. Casa.PDF (dailyscript.com).
28. Beam me up, Scotty – Wikipedia.
29. Division of Enforcement 2020 Annual Report (sec.gov).

sanctions totaled just under $4.7 billion during fiscal year 2020 (October 2019 to September 2020), an all-time high boosted by a record-setting $3.6 billion in disgorgement. The remaining $1.1 billion in penalties was slightly lower year-over-year and was the second-lowest level seen in the six years tracked by the report. The total number of enforcement actions, which dropped to

715 from 862 last year, was nearly a 20% decrease and was the lowest figure in six years.

These figures are colored by the fact that since mid-March the SEC has been working remotely because of the pandemic. The report notes that despite the shift in working conditions—and the still-ongoing efforts to adapt to those conditions—the SEC quickly dedicated substantial resources to address the emerging threats presented by COVID-19 and the ensuing dynamic market conditions.

The SEC also stated that cases against investment advisers/investment companies represented 21% of the standalone cases, while cases against broker-dealers represented 10%. The number of cases against investment advisers/investment companies dropped dramatically from FY2019, which was not unexpected given the drop in overall actions and the fact that last year's report contained the actions for the Share Class Selection Disclosure Initiative, which resulted in 95 cases. So 2019's numbers were abnormally inflated. Despite the overall decline, the number of broker-dealer cases actually increased slightly in 2020.

Takeaways:

- First, despite the pandemic and work-from-home environment, SEC Enforcement had a strong year.
- Second, monetary sanctions continue to be very important to the Commission, particularly disgorgement.
- Third, although the report did not address this issue, we expect that under a Democratically run SEC, enforcement will be even more aggressive. OCIE on CCOs

OCIE on CCOs

On November 19, 2020, Peter Driscoll, Director of the Office of Compliance Inspections and Examinations (OCIE), gave remarks on the role of CCOs.[30] He emphasized that a CCO should be empowered with full responsibility and authority to develop, implement, and enforce appropriate policies and procedures for the firm. And a CCO should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures.

Mr. Driscoll noted that some firms take the "check-the-box" approach to the CCO requirement, merely looking at it as a way to satisfy the rule, as opposed to thinking of the role as an essential component of running an advisory or fund business. He emphasized that a good CCO can be a true "value-add" to the business. By keeping up with regulatory expectations and new rules, they can assist in positioning their firms not only to avoid costly compliance failures, but also provide proactive compliance guidance on new or amended rules that may provide advisers with additional business options.

Mr. Driscoll criticized firms for devoting inadequate resources to the compliance function, including failures to spend more money as a firm grows and changes and for often failing to conduct sufficient annual reviews. Finally, he outlined dozens of areas where advisers fail to adopt and implement adequate policies and procedures, including portfolio management,

30. SEC.gov | The Role of the CCO – Empowered, Senior and With Authority.

marketing, trading, disclosures, and fees. In an accompanying Risk Alert, "OCIE Observations: Investment Adviser Compliance Programs," OCIE faulted firms that employ the dual-hat CCO

model whereby a C-suite executive with other primary responsibilities assumes the compliance role, because such executives do not have sufficient time or knowledge to adequately perform the compliance responsibilities.[31]

Takeaways:

- First, OCIE is watching what firms do regarding their CCOs.
- Second, firms should consider empowering CCOs by including them in high-level, senior executive meetings and decision-making processes. In addition, it is important that firms focus on devoting adequate resources to the CCO and compliance function more generally, both in terms of personnel and technology.
- Finally, firms may want to focus on whether they have a comprehensive compliance regime that covers all areas of a firm's business and is not simply focused on particular areas. FINRA'S 529 Plan Initiative

FINRA'S 529 Plan Initiative

On December 30, 2020, FINRA announced initial results of its voluntary self-reporting 529 Plan Share Class Initiative (Initiative).[32] FINRA originally launched the Initiative in January 2019 to encourage firms to self-report potential violations of rules governing 529 plan share class recommendations. The Initiative was announced in Regulatory Notice 19-04, which provided broker-dealers with guidance concerning how and when to self-report under the Initiative, as well as the consequences for not self-reporting.[33]

Results of the interim announcement included more than $2.7 million in restitution and interest to customers owning approximately 3,900 accounts, arising from settlements with two firms and 17 matters resolved through cautionary action letters. All 19 firms in this initial group agreed to remediate harmed customers and to enhance their supervisory systems and procedures, where appropriate.

The December 30 release also included details on the two settlements. One firm agreed to pay approximately $1.7 million in restitution and interest to customers who incurred excess fees in their 529 plan account.[34] The other firm agreed to pay approximately $250,000 in restitution and interest to customers.[35] Neither firm was fined.

Takeaways:

- First, watch for more Initiative updates and an eventual completion, possibly in 2021. Jessica Hopper, Head of FINRA's Department of Enforcement, stated in the release that FINRA "expect[s] to resolve the remaining matters in the coming year."
- Second, given the success of this Initiative, and the SEC's successful share class initiative, we expect to see similar initiatives in the future for industry-wide issues.
- Third, it appears that firms take advantage of these regulatory initiatives and self-report

31. Risk Alert IA Compliance Programs_0.pdf (sec.gov).
32. https://www.finra.org/media-center/newsreleases/2020/finra-announces-interim-progress-voluntary-529-plan-share-class. As explained further in the announcement, "529 plans are tax-advantaged municipal securities designed to save for the future educational expenses of a designated beneficiary. Shares of 529 plans are often sold in different classes with different fee structures. Certain share classes may be significantly less expensive over extended holding periods. These share classes are therefore frequently a more cost-effective choice for 529 plan accounts with younger beneficiaries and longer investment horizons, or accounts that qualify for breakpoint discounts."
33. For more information about the Initiative, see https://us.eversheds-sutherland.com/mobile/NewsCommentary/Legal-Alerts/217798/FINRAs-529-plan-share-class-initiative.
34. https://www.finra.org/sites/default/files/2020-12/morgan-stanley-smith-barney-awc-123020.pdf.
35. https://www.finra.org/sites/default/files/2020-12/b-riley-wealth-management-awc-123020.pdf.

when appropriate. The regulators use a carrot-and-stick approach. In general, if firms participate, they will not be subject to a fine, but if they do not participate, there will likely be a fine and possibly additional charges.

Going Forward.

As John Wilson shows us on HBO, some people (including some conspiracy theorists) believe that the Mandela Effect involves alternate universes. One theory "originates from quantum physics and relates to the idea that rather than one timeline of events, it is possible that alternate realities or universes are taking place and mixing with our timeline. In theory, this would result in groups of people having the same memories because the timeline has been altered as we shift between these different realities."[36] (Thus, in some other universe, some company created a sugary cereal spelled Fruit Loops because . . . in that world "fruit" is another word for colorful sugar?)

The purpose of this article is not to get into that debate. Rather, we believe, like Yogi Berra did, that, "You can observe a lot by just watching."[37] Mr. Berra should not be confused with Yogi Bear, who shouldn't be confused with Smokey the Bear. (The latter doesn't even exist. His "real" name, on his driver's—or hunter's—license, presumably, is "Smokey Bear," sans the "the."[38])

Thus, observe by:

- Taking in your surroundings;
- Going for a walk;
- Watching a film or television show;[39]
- Reading a book, magazine article, or newspaper;[40]
- Listening to music; and
- Reading enforcement cases, regulatory alerts, and speeches

And, finally, don't forget, when you come to a fork in the road (in this universe or a different one) . . . take it. ■

36. What Is the Mandela Effect? (verywellmind.com).
37. 20 Great Yogi Berra Quotes – Authentic Manhood.
38. 30 Of The Creepiest Mandela Effect Incidents Ever Recorded (playbuzz.com) ("Many people remember the fire-safety bear as being called 'Smokey the Bear' but when you look back at footage from the public service announcements his name is actually 'Smokey Bear.' When you type in Smokey Bear in google, 'Smokey the Bear' tops the list. Either we subconsciously put a 'the' in-between his name or we're living in a totally different dimension now.")
39. To make life easier for you, we checked out a couple of reviews to help you decide what to watch. "How to With John Wilson" received a 100% score on Rotten Tomatoes' Tomatometer. How To with John Wilson: Season 1 – Rotten Tomatoes. In contrast, the movie called "The Mandela Effect" received only a 20%. The Mandela Effect (2019) – Rotten Tomatoes.
40. To show that this is a full-service article, we offer another review. You may want to check out Nelson Mandela's autobiography (written while he was alive), called "Long Walk to Freedom." It received 4.8 out of 5 stars on amazon.com, and former President Barack Obama stated that it was "Essential reading for anyone who wants to understand history—and then go out and change it." Amazon.com: Long Walk to Freedom: The Autobiography of Nelson Mandela (9780316548182): Mandela, Nelson: Books.