Annual Securities Section Meeting & CLE Event

Effective Use of Compliance Consultants

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Practices

Securities Regulations
Regulatory Defense
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Bar Admissions

U.S. District Court District of Utah
U.S. District Court Southern District of New York
U.S. District Court Eastern District of New York
U.S. District Court District of Nevada
U.S. District Court Northern District of Texas
U.S. District Court District of Maryland
U.S. District Court Southern District of Florida
U.S. Court of Appeals, Tenth Circuit

Mr. Baker is a shareholder and member of Clyde Snow's Securities Enforcement, Regulatory Defense & Litigation and White Collar Crime, Government, and Independent Investigations groups. His practice focuses on defending corporate and individual clients in regulatory enforcement investigations and litigation before the U.S. Department of Justice (DOJ), the U.S. Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and other federal and state agencies. Mr. Baker represents broker-dealers, investment advisors, compliance officers, and registered representatives before the SEC and the Financial Industry Regulatory Authority (FINRA). He also handles a variety of corporate internal investigations. His practice routinely involves responding to regulatory subpoenas, preparing clients for investigative testimony, and responding to SEC "Wells Notices" of anticipated charges.

Education

- Juris Doctor, University of Oregon School of Law (1987)
- Bachelor of Arts, Speech Communication, University of Utah (1984)

Awards and Honors

- *Utah Business Magazine* Legal Elite, Securities Law (2018)
- *Mountain States Super Lawyers*, Securities Litigation, Criminal Defense: White Collar (2013-2014)
- *Utah Business Magazine* Legal Elite, Civil Litigation (2013)
- Recipient, SEC Chairman's Award for Excellence (2002)

Professional Affiliations

- Chair, Utah State Securities Commission; Re-appointed by Governor Gary R. Herbert August 27, 2015 (2015-present)
- Utah State Bar, Securities Section (2010-2011)
- Managing Editor, University of Oregon Journal of Environmental Law & Litigation
- Board Member, Former Chair, University of Utah Marriott Library Advisory Board (2007-present)

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Presentation Roadmap

- What is scaring the Financial Service industry right now?
- Protecting that attorney-client privilege.
- The attorney-client privilege and its value-add.
- Transition in the markets – reliance on CCs.
- How to Properly Interface with CCs.
- Questions?

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Implications of *Robare*

What's got everyone scared?

- 2016 SEC decision, *In re The Robare Group*, Ltd., Advisers Act Rel. No. 4566 (Nov. 7, 2016) ("Robare"). Summary.
- Can you rely on compliance consultants?
- Maintaining attorney-client privilege before and after internal investigations.
- Preservation of reliance on counsel defense.

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Initial Robare ALJ Decision

The Initial Decision rejected the SEC Division of Enforcement's claims. The Administrative Judge found that "**Respondents did not act with scienter and their conduct was not egregious. Indeed, they relied on compliance professionals in attempting to craft appropriate disclosures. Finally, the Division presented no evidence of any losses to Respondents' clients.**"

Full Commission Decision

On November 7, 2016, the Commission reversed, by a two-to-one vote, and imposed sanctions ($150,000 in fines). There are many noteworthy aspects to the decision, but today I am focusing on the erosion of the ability to rely on compliance consultants.

What's The Issue?

- The fundamental issue is that BDs and IAs seek outside assistance from CCs which exposes them to significant legal jeopardy when seeking to comply with disclosure and other requirements of the Advisers Act.
- **Compliance efforts are being used against IAs and BDs. SEC often seeks information from the CC via subpoena so don't be surprised to see testing, Mock Audits appear as exhibits in testimony.**

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Same Underlying Policies Should Apply

- Policies that underlie the attorney-client privilege should apply to the relationship with a Compliance Consultant but they don't!
- BD's and IA's can be lulled into thinking their efforts at achieving compliance will not be used against them later in the enforcement context.
- Sadly the only winner is the lawyer who has to be consulted to verify the work of the CC.

Common Pitfalls

- Attempting to be more efficient by cutting out legal counsel can end up costing the firm more in the end.
- Failing to properly interact with CCs can open firms up to additional SEC scrutiny and legal liability.

Getting the Benefit of Both Worlds

- CCs with the benefit of attorney-client privilege and reliance defense.
- Is there a way to preserve the economic efficiency of using compliance consultants and still keep your efforts at achieving compliance protected?

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Basics of Attorney-Client Privilege

Elements of Attorney-Client Privilege

> When legal advice of any kind is sought from a professional legal advisor and in their capacity as such Communication relates to that purpose made in confidence by the client, and client insistence that it be permanently protected, from disclosure by the client or the legal advisor, EXCEPT, if the protection is waived.

Communication with 3rd Party; Protected or Not Protected?

Privilege attaches only for legal advice not business purposes

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The Attorney-Client Privilege Value-Add

Benefits

- Encourages frank communications between a client/company and its attorneys (in-house or outside counsel).
- Permits a company to identify and remedy wrongdoing guided by counsel with the full protections provided by such privilege.
- When the privilege attaches properly, it can become one of the most valuable commodities a lawyer can provide to their clients.

Drawbacks

- Roadmap theory
- Waiver of privilege can happen unexpectantly or through one's careless actions

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The SEC's View of Relying on CCs

The SEC has a generally favorable view of CCs

- The Commission believes that CCs provide a "significant public benefit that flows from the effective performance of the securities lawyer's role."
- "The exercise of independent, careful and informed legal judgment on difficult issues critical to the flow of material information to the securities markets."

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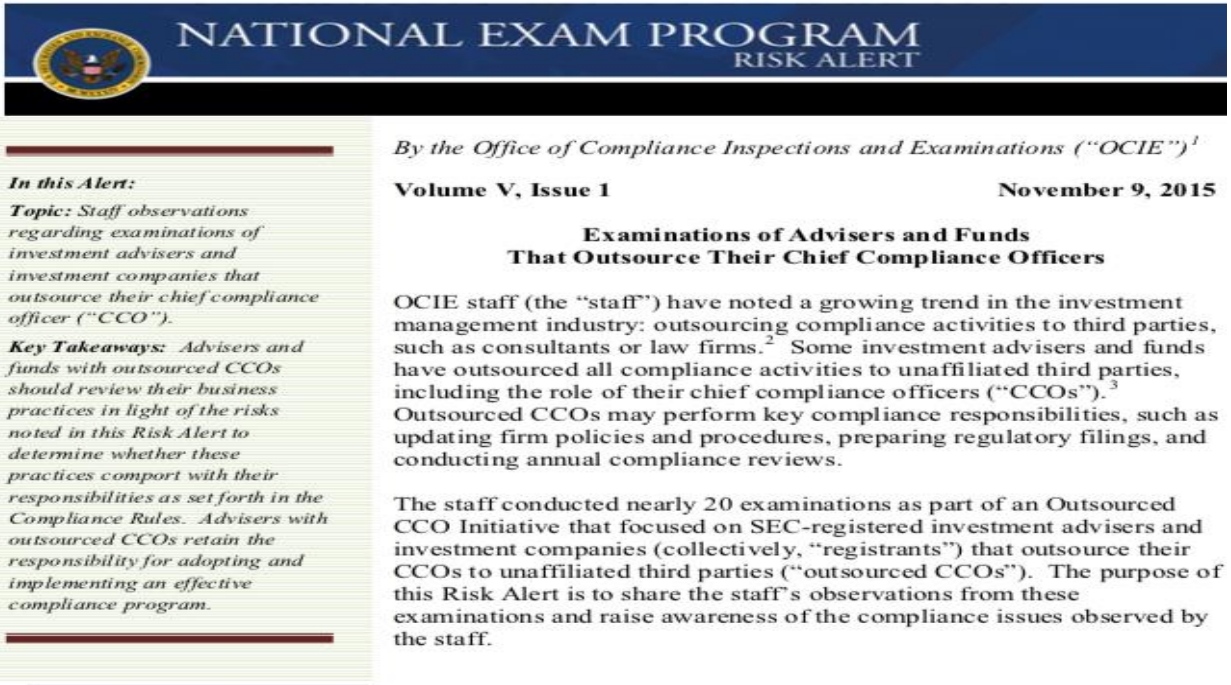
Much of the SEC's Perspective Comes From 2015 Risk Alert issued by OCIE



NATIONAL EXAM PROGRAM
RISK ALERT

By the Office of Compliance Inspections and Examinations ("OCIE")[1]

Volume V, Issue 1 **November 9, 2015**

Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers

In this Alert:

Topic: *Staff observations regarding examinations of investment advisers and investment companies that outsource their chief compliance officer ("CCO").*

Key Takeaways: *Advisers and funds with outsourced CCOs should review their business practices in light of the risks noted in this Risk Alert to determine whether these practices comport with their responsibilities as set forth in the Compliance Rules. Advisers with outsourced CCOs retain the responsibility for adopting and implementing an effective compliance program.*

OCIE staff (the "staff") have noted a growing trend in the investment management industry: outsourcing compliance activities to third parties, such as consultants or law firms.[2] Some investment advisers and funds have outsourced all compliance activities to unaffiliated third parties, including the role of their chief compliance officers ("CCOs").[3] Outsourced CCOs may perform key compliance responsibilities, such as updating firm policies and procedures, preparing regulatory filings, and conducting annual compliance reviews.

The staff conducted nearly 20 examinations as part of an Outsourced CCO Initiative that focused on SEC-registered investment advisers and investment companies (collectively, "registrants") that outsource their CCOs to unaffiliated third parties ("outsourced CCOs"). The purpose of this Risk Alert is to share the staff's observations from these examinations and raise awareness of the compliance issues observed by the staff.

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1 The views expressed herein are those of the staff of OCIE, in coordination with other staff of the Securities and Exchange Commission ("SEC" or "Commission"), including staff of the Division of Investment Management and the Division of Enforcement. The Commission has expressed no view on the contents of this Risk Alert. This document was prepared by SEC staff and is not legal advice.

2 *See* Charles Schwab & Corp., Independent Advisors' Revenue and Assets Rebound for Record Year, Says 2011 Charles Schwab RIA Benchmarking Study (July 5, 2011). The study recorded that 38% of firms are outsourcing some aspect of their compliance function, which was up over ten percent from 27% the previous year. This survey covered 820 RIAs with more than $300 billion in combined assets, with the median study participant having ended 2010 with $212 million in assets under management. In a Charles Schwab Market Knowledge Tools synopsis regarding the 2012 Benchmarking Study, Charles Schwab stated that "[i]ncreased reliance on outside experts for compliance has been a strong trend…not only reducing expense but potentially lowering the risks of overlooking or misinterpreting evolving requirements." (*See*, Charles Schwab & Corp., "Moving Forward in Uncertain Times: Insights From the 2012 RIA Benchmarking Study from Charles Schwab.") By contrast, see Investment Adviser Association ("IAA"), Summary Report for the 2013 Investment Management Compliance Testing Survey (June 11, 2013). The survey reported that 99% of the firms surveyed did not outsource the role of the CCO. More than 92% of the participants in the 2013 IAA survey managed in excess of $500 million in assets, and the average firm managed between $1 billion and $20 billion.

3 Articles have been written and speeches delivered on the trend of outsourcing the role of the CCO. *See, e.g.*, Rachel Louise Ensign, "Companies Are Outsourcing the Chief Compliance Officer Job," WALL STREET JOURNAL (July 17, 2014); Nick Georgis, "The Outsourcing Boom: Compliance," THINK ADVISOR (December 27, 2011); and Bettiny Eckerle, "Trend to Watch for 2012: Outsourcing Investment Adviser Compliance," Eckerle Law (January 11, 2012).

The SEC's View of Relying on CCs

So, why doesn't *Robare* feel like the SEC is trying to encourage reliance on CCs defense?

- Maybe it is misreading of the case? (most likely not)
- Maybe it's a misunderstanding of what the Commission is really trying to say? (more likely)
- A better understanding of the *Robare* ruling may be to rely on counsel, not consultants.

Cases Similar to *Robare*

In the Matter of Edgar R. Page & Pageone Fin. Inc. ("Page")

- Similar to *Robare*, "assuming that engagement of compliance professionals—as compared to counsel—might, under some circumstances, mitigate the egregiousness of a wrongdoer's misconduct" such a defense would still need to meet the elements of a defense of advice of counsel case.

Cases Similar to *Robare*

Dep't of Enforcement v. McCrudden, FINRA Disciplinary Actions.

- In a FINRA disciplinary action, the advice of consultants defense was not seen as adequate when there was not a full disclosure to a non-lawyer.
- Discussions and interactions with counsel was scant, incoherent, and did not meet the standards necessary to establish an advice of counsel defense.

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So, What's the Message?

If a client hopes to preserve a reliance CCs defense, the client must properly interface with a CC in a way that maintains attorney-client privilege and meet the reliance on counsel defense elements.

New Markets Shifting

How do we spot change?

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Markets Shifting Towards More Use of CCs

- The need for CCs is only going to increase
- Their value-add is targeted and efficient
- The only issue is how best to use them to protect your business or your clients' businesses

Uncertainty

- The *Robare* Decision has created uncertainty in the market.
- Uncertainty drives change.

Compliance Consultants Remain in Demand – Rules are Fluid

Financial institutions are struggling to comply with the growing number of rules, regulations, and standards and are investing tremendous resources in the way of money, time, and people toward attaining compliance. The enormity of these investments has provided ample opportunity for new entrants into the regulatory compliance consulting market. The service provider market for regulatory compliance consulting has expanded over the past decade.

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Compliance Burden is Growing

AML is close?

One study found that RIAs would have to devote a total of 33,000 per year just to comply with BSA

Marketing Practices?

Fees, fees, fees?

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Dealing with Uncertainty

How some deal with uncertainty and change?

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How We Deal With Change

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"Only the Paranoid survive."

BDs and IAs should be wary about relying solely on the advice of a compliance consultant. **Compliance Consultants are a great value until you have to hire another layer of lawyers to check their work.**

What Should BDs and IAs do?

- BDs and IAs should consider compliance interfacing mechanisms to maintain attorney-client privilege and preserve any possible reliance defense when needed.
- I am seeing more compliance law firms who employ non-lawyer staff like FINRA Specialists etc.

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The Winning Formula – Advice of Counsel

Advice of Counsel Defense - Elements

1. Counsel is aware of all relevant facts (complete disclosure by client)
2. Counsel is consulted as to legality of conduct before the action taken
3. Counsel's advice is clear (that conduct was legal)
4. Counsel's advice is relied upon in good faith and followed

Sec. & Exch. Comm'n v. Savoy Indus., Inc., 665 F.2d 1310, 1315 (D.C. Cir. 1981); *Markowski v. SEC*, 34 F.3d 99, 105 (2nd Cir.1994)

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The Winning Formula – Attorney-Client Privilege

Maintain Attorney-Client Privilege - Each of the following four elements must be met to establish the privilege:

1. The person or entity asserting the privilege is a "client;"
2. The communication was made to a lawyer acting as a lawyer;
3. The communication was made by a client to the lawyer in confidence (i.e., outside the presence of strangers) for the purpose of securing an opinion or legal services (and not to commit a crime or a tort); and
4. The client has invoked and not waived the privilege.

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Perhaps *US v. Kovel* May Be Instructive

Generally speaking, there is no privilege applicable to accountants in connection with a criminal investigation or prosecution. **An exception to this is if the accountant is retained by an attorney** and abetting the provision of legal services. Such arrangement are often memorialized with a Kovel letter which is named after a federal case from the 1960's, *United States v. Kovel*, which extended the attorney client privilege to an accountant retained by the attorney.

Possible Analogue

In effect, the accountant is doing your tax accounting and return preparation, but reporting as a subcontractor to your lawyer.

Properly executed, it extends attorney-client privilege to the accountant's work and communications.

Question

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Take away?

Until the DC Circuit rules on the *Robare* appeal, be careful about relying on compliance consultants.

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