IAWatch
WEEKLY BRIEFING
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INSIDE...

The Rep Turned Whistleblower.................... 1
Victory for IA in Form ADV Case 1
IA Case Tests Statute of Limitations............ 1
FINRA Officials Answer Questions 4

June 15, 2015

Vindicated rep offers warning that U5 system can punish whistleblowers

As business divorces go, the split between **Scott McCaskill** and **David Orosky** spilled its fair share of bad blood. Both would be terminated by **Raymond James** ($75B in AUM), Orosky for borrowing $400,000 from clients.

McCaskill, who along with Orosky became equal owners of **VOSO Financial Advisers** in 2009, contends he discovered and reported the wrongdoing by Orosky – a big producer at Raymond James – and the firm punished him for blowing the whistle by publishing a negative Form U5 that left him unemployable and "two steps away from being bankrupted."

McCaskill's case offers a cautionary tale for firms that fail to carve out a proper role for compliance staff, raises questions about the fairness of the U5 system and suggests regulators too quickly side with large advisers over small-time reps.

The split

By 2009, Orosky had been linked to Raymond James since 2002; McCaskill had long run an independent firm. In 2011, Orosky entertained moving to **Morgan Stanley**, lured by a potential $1.4 million recruitment check. McCaskill considered the idea but decided to remain independent, not wishing to give up his book of business. That decision would cleave their partnership.

Bills would go unpaid. The electric company threatened to turn off power to their office. McCaskill claims he even stumbled upon mail from the Maryland securities

(After Whistleblowing, continued on page 5)

SEC ALJ dismisses action against small adviser over Form ADV disclosures

It was the case advisers had been closely watching for months. An **SEC** ALJ June 4 dismissed Advisers Act charges against **The Robare Group** ($160M in AUM), the Houston-based RIA that last year was charged with poor disclosures in its Form ADV brochure about revenue sharing with **Fidelity**.

At the time, the firm vowed to fight the charges (**IA Watch**, Sept. 5, 2014). The decision by ALJ **James Grimes** presents the firm with a complete victory. After hearing all of the testimony, the judge concluded "that investment advisers operate in an uncertain regulatory environment in respect to disclosing potential conflicts of interest."

Mark Robare, 62, was the CCO of his company. He, his firm and his son-in-law, **Jack Jones**, who also worked at the adviser, had been charged in the case. "The decision was accurate and on target. It took in all of the facts," Robare tells **IA Watch**. *(Robare Victory, continued on page 2)*

SEC commissioners to weigh adviser's case as test of statute of limitations

The latest skirmish in the **Timbervest** ($1.3B in AUM) vs. the **SEC** case will feature the commissioners deciding if the firm and its principals violated the Advisers Act in not disclosing fees obtained in real estate deals from 2006 or whether the Enforcement Division was mistaken.

The Atlanta-based RIA and four of its principals – including its former CCO – vowed to fight the fraud charges. Even a partial victory last year at the ALJ stage – the first case to hang on the question of the SEC's five-year statute of limitations since a U.S. Supreme Court ruling – hasn't quelled that zeal (**IA Watch**, Aug. 21, 2014).

At a full hearing before the commissioners last week, Timbervest's attorneys argued the passage of time, fuzzy memories and missing evidence justified vindication. Enforcement Division attorney **Anthony Winter** countered that "egregious" behavior by the principals that included abandoning their fiduciary duty to clients in exchange

(Timbervest Fight, continued on page 3)

Robare Victory (Continued from page 1)

He estimated he spent upwards of $300,000 defending the firm. The Enforcement staff "really drove hard to try to get us to settle," he adds. "I was not going to settle, and it was a matter of principle."

ALJ Grimes wrote that even if he had found culpability, he would have assessed no fines because no clients suffered losses due to the behavior and that he found the principals to be honest and well-intentioned.

"I don't think the SEC should have brought [the case] in the first place," says Robare's attorney **Alan Wolper**, a partner with **Ulmer & Berne** in Chicago. Robare and Jones "were so well intended ... and the SEC knew that we could prove that," he adds.

When the case first surfaced, some felt regulators were nitpicking, quibbling over the use of the word "may" in the brochure. In one Form ADV brochure revision – of many – the RIA, backed by a consulting firm, disclosed that "we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity." In testimony, Robare said the firm chose the word "may" because the agreement with Fidelity could end the payments at any time.

Aided by the use of a compliance consultant

The RIA was clearly helped because it turned to industry compliance consultants throughout the years to assist them with their Form ADV disclosures. "No doubt, Mr. Robare and Mr. Jones paid **Renaissance** [**Regulatory Services** in Boca Raton, Fla.] in hopes of avoiding the very proceeding of which they are now the subject," wrote ALJ Grimes.

The case "shows that the SEC is better off providing guidance [on disclosure] than trying to dictate rules through legal proceedings," says **Bart McDonald**, Renaissance's executive VP. "The firm was trying to do the right thing." The matter should have been handled differently rather than putting "the full force and weight of the U.S. government on basically a two- to three-man shop," continues McDonald.

According to the ALJ decision, Robare didn't even know about the Fidelity program that shared 12b-1 fees with advisers that invested client assets with Fidelity funds until the RIA's broker-dealer informed him. Robare's first question was whether the arrangement would cost his clients anything. He was told no.

The advisory firm received about $50,000 a year from 2005-2013 from the Fidelity program. The RIA's annual revenues averaged about $2 million. A 2008 OCIE exam of The Robare Group ended with no findings and no mention of any Form ADV disclosure issues.

In 2011, the SEC began investigating another adviser's revenue-sharing relationship with Fidelity. This caused Fidelity to insist that all of its contracts for the program be revised, including The Robare Group's. The SEC hammered out settlement agreements with some advisers but Robare refused.

After Fidelity brought up the contract, Robare once again revised its Form ADV disclosure: "we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional compensation does not represent additional fees from your accounts to us."

"This language concisely encapsulates the Program," wrote ALJ Grimes and was "plainly adequate."

(Robare Victory, continued on page 3)

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2. Soft Dollar & Commissions Worksheets
3. Sample Annual Certification Form
4. Risk Questionnaire
5. Sample DDQ

Robare Victory (Continued from page 2)

The judge went on to write that "it is difficult to imagine them trying to defraud anyone, let alone their investment clients. They came across as honest and committed to meeting their disclosure requirements. Indeed, their belt-and-suspenders approach to compliance, through which they relied on multiple firms, including [B-D] **Triad** and Renaissance, to ensure the Robare Group was compliant with its disclosure obligations belies any argument that Mr. Robare or Mr. Jones acted with intent to deceive, manipulate, or defraud anyone."

Key takeaways

The decision, which doesn't stand as a precedent, held that disclosure includes more than just the Form ADV, says Wolper. The clients' agreements with Fidelity featured detailed disclosure about the arrangements.

But it also makes clear that any compensation should be disclosed. You should be "extra clear and careful about your disclosures but you need your disclosures no matter what the compensation level is," recommends McDonald.

The case supports seeking professional help from experts. "Follow their advice and do everything you can to do proper disclosure even in grey areas where there's absolutely no guidance then that's the best that you can do," recounts Robare. "Just be very careful and make sure everything is disclosed." ■

Most of this story first appeared as breaking news at www.iawatch.com on June 5. ■

Timbervest Fight (Continued from page 1)

for personal gain warranted at least association bars.

"This isn't a violation of the securities law," said Timbervest's attorney, **Stephen Councill**, a partner with **Rogers & Hardin** in Atlanta. The RIA was managing forestry property for **AT&T**'s pension plan, putting the jurisdiction under ERISA, he contended.

Last month, AT&T sued Timbervest and the principals in federal court in Texas, claiming ERISA violations. The company builds its case largely on the SEC's investigation.

Round one

Last year, SEC ALJ **Cameron Elliott** ruled that the firm should pay $1.9 million but held that the firm's registration couldn't be revoked or its four principals barred from the industry because the violations occurred "outside" of the agency's five-year statute of limitations.

That decision displeased both sides. Timbervest and the Enforcement Division appealed the case to the full Commission.

The SEC's Winter told commissioners the Enforcement Division began its investigation in 2010, following an OCIE exam. But the conduct at the heart of the case wasn't discovered until 2012. "It was highly concealed" via shell LLCs that resembled a money laundering operation, he said.

Councill questioned the testimony of a key witness, saying "he changed his story dramatically." He also stated that years ago a Timbervest principal had a conversation with a pension plan representative where he disclosed the real estate sales and fees.

The Enforcement Division alleges Timbervest principals engaged in a "round trip" sale. One property was sold for $15.5 million and repurchased only weeks later for $14.5 million, generating commissions that the principals split. Each received checks valued at $260,000, stated Winter.

ALJ system questioned

Timbervest attorney **George Kostolampros**, a partner with **McKenna Long & Aldridge** in Washington, D.C., argued that the ALJ system is unconstitutional. "Through adjudication, policy is being formulated," he said.

The case deserves watching for how the Commission rules on that issue and whether some bar is possible despite the statute of limitations.

According to the complaint in the AT&T lawsuit, the firm didn't learn about the alleged fraud until it was "contacted by the SEC in May 2012." AT&T alleges that Timbervest has refused to "provide any pre-2011 books and records related to its activities" overseeing the pension plan. "To this day, Timbervest has still never turned over the pre-2011 books and records, perhaps because such records would reveal additional wrongdoing by Defendants," it reads.

ALJ system ruled unconstitutional

Ironically, on the same day Kostolampros made his arguments, a federal judge in Atlanta blocked an SEC ALJ hearing in an insider trading case on constitutional grounds. U.S. District Court Judge **Leigh Martin May** June 8 ruled that the SEC's case against **Charles Hill** had to be temporarily halted because the system of appointing ALJs "is likely unconstitutional." She noted that ALJs are hired and not appointed by the President, SEC commissioners or the judiciary.

"Because SEC ALJs are inferior officers, the Court

(Timbervest Fight, continued on page 4)

Timbervest Fight (Continued from page 3)

finds Plaintiff has established a likelihood of success on the merits on his Appointments Clause claim. Inferior officers must be appointed by the President, department heads, or courts of law," she ruled. It remains to be seen how much sticking power this decision will have nationally. ■

FINRA officials address wide range of questions from conference attendees

A highlight of **FINRA**'s annual spring conference is when firms get a chance to turn the tables on top officials of the SRO and ask what they are up to and why. Here's the dish from this year's *Ask the Regulators* session held May 29 in Washington, D.C.

Outsourcing

FINRA has retrenched since considering an outsourcing rule five years ago. But it remains an active area of interest and focus. "We are doing a number of exams this year to look at the issue, not from a compliance aspect but more to spot issues," said **Bill Wollman**, executive VP for risk oversight and operational regulation.

The focus is on the adequacy of supervision. Some firms are using a best practice of auditing the outsourced provider, while others have "put that function on auto pilot," stated Wollman. Expect FINRA to assess findings at year-end to decide whether to proceed with a new rule.

CCO personal liability

"You will see zero cases" where compliance officers are pursued purely for failing to supervise employees on the business side, said **Brad Bennett**, executive VP, enforcement, alluding to the **SEC**'s infamous **Ted Urban** case (**IA Watch**, Oct. 23, 2014).

Common themes that Bennett said mark cases FINRA does bring include clear assignment of responsibility in a particular area; numerous red flags, and acknowledgment by the CCO that there were issues that were not being fixed yet caused significant problems.

According to Bennett, the vast majority of cases involve under-reporting on the compliance officer's own U4 or breakdowns stemming from the officer wearing multiple hats. Compliance officers have been targeted for knowingly retaining a suspended **FinOP** and having specific oversight responsibility of a rep that sent out phony client account statements.

Enforcement Trends

Cases are up 30% from last year. "We are seeing a steady flow of individual broker cases – in excess of 800 this year," Bennett said, adding that AML is a problem "across the board," and penny stock abuses are a growing issue for smaller firms.

Liquidity

The **Federal Reserve** last month proposed a rule that would allow large banks to count some municipal bonds as high-quality liquid assets. Don't expect FINRA to follow suit. Wollman noted the muni market is such that you cannot liquidate your portfolio in a day. Muni bonds fall "more in the middle, giving them some value but not quite putting them in the high-quality liquid asset bucket," he said.

Belligerent examiners?

If you encounter rude examiners make sure to elevate and escalate your concerns. "That is not acceptable behavior by anyone" said **Mike Rufino**, executive VP for sales practice. Wollman said firms should not fear retaliation if they complain (he noted that FINRA has a "mirror problem" with firms' junior compliance officers). "We want to run a professional program," Wollman said.

Identifying high-risk brokers

The SRO uses "quantitative" as well as "qualitative" analytics, said Rufino. Complaint volume is just one indicator. Tips and U5 filings are major tools. "We still attract phone calls and e-mail virtually every day," said **Cameron Funkhouser**, executive VP for fraud detection and market intelligence, adding that FINRA has no plans to start a whistleblower program like the SEC. "There's a bunch of ethical people and nosey neighbors in the world who are motivated to report potential fraud," he added.

Recidivist brokers face "a thorough review," including of their book of business, their communications, their account activities, and the level of firm supervision, Rufino said. But **Susan Axelrod**, executive VP of regulatory operations, said "just because someone worked at a firm that was high risk doesn't mean we tag them as someone who is a bad broker.… We evaluate people based on their individual conduct."

Protecting seniors is a FINRA priority and a new senior help line has attracted more than 400 calls in a month. Callers are having trouble with everything from using *BrokerCheck* to liquidating the accounts of deceased relatives after supplying required legal documents. "We have seen a lot of loans from brokers to customers," Axelrod said. Be prepared to act if FINRA calls. The SRO is bringing senior help line matters to the attention of firms and the expectation is they will

(FINRA Q&A, continued on page 5)

FINRA Q&A (Continued from page 4)

be "doing the right things on a real time basis" without arbitration or a formal complaint, Axelrod said.

FINRA is seeking comment on a revised proposal to alert investors about the consequences of their brokers changing firms. Firms would have to send an "educational communication" outlining questions investors should ask about compensation and inducements when their broker changes firms. ■

Click here to read this entire story. ■

After Whistleblowing (Continued from page 1)

regulator stating VOSO's registration had technically lapsed. He blamed Orosky, who wouldn't talk on the record with **IA Watch**. Orosky now works with **Capital Securities Management** out of a Maryland location.

Circumstances forced McCaskill to dig into what was happening. It was then that he claims he discovered Orosky's loans from clients. He alerted Raymond James' Regional Manager **Tom Harrington**. "'It sounds like a compliance matter,'" McCaskill quotes Harrington's response. The manager promised to have a compliance officer contact him, even as McCaskill e-mailed Raymond James evidence of his findings.

Instead, McCaskill says Harrington went to Orosky, who had been one of Raymond James' "chairman counsel winners," a top 50 producer in the country. Orosky learned that, as branch manager, Raymond James vested him with the power to fire McCaskill. He did – changing the locks, even on the building that McCaskill owned.

McCaskill's world was whirling. Things worsened when Raymond James' compliance person **Nicole Caringal** investigated the allegations and turned her attention to McCaskill. He claims she never talked with him. But Raymond James did bring the matter up with Maryland securities regulators. McCaskill also says the firm sent his clients misleading letters that appeared to lump him in with Orosky's behavior, correspondence that he says cost him some long-term relationships.

U5 filings

Orosky's original U5 filing on McCaskill's termination noted he wasn't a "team player." Raymond James would later amend the U5. Despite **FINRA** rules that brokers share U5 filings with the rep, McCaskill learned of the revision only when **LPL** spotted it and retracted a job offer. McCaskill sued for expungement and won a defamation claim in FINRA arbitration last year, capturing a $600,000 judgment.

Still, based on the correspondence from Raymond James, Maryland authorities would charge McCaskill with functioning as a financial adviser when not licensed during the weeks following his termination. McCaskill says he attempted to fight the charges but found himself unemployed, with dwindling money, a tarnished U5 and a state regulator that promised a hearing in 12 months. He didn't have that much time. He reluctantly signed the state's consent order, agreeing to pay $5,000.

"Unfortunately, Scott's case is not an outlier," says **Robert Lowry** of **RL Consulting Services** in Leesburg, Va., who is an expert on U5 cases. He finds the most fault in Raymond James's compliance investigation. "You don't tell someone that you're watching them," he says. "It should be an objective review."

"It would appear to me that the sales side of Raymond James makes the final call on what the compliance side reports," says **David Cosgrove** of the **Cosgrove Law Group** in St. Louis, who won McCaskill's arbitration case. Raymond James declined to comment and neither Caringal or Harrington returned **IA Watch**'s requests for comment.

Firms rarely charged for bad U5s

Cosgrove wonders why FINRA never charged Raymond James for filing an improper U5. FINRA wouldn't comment to **IA Watch**. The SRO does punish firms for inaccurate U5s, says **Scott Stechman**, counsel with **Lehman & Eilen** in Uniondale, N.Y. He found three recent cases of firms sanctioned for incomplete or inaccurate U5s.

At least 20% of U5 filings are inaccurate, believes **Stewart Meissner**, a New York attorney who represents reps. FINRA provides steps reps can take to expunge errant U5s but "they don't publicize the procedures," he adds.

"It's certainly a system that can be abused," says **Ronald Amato** of the **Amato Law Firm** in Chicago, who also represents reps. "Firms can frame things in a way that make an adviser appear to have done something egregious." The motivation could be to steal the rep's book of business, vengeance, retribution or simple incompetence, says Amato.

For example, the firm could file that the rep exhibited an "improper use of discretion" in an account. That looks bad. But it may have been an isolated situation. Or the rep may have received the client's consent on Tuesday and waited until Wednesday to make the trade, adds Amato.

Many problem U5s come down to poorly written submissions that lack any intended malice, says **Brittany Weiner**, a partner with **Imbesi Law** in New York. She

(After Whistleblowing, continued on page 6)

After Whistleblowing (Continued from page 5)

recommends compliance officers be involved in crafting any language posted to a U5, especially if the case accuses one of an ethical violation.

A rep deserves such diligence because a poorly written U5 can render him virtually unemployable, she adds.

The state's investigation

McCaskill continues to challenge the consent order he signed with Maryland authorities, even though it technically prohibits him from doing so. He seeks to be vindicated there as well.

He claims Maryland officials did little or no investigation but simply took the word of Raymond James. Maryland security officials wouldn't talk about the case because of the continuing challenge.

"Scott McCaskill should never have been subjected to a consent order in the first place," says the attorney who represented him in the state action, **Jacob Frenkel** of **Shulman Rogers Gandal** in Rockville, Md. "I was astounded how dismissive" Maryland securities staff were despite "compelling facts" and a large binder of evidence, he adds.

"I think this is a tragic but very common situation," Frenkel continues. He believes that regulators target small fries who can't wage a fight, insist on some fine to justify their time and turn to hearing officers who are salaried employees of the regulator itself to decide cases.

No one would dispute the industry's right to quickly remove bad guys so they couldn't continue to cause harm. But McCaskill's attorneys argue the system can also punish a whistleblower by using the U5 system to deny him the ability to work and earn money needed to mount a defense against questionable charges.

Solutions

Amato notes New York law extends an absolute privilege to firms that prevent a defamation claim over a U5 filing. And anything negative on a U5 will stay there permanently, unless a rep were successful obtaining expungement via FINRA arbitration, he adds. One solution would be to negotiate with the firm or suggest some agreed upon language for the U5, Amato states.

RL Consulting's Lowry holds that what's needed is for firms to employ competent compliance staff that won't be swayed by economic considerations but rather be guided by integrity to take investigations wherever they may lead.

McCaskill, who opened **McCaskill Financial Advisors** only weeks after parting with Orosky, says Raymond James' Caringal was moved out of compliance and into sales – under Harrington. Lessons he learned include to pick your business partners wisely. He also wants other reps to know that a broker they link with may only consider the branch manager as boss. ■

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