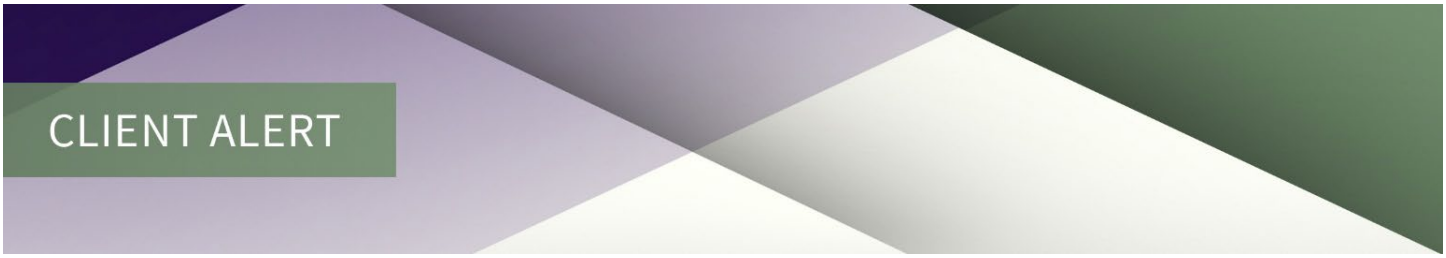

SEC Enforcement – Top Developments from May 2024

July 11, 2024

AUTHORS

Adam S. Aderton | Elizabeth P. Gray | A. Kristina Littman | Erik Holmvik

In May, the U.S. Securities and Exchange Commission (the "SEC") settled its latest action involving violations of Reg BI and prevailed in first-of-its-kind litigation involving a statutory underwriter theory in the crypto context. In this month's issue, we cover:

- An action against an auditor for "deliberate and systemic" auditing and reporting failures;
- A recent Reg BI enforcement action;
- A duty of care enforcement action; and
- The SEC's successful application of a statutory underwriter theory to a crypto offering.

1. Audit firm and owner suspended indefinitely, ordered to pay $12 million for fraudulent conduct

On May 3, the SEC announced it had settled charges with audit firm BF Borgers CPA PC ("BF Borgers") and its owner, Benjamin F. Borgers ("Borgers"), for "deliberate and systemic failures" to comply with Public Company Accounting Oversight Board (the "PCAOB") standards in audits and reviews that were incorporated into over 1,500 SEC filings.[1] As part of the settlement, BF Borgers agreed to pay a $12 million civil penalty and Borgers agreed to pay a $2 million civil penalty. Both Borgers and the firm consented to permanent suspensions from appearing and practicing before the PCAOB.[2]

The SEC's order found that Borgers and his firm falsely represented to their clients that the firm's work complied with PCAOB standards. In fact, those representations were false with respect to more than 500 public company audits. For example, the SEC's order found BF Borgers failed to obtain an engagement quality review for audits and reviews of financial statements that were incorporated into at least 75% of its clients' public filings and disclosures. In addition, the order found that Borgers himself failed to carry out important duties as the engagement partner, such as conducting audit planning meetings and reviewing important audit workpapers. According to the order, the firm fabricated documents and Borgers himself authorized the fabrication of work product included in the firm's audits, including copying workpapers from previously conducted audits and passing them off as new.

The SEC Enforcement Director Gurbir S. Grewal described BF Borgers and Borgers' conduct as "one of the largest wholesale failures by gatekeepers in our financial markets."[3] While the facts asserted in the SEC's order are egregious, this action demonstrates the SEC's continued focus on the role of accountants as gatekeepers of the public securities market.

2. Broker-dealer charged under regulation best interest and investment advisers act

On May 21, the SEC settled charges with a dually registered broker-dealer and investment adviser for failing to comply with Regulation Best Interest ("Reg BI") and the Investment Advisers Act of 1940. The was action focused on the broker-dealer's maintenance of an undisclosed referral fee program that created multiple conflicts of interest.[4] To settle the charges, the firm agreed to pay a $223,228 monetary penalty.

The action arose from the broker-dealer's policy of paying its representatives a finder's fee for making a certain number of customer referrals to the broker-dealer's affiliate wealth management firm, which was part of the same parent organization. When the broker-dealer's representatives recommended that certain clients and customers transfer investments to the

1 The SEC's press release can be found here.
2 The SEC's enforcement order can be found here.
3 *Supra* Note 1.
4 The SEC's press release can be found here.

affiliate wealth management firm, they did so without disclosing that they could receive compensation for making such recommendations. In addition to the finder's fee, this compensation included an annual fee based on the transfer of securities and other assets to the affiliate wealth management firm. Additionally, the SEC alleged that the broker-dealer's internal policies "were not reasonably designed to achieve compliance with . . . disclosure obligations under Reg BI and the Advisers Act[.]"[5]

Reg BI enforcement has gradually been increasing with both the SEC and FINRA now regularly bringing Reg BI actions. Click here to read this Willkie Client Alert addressing the SEC's Division of Examination's 2024 Priorities, which indicated a focus on Reg BI.

3. SEC settles charges with investment adviser for breaching duty of care

On May 20, the SEC settled charges with a registered investment adviser for breaching its duty of care in connection with failing to conduct an analysis to determine whether commission-paying variable annuities were in its clients' best interest.[6] Without admitting or denying the SEC's findings, the investment adviser agreed to pay roughly $890,000 in disgorgement and a $175,000 civil penalty.

According to the SEC's order, the investment adviser recommended variable annuity investments that were sponsored by insurance companies. These investments paid up-front sales commissions to the investment adviser's affiliated broker-dealer. However, a majority of those same insurance companies offered the same variable annuities with lower ongoing fees and without a commission. According to the order, the adviser did not analyze whether it was in its clients' best interest to invest in the higher cost versions of the variable annuities.

The order also emphasized the adviser's disclosure failures and compliance deficiencies in connection with its policies and procedures regarding commission-paying investment products. The order found that the adviser also failed to disclose to its clients the conflicts of interest posed by the recommendation of annuity investments that paid commissions to the adviser's affiliated broker-dealer and failed to adopt and implement appropriate written policies and procedures.

In the Division of Examinations 2024 Examination Priorities, investment advisers and their duty of care was, quite literally, at the top of the list.[7] This action demonstrates the SEC's continued commitment to pursuing enforcement actions based on a duty of care theory.

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5 The SEC's order can be found here.

6 The SEC's press release can be found here.

7 U.S. SECURITIES AND EXCH. COMM'N, 2024 EXAMINATION PRIORITIES (2023), https://www.sec.gov/files/2024-exam-priorities.pdf.

4. SEC successfully advances underwriter theory in crypto security resale action

On May 22, in *SEC v. Balina*, the United States District Court for the Western District of Texas granted in part and denied in part the SEC's motion for summary judgment while denying Balina's cross-motion for summary judgment.[8] This case is the first instance of the SEC pursuing a statutory underwriter theory in the context of a crypto offering.[9]

The SEC's complaint against Balina, a crypto social media influencer, alleged that Balina violated Sections 5(a), 5(c), and 17(b) of the Securities Act of 1933 by selling and offering an unregistered security through his soliciting of purchasers for the SPRK crypto token, which was created by software development company Sparkster.[10] The Court held as a matter of law that Balina violated Sections 5(a) and 5(c) of the Securities Act by engaging in the unregistered offer and sale of securities, while finding there was a factual issue as to whether Balina violated Section 17(b) by promoting the securities offering without disclosing his receipt of compensation in exchange for his promotion.

On May 20, 2018, Balina reached an agreement with Sparkster to purchase SPRK tokens. The same day, Balina began seeking prospective investors to purchase SPRK tokens from his share. Over the course of the next month, Balina continued to promote the SPRK tokens to investors and followers through various online channels.

The Court found that Balina's actions violated Sections 5(a) and 5(c) of the Securities Act, with the key element at issue being whether "[Balina] sold or offered to sell these securities."[11] Balina argued that he was but one member of a large pool of individuals who bought the SPRK tokens. But the Court was unconvinced, citing the facts that Balina signed a $5 million contract with Sparkster to buy SPRK tokens, and then repeatedly solicited purchasers of SPRK tokens. With the Section 5 violation issue decided, the Court turned to the issue of whether Balina was actually covered by the Securities Act.

Balina argued he was exempt under Section 4(a)(1) of the Securities Act, which exempts transactions by anyone who is not an "issuer, underwriter, or dealer."[12] But the Court again disagreed, finding Balina's actions met the criteria for being a statutory underwriter. The Court cited the fact that Balina formed a pool of potential investors in SPRK the day he signed the token purchase contract, and afterwards asked for more SPRK tokens from Sparkster due to investor interest. The Court ruled that Balina purchased the SPRK tokens with an intent to distribute, and was thus an underwriter for purposes of the Securities Act.

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8 The Order on Cross Motion for Summary Judgment can be found here.

9 The SEC also successfully argued in this action that the asset was offered and sold as a security.

10 *SEC v. Balina*, No. 1:22-CV-00950-DAE (W.D. Tex. May 22, 2024).

11 *Supra* Note 8 at 34.

12 Under Section (2)(a)(11), an "underwriter" is anyone who "has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking . . ."

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Adam S. Aderton
202 303 1224
aaderton@willkie.com

Elizabeth P. Gray
202 303 1207
egray@willkie.com

A. Kristina Littman
202 303 1209
aklittman@willkie.com

Erik Holmvik
202 303 1048
eholmvik@willkie.com