Dechert LLP

Financial Services

MAY 27, 2003 / NUMBER 30

update

Vernazza v. SEC -- Ninth Circuit Upholds SEC Sanctions Against Investment Adviser and Affiliated Persons for Fraudulently Disguising a Referral Fee Agreement

Summary

On April 24, 2003, the Court of Appeals for the Ninth Circuit denied the petition of Jerome B. Vernazza, Vernon T. Hall, Stanley E. Hargrave, and IMS/CPAs & Associates ("IMS") (collectively the "Petitioners") for review of an order of the Securities and Exchange Commission (the "SEC") imposing sanctions for violations of several antifraud provisions of the federal securities laws.[1] The Court held that to establish scienter under the various securities violations at issue, a showing of "knowing and reckless conduct" is sufficient. Accordingly, the Court found that the SEC had substantial evidence, supported by the laws and facts, that Petitioners, who are investment advisers, knowingly or recklessly made materially false statements and omissions to their clients and in their filings with the SEC when they represented that they had no financial interest in nor received benefits for their investment recommendations.

Facts

Vernazza[2], Hall and Hargrave are partners in IMS, an investment adviser registered under the Investment Advisers Act of 1940 ("Advisers Act"). They also owned the accounting firm Hall & Vernazza, CPAs ("H&V"), which essentially was the same business as IMS.

World Money Managers ("World"), a registered investment adviser, served as the adviser while H&V served as the subadviser to the Tax Planning Federal Cash Fund ("Tax Fund"). In June 1992, World and H&V closed the Tax Fund. The closing costs for an investment fund are usually paid by the fund itself. Accordingly, H&V obtained a loan from World to pay the $60,000 closing costs.

The day after the loan was made, World and H&V entered into a Shareholder Servicing Agreement ("SSA") which provided that World would pay H&V for services related to

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[1] *Vernazza v. SEC*, No. 01-71857, No. 02-70016 (9th Cir. 2003).

[2] Jerome B. Vernazza also was a registered adviser but withdrew his registration in 1997.

World's Permanent Portfolio Family ("PPF") of Funds. H&V's compensation would be based on "time, effort and complexity of services" at an annual rate capped at certain percentages of "Additional Assets." "Additional Assets" was defined as the value of H&V's or IMS's clients' investments in PPF Funds. In order for H&V to be paid under the SSA, H&V must meet a minimum investment requirement that its and IMS's clients purchased at least $1,000,000 in PPF funds.

When the amount of H&V's services was greater than the caps, H&V was paid the maximum under the cap and the balance carried over to the next billing cycle. During the life of the SSA, H&V consistently performed services entitling it to more money than it could recover under the caps. Additionally, H&V's payments to World on the $60,000 loan closely tracked the payments made by World under the SSA. By September 5, 1993, World had paid H&V $24,431 under the SSA while H&V had paid World $24,000 under the promissory note.

During this same period, Petitioners made false representations in engagement letters to their clients that they neither had financial interest in nor receive commission for recommending PPF funds. Vernazza and IMS also made similar representations in filings with the SEC. Specifically, as investment advisers, Vernazza and IMS were required to file a Form ADV annually with the SEC, which contained questions regarding potential conflicts of interest, financial interest in securities recommended to clients, arrangements material to their advisory business or clients with a related person who is another investment adviser.[3] Vernazza and IMS originally made no disclosure of the SSA compensation in their responses in Form ADV. Eventually in 1992 and 1993, Vernazza and IMS respectively, disclosed that H&V was paid by World for advisory and administrative support services under the SSA but neither disclosed that H&V's compensation caps applied only to investments made by H&V/IMS clients. Under Form ADV, Vernazza and IMS were also required to furnish clients with disclosure statements regarding potential conflicts of interest issues. The disclosure statements for Vernazza, Hall, and Hargrave during 1993-94 stated that they did not receive fees or commissions for selling investments they recommended, however, under the SSA, H&V received compensation from World for advisory and administrative support services.

In July 1996, the SEC initiated proceedings against Petitioners alleging fraud in violation of the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), and the Advisers Act and making materially false statements in violation of the Advisers Act. An administrative judge found that Petitioners had committed the violations and issued a cease-and-desist order, suspended Vernazza's and IMS's registration as advisers, prohibited Vernazza, Hall and Hargrave from associating with any adviser for six months, and ordered disgorgement of payments received under the SSA. The SEC, after a de novo review, affirmed the administrative law judge's order in large part . Petitioners challenged the SEC's order on grounds that the SEC erred in finding that Petitioners acted with scienter and in excluding testimony of an expert witness, and that the SEC abused its discretion in imposing sanctions.

Violations of Antifraud Provisions and for Making Materially False Statements

The SEC concluded that Petitioners recklessly and knowingly made materially false statements when they represented that they had no financial interest in nor received benefits from their investment recommendations. The SEC found that the SSA was merely a disguised referral fee agreement. The SEC held that the Petitioners committed fraud in violations of Section 17(a) of the Securities Act, which criminalizes the use of fraudulent schemes or business practices and criminalizes obtaining money by making false statements of material fact or misleading omission. The SEC also

3 *See* Rule 204-1(a).

found fraud in violation of Section 10(b) and Rule 10b-5 of the Exchange Act, which prohibit the use of deceptive devices in connection with the sale of securities and prohibit making false statements of material fact or misleading material omissions. Additionally, the SEC concluded that Petitioners violated Section 206 of the Advisers Act, which prohibits advisers from, directly or indirectly, employing a scheme to defraud clients or engaging in practices which operate as a fraud upon clients.

The Court in evaluating Petitioners' request for review of the SEC order, held that Petitioners made materially false statements when they failed to disclose the potential conflicts of interest under the SSA and when they represented that they did not have an ownership, sale interest or financial interest in recommended securities and did not receive economic benefits in connection with giving advice to clients.

The Court relied on two bases for its conclusion. First, the minimum investment provision created an incentive for Petitioners to encourage their clients to invest at least $1,000,000 in PPF funds; otherwise H&V would not receive any payment under the SSA. The Court held that when a person's compensation is contingent on his or her clients investing a minimum amount of money, that person has a financial interest in recommending the fund until that minimum amount is reached. Secondly, the caps under the SSA created a financial interest in recommending PPF funds after the minimum investment has been reached. The Court explained that when H&V perform services entitling it to compensation in excess of the caps, the balance was rolled over to the next period. The Court held that as long as the balance was carried over, H&V's compensation was still dependent on the amount of money its and IMS's clients invested in PPF funds. The Court added that the actual amount of work performed by H&V was irrelevant to the conclusion, because as long as the balance of compensation in excess of the cap was carried forward, Petitioners continued to have a financial interest in recommending PPF funds.

SEC's finding of "Scienter"

The Court concluded that scienter is a required element for violations of Section 17(a)(1) of the Securities Act, Section 10(b) and Rule 10b-5 of the Exchange Act, and Section 206 of the Advisers Act. In the Ninth Circuit, a violation of Section 17(a)(1) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act may be evidenced by "knowing and reckless conduct," without a showing of "willful intent to defraud." The Court held that because the language under Section 206(1) of the Advisers Act is nearly identical to Section 17(a)(1) of the Securities Act, scienter under Section 206(1) of the Advisers Act also only requires knowing or reckless conduct.

The Court deferred to the SEC's finding that Vernazza, Hall and Hargrave had knowledge of the caps under the SSA and reason to know of the false statements made in the Forms ADV and disclosure statements. The SEC held that even if Petitioners' failure to disclose the potential conflicts of interest was unknowing, it was nonetheless reckless, thus, establishing that Petitioners had the requisite scienter.

Exclusion of Expert Testimony

The Court held that the SEC did not err in excluding expert testimony of a lawyer who would testify to the complexities and difficulties in answering certain questions on Form ADV. The Court deferred to the SEC's conclusion that "[w]hether Form ADV is difficult or not is irrelevant; investment advisers are obligated to respond to questions in Form ADV correctly and seek whatever assistance they need in fulfilling this obligation." The Court recognized that expert testimony as to industry practice is relevant to show the standard of care in a recklessness inquiry. The Court, in its deference to the SEC's findings, held that the standard of care in this instance required the Petitioners to correctly identify the potential conflicts of interest under the SSA. Thus, the SEC need not accept expert testimony, which

purported to show that other investment advisers would have answered the question incorrectly. However, presumably this Court might allow expert testimony where the factual issues were more complex, rather than simply whether the Form ADV itself is difficult.

However, the Court "disapproved" of the SEC's statement that "[w]hether Form ADV is difficult or not is irrelevant" because it implies that a strict liability standard always applies in identifying conflicts of interest. The Court recognized that in cases where the financial interests are more complex or uncertain, an investment adviser might not be reckless in answering a particular question incorrectly and that expert testimony would be appropriate.

Appropriateness of SEC Sanctions

The Court upheld the SEC sanctions against Petitioners. Section 203 of the Advisers Act provides that when it is in the public interest the SEC may suspend the registration of registered advisers or bar association with advisers as a penalty for making false statements, and may impose monetary penalties for any violations of the Securities Act, the Exchange Act, or the Advisers Act. The Court said it would not find that the SEC abused its discretion without a showing that the sanction "is unreasonable or that it is unwarranted in law or without justification in fact."

Petitioners argued that the SEC sanctions were impermissibly punitive and unduly harsh and cited six similar cases where the SEC did not suspend the registration of registered advisers. The Court distinguished those cases on the facts. Those cases were settled and did not involve the scheme at issue here. Additionally, in those cases the SEC considered remedial actions already taken by the advisers or the adviser agreed, as part of the settlement, to institute policies and procedures to prevent future violations.

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