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Day Pitney White Collar Roundup - April 2022 Edition

Russian Legislator and Aides in DOJ Crosshairs

At the intersection of national security, foreign intrigue and criminal conspiracy, a senior Russian legislator, along with two of his aides, were recently charged by the U.S. Department of Justice (DOJ) with a sprawling scheme to unlawfully influence U.S. foreign policy, notably including U.S. policy with respect to Ukraine.

In the unsealed indictment, DOJ alleged that Aleksandr Babakov, a very senior member of the Russian Duma, a Russian house of parliament, along with staffers Aleksandr Vorobev and Mikhail Plisyuk, conspired to influence members of the U.S. Congress and to advance Russian political aims, including to undermine the sovereignty of Ukraine. Babakov and his staffers facilitated the alleged scheme through the academic-sounding Institute for International Integration Studies.

As laid out in the indictment, Babakov, Vorobev and Plisyuk used the nonprofit institute as a front for an influence campaign in support of harmful Russian objectives, including to weaken U.S. partnerships in Europe, undermine Western sanctions against Russia and destroy the sovereignty of Ukraine. The defendants and a co-conspirator contacted members of Congress to arrange meetings with Babakov and associates and to offer them free travel. In particular, the indictment alleges that defendants sought to entice a member of Congress to a conference in Russia-controlled Crimea in 2017 to benefit the so-called Crimean prime minister, who for years had been sanctioned by the United States for his role related to the Russian annexation. They further sought to promote and solicit American attendance at a conference in Crimea for the benefit of its Russian-backed "government."

For their efforts, Babakov and his associates were charged, among other crimes, for conspiring to have a U.S. citizen act as an unregistered agent for Russia, in violation of 18 U.S.C. 951, and to violate U.S. sanctions against Russian actors, in violation of prohibitions in and under the International Emergency Economic Powers Act, 50 U.S.C. 1701 et seq.

With the U.S. government's recent formation of Task Force KleptoCapture, we can expect the investigation and prosecution of unlawful activities by Russian actors to ramp up. Task Force KleptoCapture is charged with enforcing the sanctions, export restrictions and other economic measures the United States has imposed or strengthened in response to Russia's full-blown military invasion of Ukraine. The Task Force can prosecute any criminal offense related to its mission, including conspiracies to defraud the United States by interfering in its government functions and many other crimes. As a result, Babakov and his aides are likely not the only Russian actors squarely in DOJ's crosshairs.

No Rounding Error: PCAOB Imposes Historic Sanctions on Accountant

Last month, the Public Company Accounting Oversight Board (PCAOB) announced a $100,000 penalty and censure sanctions against Scott Marcello, the former vice chair of audit for a Big Four firm, for failing to reasonably supervise other accounting personnel. This marked the first time that the PCAOB has imposed sanctions based on a failure to supervise other accountants, despite having had the legal authority to do so since passage of the Sarbanes-Oxley Act in 2002.

Marcello was sanctioned for failing to supervise former accounting firm personnel who obtained and used confidential information from the PCAOB in order to improve the firm's inspection results. The PCAOB oversees audits of public companies and performs routine inspections of public accounting firms, which includes an evaluation of audit engagements, though the firms are not told ahead of time which engagements will be evaluated. In this case, former KPMG personnel were able to obtain, in advance of the inspection, a list of audit engagements the PCAOB intended to review. The audit work papers for these engagements were then carefully reviewed to fix any errors. In January 2018, five former KPMG and PCAOB employees involved in the scheme were charged with conspiracy and wire fraud, but Marcello was not among them.

As described in the PCAOB's sanctions order, Marcello learned in 2016 that firm personnel he then supervised had obtained confidential information from the PCAOB. At the time, Marcello did not report or escalate the matter or tell his subordinates to refrain from reviewing work papers in advance of the inspection. In 2017, Marcello again learned that the firm had advance knowledge regarding the PCAOB inspection. This time he escalated the issue to in-house counsel, but only after others said they would report the issue if Marcello did not.

Based on this conduct, the PCAOB concluded that Marcello failed to reasonably supervise those who were directly involved in the scheme and, for the first time since the passage of the Sarbanes-Oxley Act, imposed sanctions for failing to reasonably supervise other accounting personnel. It remains to be seen whether the sanctions in this case are an outlier or an indication that the PCAOB intends to more aggressively pursue accounting supervisors. In either case, the sanctions highlight the importance of the "tone at the top" in promoting a culture of compliance. Regulators of all stripes, including the PCAOB, regularly scrutinize how executives respond to evidence of potential violations by their direct reports or subordinates. In Marcello's case, he eventually reported the issue to in-house counsel, but definitely not soon enough to avoid the PCAOB's ire.

SPACs Likely to Attack Proposed Rule Changes

As we've reported, the U.S. Securities and Exchange Commission (SEC) has been sounding the alarm for months over special purpose acquisition company (SPAC) transactions. SEC Chair Gary Gensler has posited that existing regulations may not sufficiently protect SPAC investors. Now, the SEC is taking rulemaking action.

Following a 3-1 vote among the commissioners, the SEC has proposed new rules intended to "enhance disclosure and investor protection" in SPAC transactions. Gensler remarked that SPAC transactions are being used as an alternative means to conduct initial public offerings (IPOs), which have been regulated for decades. SPAC investors, in turn, "deserve the protections they receive from traditional IPOs, with respect to information asymmetries, fraud, and conflicts, and when it comes to disclosure, marketing practices, gatekeepers, and issuers."

The proposed rules are extensive and warrant a close review by anyone involved in or contemplating a SPAC-related transaction. We highlight below just a few proposals that could be subjects of securities and white collar litigation or enforcement.

Enhanced disclosure requirements. The proposed rules set forth specialized disclosure requirements applicable to IPOs that form a SPAC, and to de-SPAC transactions, which occur when the public shell company acquires or merges with a private company. These include additional disclosures about (1) the SPAC sponsor, its affiliates and any promoters, and an organizational chart that shows the relationship among them; (2) actual or potential material conflicts of interest; and (3) the fairness of the de-SPAC transaction to investors.

Liability exposure for underwriters. SEC officials have been warning investment banks, financial advisers, accountants and other advisers and "gatekeepers" of their due diligence responsibilities, and potential exposure, in connection with SPAC and de-SPAC transactions. Following up on those warnings, the proposal would deem an underwriter of a SPAC IPO that

"takes steps to facilitate the de-SPAC transaction, or any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction" to be engaged in a distribution of the securities of the combined company and therefore a statutory underwriter for Securities Act liability purposes. In short, the proposal takes an expansive view of who may be subject to underwriter liability, encompassing investment banks and other advisers that may have had relatively small engagements in only part of the SPAC process.

Excluding de-SPAC transactions from safe harbor protections. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements under certain conditions. Whether that safe harbor applies in connection with de-SPAC transactions has been an unsettled question. The SEC's proposal would settle it by expressly designating the safe harbor *unavailable* for disclosures in de-SPAC registration statements.

The proposed rules will not pass without a fight. The dissenting SEC commissioner, Hester Peirce, has proclaimed that she would have supported enhanced disclosure requirements, but the sweeping proposal "seems designed to stop SPACs in their tracks." We expect a heated public debate during the comment period over the coming weeks and months, including with concerted industry pushback over the SEC's proposed rule changes. It may be a bumpy ride.

More Mortgage Fraud, More Prison Time

A New Jersey man who led a yearslong bank and securities fraud scheme was sentenced in late March by U.S. District Judge Susan D. Wigenton to a prison term of more than eight years, as announced by the U.S. Attorney's Office for the District of New Jersey. A little over one year ago, Seth Levine pled guilty to an information charging him with conspiracy to commit bank and securities fraud. The fraud cost the victims, banks and investors a total of at least $60 million.

Levine owned and managed a company with subsidiaries that in turn owned multifamily buildings. From 2009 to 2019, Levine fraudulently obtained cash-out refinancing mortgages for the properties by providing materially false documents and information to financial institutions. Lenders, relying on the fake leases, expenses and rental documents, provided inflated cash-out refinance payments that Levine and his co-conspirators either pocketed for their own benefit or used to continue the scheme. Because the refinances were obtained with fabricated information, the properties were overvalued and their income did not support their rent. In order to make up the difference, Levine continued the cycle of fraud by obtaining additional cash-out refinances and using the cash payouts to cover bills from other properties.

In addition to defrauding the banks, Levine provided investors with fabricated documents and false reassurances regarding the condition of the properties and plans for funds to encourage investments. After securing them, Levine failed to abide by the terms he had promised investors, including making unauthorized use of the investment funds and using them to support his other properties. And just like with the banks, one fraud led to another when Levine started using funds from one investor to pay other investors.

According to the U.S. Attorney's Office, Levine's conspiracy to commit bank fraud resulted in losses to the lenders of at least $47 million and further losses to the investors of at least $13 million. In the end, this level of losses and the series of frauds underlying it produced another large number, to wit, a prison sentence of more than eight years.

Authors

Helen Harris

Partner

Stamford, CT | (203) 977-7418

hharris@daypitney.com

Mark Salah Morgan

Partner

Parsippany, NJ | (973) 966-8067

New York, NY | (212) 297-2421

mmorgan@daypitney.com

Naju R. Lathia

Partner

Parsippany, NJ | (973) 966-8082

nlathia@daypitney.com

Stanley A. Twardy, Jr.

Of Counsel

Stamford, CT | (203) 977-7368

satwardy@daypitney.com