Published on *The National Law Review* https://natlawreview.com

Highlights from SEC Speaks 2017: Litigation and Enforcement Trends

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The ***U.S. Securities and Exchange Commission*** ("SEC" or the "Commission") held its annual SEC Speaks conference in Washington, DC on February 24 and 25, 2017, and provided an update on recent litigation trends, the current enforcement initiatives in place at the Commission and the enforcement priorities for the coming year.

Acting Chairman Piwowar Focused on "Remembering the Forgotten Investor"

In his remarks at the conference, Acting Chairman of the SEC Michael S. Piwowar emphasized that securities regulation today must take into account all investors, including those "whom securities regulation is meant to serve and protect but so often has not." Borrowing from sociologist William Sumner, who authored the book and coined the term "*Forgotten Man*," Mr. Piwowar asserted that the "Forgotten Investor" has suffered as a result of certain securities regulations over the years, including disclosure provisions, the "accredited investor" threshold and civil monetary penalties.

Disclosures

While disclosure-based securities regulation is a "great innovation of our agency," Mr. Piwowar observed that, today, disclosures are fraught with "an avalanche of immaterial information." In that respect, Mr. Piwowar argued that "the Dodd-Frank Act is rife with examples of burdens ultimately borne by the Forgotten Investor through shareholder money and company resources being expended to provide non-material disclosures."

Mr. Piwowar referenced three disclosure rules in particular, noting that he directed the SEC staff to begin reconsideration of two such rules, while Congress and President Trump recently vacated the

third rule. Specifically, on January 31, 2017, Mr. Piwowar instructed the SEC staff to consider the propriety of its 2014 guidance on the conflict minerals rule.[1] According to Mr. Piwowar, “it is categorically wrong to use shareholder assets to fund a humanitarian effort better left to executive agencies with the requisite experiential knowledge.” Similarly, on February 6, Mr. Piwowar asked for public comment with respect to the pay ratio rule and any “unexpected challenges” in the rule’s implementation. Next, on February 14, 2017, President Trump signed into law a joint resolution of Congress that vacated the Commission’s rule requiring resource extraction disclosures.

The Accredited Investor Threshold

According to Mr. Piwowar, the Securities Act of 1933 (the “Securities Act”) and certain of its corresponding regulations further restrict the Forgotten Investor. Mr. Piwowar called attention to Regulation D as an example, noting that it divided private offering investors into two categories—“those persons accorded the privileged status of ‘accredited investor’ and those who are not.” Under the Securities Act and Regulation D, non-accredited investors are prohibited from investing in high-risk securities. Mr. Piwowar stated that, as a result, non-accredited investors are constrained from “earning the very highest expected returns.” Such constraints, Mr. Piwowar said, exclude the Forgotten Investors from diversification options and “deprive[ ] them of important risk mitigation techniques.” In that regard, Mr. Piwowar questioned “the notion that non-accredited investors are truly protected by regulations that prevent them from investing in high-risk, high-return securities available only to the Davos jet-set.”

Civil Monetary Penalties

Next, Mr. Piwowar focused on the assessment of civil monetary penalties on corporations. According to Mr. Piwowar, “[i]t is entirely appropriate to discipline and punish corporate malefactors who violate our laws, but, when we speak of penalizing a corporation, we must also remember the innocent investors who are so often the primary victims of the fraud.”

Noting that, in the past, he voted both for and against the assessment of civil monetary penalties against a corporation, Mr. Piwowar stated that every case is different, and that “there are circumstances in which I am fully prepared to support the imposition of civil monetary penalties on a corporation.” Mr. Piwowar said that regulated entities—such as broker-dealers and investment advisers—provide disclosures as to the regulations that apply to them. As a result, “shareholders are on fair notice—and the market has presumably priced in—that they are investing in a type of entity subject to particular enforcement risks.” Mr. Piwowar advised that the same principles apply to cases involving the Foreign Corrupt Practices Act.

When deciding whether to assess civil monetary penalties against a corporation, Mr. Piwowar said that he will look to “the factors set forth in the Commission’s 2006 guidance on penalties” and to the analyses provided by the Division of Economic and Risk Analysis.[2] He stressed, however, that the Commission should not overlook the Forgotten Investor who was already “victimized by corporate fraudsters” and “further made to pay for the sins of others.”

Two’s a Quorum

Mr. Piwowar concluded his remarks by stating that, during this time of transition in the federal government, he and Commissioner Kara M. Stein will continue to keep the Forgotten Investor in mind as they consider the following disclosure recommendations at the next open meeting set for March 1,

2017: (1) a request for public comment regarding disclosures provided by registrants in the financial services industry; (2) a requirement to include a hyperlink to each exhibit listed in the exhibit indices of certain filings; (3) a requirement that registrants submit registration statements and reports to EDGAR in HTML format; (4) a requirement to use the "Inline XBRL" format for the submission of operating company financial statement information and mutual fund risk/return summaries; (5) the elimination of the requirement for filers to post Interactive Data Files on their website; (6) the termination of the Commission's voluntary program for the submission of financial statement information interactive data; and (7) proposals for potential amendments to Exchange Act Rule 15c2-12 concerning event notices.

Commissioner's Remarks

Commissioner Kara M. Stein's remarks focused on recent changes in the financial markets and what is at stake for the future of market regulation as we make policy and rule-making decisions in response to the same. Commissioner Stein expressed her view that the Commission's policies should reflect its purpose of facilitating economic activity in a way that is fair and efficient and benefits Americans who are saving and investing. However, promoting these goals begins with an understanding of where the markets are today and where they are headed. Noting that "change is the only constant," Commissioner Stein identified and discussed several recent trends in the financial markets, stemming primarily from advancements in financial technology, and the challenges and opportunities they present.

First, Commissioner Stein discussed the marked increase in institutional investing, which now dominates the U.S. equities market, with institutional investors owning 70 percent of public shares in 2016. This increase has been driven primarily by the rapid growth of exchange-traded products ("ETPs") and, specifically, exchange-traded funds ("ETFs"). In fact, ETP assets under management have more than tripled in the last decade. Commissioner Stein noted that, while ETPs offer retail investors new opportunities and options, including access to a wider variety of products and markets, they also continue to be governed by rules and exemptions developed more than a decade ago, which could be problematic.

Second, Commissioner Stein observed that investors now have access to additional types and sources of investment advice, including from traditional advisors, "robo-advisors," and various hybrids. She referred to the SEC Staff's recent guidance on this issue, which noted that, while "robo-advisors" can make advice more affordable for investors and increase competition, they can also create disclosure, suitability and other related problems.

Third, Commissioner Stein noted the rapid movement from "floor" to electronic trading, both in the equity and fixed income markets. This move to electronic trading, while increasing the overall speed of information and interconnection between products and markets, and reducing the cost of most trades, has also had numerous less desirable consequences, including an increase in so-called "flash crashes" and "flash rallies." Electronic trading has also driven a reduction in workforces, as evidenced by one investment bank that not only reduced its number of equity traders from 600 to two, but also now employs a workforce that is nearly one-third computer engineers.

Fourth, Commissioner Stein described an overall reduction in transparency caused by increased off-exchange trading, including in so-called "dark pools." This move to less transparent venues negatively affects both price discovery and transparency. Commissioner Stein also noted that capital raising is experiencing a similar trend, with more money now invested through unregistered private offerings than public. Moreover, there are also fewer reporting companies overall, meaning more

companies are unregistered and not subject to public disclosure obligations. Finally, Commissioner Stein observed that the effects of these changes are not isolated to a handful of sophisticated investors since millions invest in impacted products through institutional investors.

Commissioner Stein then broadly considered what these changes mean through several high-level questions they have raised for the Commission and its mission going forward. For instance, with stock ownership becoming increasingly concentrated in the hands of a small group of large institutional investors, are the markets allocating money to those who will put it to the best use? What effect does this concentration have on the willingness of companies to compete and invest in innovation? With respect to structure, are anti-manipulation laws passed in an era of "floor" trading sufficient for electronic trading or do they need to be amended? As more companies choose to stay private, do we need enhanced disclosure laws to cover these private companies, or do they need their own unique set of rules? How do we protect investors from increasingly complex retail products, including ETPs, and ensure appropriate disclosures are made?

In Commissioner Stein's view, disclosure and transparency have been and will remain critical because honest and effective markets require honest disclosure. Ensuring such disclosure and transparency and continuing to effectively regulate markets will require the Commission to take advantage of all tools at its disposal, including but not limited to the Consolidated Audit Trail ("CAT") and other pilot projects developed in conjunction with various exchanges, in order to peer into and analyze markets and assess whether the current structure is sufficient to withstand the growing challenges we face.

Commissioner Stein concluded her remarks by reiterating her view that the financial markets landscape is rapidly changing, and that we cannot simply turn the clock backward, but rather, must look to the future. Indeed, quoting President John F. Kennedy, Commissioner Stein stated: "Change is the law of life. And those who look only to the past or present are certain to miss the future." In Commissioner Stein's view, we cannot afford to miss the future. She believes that the markets are too important—to capital, jobs, and the ability of investors to save for education and retirement—and we need to do everything possible to help them adapt to meet the demands of an ever-changing landscape.

Division of Enforcement: Litigation Enforcement Trends and Priorities for 2017

Speakers from the Division of Enforcement (the "Division") discussed the Division's recent cases as well as its priority areas for 2017, which include financial reporting fraud, cybersecurity, gatekeepers, insider trading, complex products and complex market practices, and the Foreign Corrupt Practices Act ("FCPA"). Speakers also highlighted the various initiatives within the Division and how the Division has been able to leverage data that other units and groups within the SEC have compiled as well as developments and improvements in the technological tools the Division uses to assist in identifying issues earlier and faster, enabling the Division to bring better and more effective enforcement actions.

Legal and Policy Developments

Joseph K. Brenner, Chief Counsel for the Division, expressed surprise at what he considered a widespread lack of attention to the SEC's own prior decisions and opinions in legal submissions to the SEC, noting that submissions instead have tended to rely on federal court cases. Mr. Brenner noted that the SEC will apply the securities laws and regulations in accordance with its decisions and opinions, and that he views citation to federal court cases as effective only in circumstances such as

when potential federal court litigation is being discussed or when courts disagree with the SEC's decisions and opinions. Citation to federal court cases from other jurisdictions, according to Mr. Brenner, is effective when the matter at issue would be one of first impression in the court in which the relevant SEC litigation would proceed.

Mr. Brenner then focused on recent Commission rulings that have shed light on how the SEC views negligence-based claims and defenses thereto: *In the Matter of Harding Advisory, LLC*, *In the Matter of The Robare Group, Ltd.*, *In the Matter of Dennis J. Malouf*, and *In the Matter of Bernerd E. Young*. These rulings, according to Mr. Brenner, demonstrate that the SEC places a heavy emphasis on circumstances in analyzing the "reasonable person" component of the negligence standard. Specifically, Mr. Brenner noted that under a negligence standard, a respondent owing a fiduciary duty may be required to take greater action than one who did not owe a fiduciary duty.

Mr. Brenner also talked about use of expert testimony in negligence cases, stating that, for example, in *In the Matter of The Robare Group, Ltd.*, the Commission did not need expert testimony to understand what was reasonable for an adviser to do. However, as demonstrated by *In the Matter of Harding Advisory, LLC*, the more narrow and specialized a respondent's role is, the more useful expert testimony becomes.

According to Mr. Brenner, the Commission's recent negligence rulings—including *In the Matter of The Robare Group, Ltd.*—also shed light on how the Commission views the defense of reliance on counsel (or other professionals) in the negligence context. While the 4-factor test[3] used to analyze such a defense developed in scienter-based cases, it applies in the negligence context as well. Mr. Brenner noted that there is a difference between, for example, showing an ADV to a consultant and then stating that the consultant didn't raise an issue with it versus specifically asking the consultant about how to handle a particular issue.

Litigation

Investigate to Litigate

David Gottesman, Acting Co-Chief Litigation Counsel, praised the SEC's "investigate to litigate" initiative—started a few years ago—by which the SEC conducts enforcement investigations "with enhanced emphasis on developing admissible evidence" during the investigation. The SEC seeks to fulfill the goal of this initiative by training investigative attorneys to focus more on evidence gathering, getting trial attorneys involved in investigations earlier than in the past, and by keeping investigative attorneys on the trial team. While Mr. Gottesman noted that the "investigate to litigate" program does not eliminate the need for discovery if and when litigation is filed, he lauded the SEC's ability to better evaluate cases at the end of the investigative phase, and to better litigate matters that cannot be settled.

Litigation Results

Mr. Gottesman noted that the SEC has won approximately 90% of its trials (federal court litigation and administrative proceedings) since October 1, 2015, and that the SEC's win rate in federal district court has been "particularly high." He also emphasized the SEC's success at the summary judgment stage of litigation, touting nearly a dozen cases—ranging from offering fraud to Ponzi schemes to other 10b-5 violations—in which the SEC prevailed as a matter of law prior to trial.

Challenges to Administrative Proceedings

Bridget Fitzpatrick, Acting Co-Chief Litigation Counsel, noted the recently developed split between the Tenth Circuit (*Bandimere v. SEC*) and D.C. Circuit (*Lucia v. SEC*) regarding the compliance of SEC ALJ appointments with Article 2 of the U.S. Constitution. The D.C. Circuit—which had ruled in favor of the SEC—has granted *en banc* review of its ruling. The SEC's window to seek *en banc* review of the Tenth Circuit's ruling in *Bandimere*, or to appeal to the U.S. Supreme Court, will close in March. Stephanie Avakian, Acting Director of the Division, noted that the attacks on the constitutionality of the SEC's ALJs are "no doubt a factor" when deciding where to bring claims.

Cooperation Initiatives

Ms. Fitzpatrick also spoke about the SEC's cooperation initiatives, noting that the SEC takes such initiatives very seriously and wants to encourage people to cooperate "early, frequently, and strongly." The availability of cooperators has allowed the SEC to bring cases faster, and the SEC uses cooperators both at trial as well as via affidavit in support of efforts to seek injunctive relief or asset freezes. The benefits available to cooperators depend on the specific case at hand, and could include the SEC recommending against charges or recommending only non-scienter-based charges, reducing penalties or assessing no penalties at all.

In cases with cooperators, the SEC "generally favors" bifurcated settlements by which liability is established, but a decision as to remedies is pushed to a later date to allow the SEC to effectively assess the value of the cooperation. According to Ms. Fitzpatrick, a substantial percentage of bifurcated agreements result in the SEC recommending that no penalty be imposed. Ms. Fitzpatrick recommends that attorneys representing persons or entities being investigated by the SEC evaluate the potential for cooperation early in the process, and that respondents be prepared to honor their cooperation agreements. In support of the latter recommendation, Ms. Fitzpatrick highlighted *SEC v. Thomas Conradt*, in which Conradt, a defendant charged with insider trading, entered into a cooperation agreement requiring him to testify at trial. He testified at a deposition, but then during trial testified differently. The SEC nonetheless prevailed at trial and then sought additional remedies against Conradt, in response to which Judge Rakoff imposed a nearly $1 million penalty on Conradt.

Market Abuse and Insider Trading

Joseph Sansone, Co-Chief of the SEC's Market Abuse Unit, spoke about cyber fraud issues. Specifically, he identified three types of cyber fraud that the Division dealt with in 2016: (1) schemes to steal nonpublic information through hacking; (2) account intrusion; and (3) dissemination of fake information to impact markets. With respect to the theft of nonpublic information through hacking, the SEC has continued to work on its newswire hacking case, in which an international group of hackers stole sensitive nonpublic information by hacking newswires, then used that information to trade before the news became public. Detailed data analysis by the SEC showed that this group of hackers was consistently trading in a narrow window each quarter (i.e., between when news outlets received corporate information and the time that the news outlets published such information). In another example, *SEC v. Hong*, hackers targeted law firms advising clients on mergers and acquisitions. Data analysis allowed the SEC to identify offshore trading accounts used to generate profits by the hackers, and to establish IP address overlap between various hacking incidents. With respect to account intrusion, Mr. Sansone referenced *SEC v. Mustapha*, a case in which a hacker accessed a victim's investment account and made unauthorized trades in an effort to move markets. With respect to the dissemination of fake information to impact markets, Mr. Sansone referenced *SEC v. Aly*, a case in which a fake filing was made with the SEC.

Mr. Sansone noted that the SEC viewed the hacked entities in the above-referenced matters (i.e., the newswire services and law firms) as victims, and pointed out that the SEC's rules and regulations regarding protection of customer information apply more to registrants than to issuers, law firms, etc. Ms. Avakian noted that a registrant who is hacked could potentially be the subject of an enforcement action if such registrant failed to comply with relevant regulations such as S-P, S-ID, or the Market Access Rule. In the case of public companies, a hacked company could be subject to discipline if there was either a related failure to disclose material information or a misleading disclosure.

Mr. Sansone also discussed insider trading, another area that relies heavily on data analysis. The SEC brought insider trading cases against 78 different parties, ranging from high-profile to small cases. Mr. Sansone highlighted *SEC v. McClatchey*, a case in which an investment banker and his plumber friend engaged in an insider trading scheme. The plumber kept his transactions small to avoid detection, but the SEC's data analysis revealed an incriminating pattern. The strength of the pattern uncovered through data analysis was sufficient to convince the plumber to cooperate, leading to a successful outcome for the SEC.

Public Finance

LeeAnn G. Gaunt, Chief of the SEC's Public Finance Abuse Unit, stated that her Unit is focused on misconduct in the municipal bond market and public pension funds. Municipal bonds are an important area of focus because: (1) they are the primary way that state and local governments raise funds; (2) municipal securities are exempt from registration and thus have fewer rules and requirements; (3) investors in this market rely heavily on issuers' continuing disclosure obligations; and (4) the holders of these securities are predominantly retail investors such as senior citizens. Currently, Ms. Gaunt's top priority is offering and disclosure fraud. In 2016, the SEC brought actions against muni issuers from nearly every U.S. state for making false statements about prior compliance with continuing disclosure obligations. This widespread action was important in that it raised awareness for all municipal securities market participants regarding the need for issuers to focus on continuing disclosure obligations. Ms. Gaunt also referenced *SEC v. Rhode Island Commerce Corporation and In the Matter of The Port Authority of New York and New Jersey* as enforcement actions brought by the SEC based on a failure to disclose material information (as opposed to making false statements in disclosures).

Other important types of cases brought in this area by the SEC in 2016 include financial fraud and public corruption. Key financial fraud cases included *SEC v. Ramapo* (a case in which a town filed fraudulent financial statements to hide its deteriorating financial condition), *In the Matter of Wetlands Water District* (a case in which California's largest agricultural water district misled investors about its financial condition when issuing a $77 million bond offering), and *SEC v. City of Miami* (a case in which the City of Miami and its former budget director were accused of misrepresenting the city's financial condition). *SEC v. City of Miami* was the first SEC trial against a municipality and resulted in the largest financial penalty ($1 million) ever paid by a municipal issuer. A key public corruption case was *SEC v. Kang*, in which the former director of fixed income and head of portfolio strategy for the New York State Common Retirement Fund solicited and accepted bribes in exchange for directing pension funds business to certain firms. Ms. Gaunt also noted that the SEC is focused on ensuring that broker-dealers in the municipal securities space are fulfilling their required duties regarding due diligence, suitability, and fair and reasonable pricing.

A new area of focus for the SEC is claims against municipal advisors. Like investment advisors, municipal advisors owe their clients fiduciary duties as demonstrated by *In the Matter of Central States Capital Markets, LLC*.

When considering penalties in municipal securities cases, the SEC tries to find sources other than taxpayer dollars to fund such penalties (such as user fees, for example). However, in the case of *SEC v. City of Miami*, the city was a recidivist and the SEC had to take the case to trial to prevail, so obtaining a large monetary judgment against the City was acceptable to the SEC.

Whistleblowers

Jane A. Norberg, Chief of the SEC's Office of the Whistleblower, provided an overview of the SEC's whistleblower program to date, noting that the SEC has received over 4,200 tips from all 50 states and from 103 countries. The highest number of tips have come from New York, California, and Florida, and the most common allegations involve corporate disclosures, offering fraud, and manipulation. In August 2016, the SEC's whistleblower program went over $100 million in awards paid out since its origination approximately five years ago. In the six months since then, the SEC has awarded another $50 million to whistleblowers. Ms. Norberg believes that the large amount of payouts over the past six months is a product of the whistleblower program hitting its stride and the cases on which whistleblowers came forward beginning to come to fruition. Ms. Norberg emphasized that whistleblowers are not paid from funds that would otherwise go to injured investors, and that the real measure of success of the program is not the amounts paid out to whistleblowers, but rather the roughly $940 million in remedies obtained from wrongdoers—including disgorgement returned to investors—as a result of whistleblower assistance.

Ms. Norberg also noted that the SEC has now brought three whistleblower retaliation cases—including two in the last year alone—including a stand-alone retaliation case in which the SEC declined to bring charges for the underlying conduct brought to its attention by the whistleblower. Additionally, the SEC has brought nine actions to date against companies alleged to have used agreements (such as employment agreements or severance agreements) to attempt to chill whistleblowing. Ms. Norberg recommends that companies read their agreements through the eyes of an average employee, because the SEC focuses on whether such an employee feels that he or she can bring information to the SEC and feel safe from reprisal for doing so.

Asset Management Matters

C. Dabney O'Riordan, Co-Chief, Asset Management Unit, provided an overview of the Asset Management Unit and discussed the Unit's priorities, key cases from 2016 and areas of continued focus. The SEC views the asset management space as being divided into three categories: retail accounts, registered investment companies and private funds. With respect to retail accounts, Ms. O'Riordan noted that many of these investors are not sophisticated and are relying on the knowledge and expertise of their advisor. Within the retail space, the Unit looks for undisclosed conflicts of interest, undisclosed fees, and how the advisor allocates trades. In addition, there is focus on situations in which the advisor receives financial benefits from brokers but does not disclose them to clients. The failure to disclose fees or compensation that directly or indirectly benefits advisors is of great concern to the Unit. Ms. O'Riordan discussed *In the Matter of Royal Alliance et al.*, as an example. There, the advisor was selecting for clients more expensive mutual fund share classes that paid higher 12b-1 fees. These fees have an impact on the advisor clients' overall return in the fund. In that case, the advisor was getting paid a portion of 12b-1 fees to the tune of about $2 million, which presented a conflict of interest with its advisory clients that should have been disclosed.

The Unit also focuses on trade allocations in which an advisor allocates more favorable trades to its own accounts, more favorable trades to an account in which the advisor receives more fees or the advisor is allocating trades inconsistent with what was disclosed to the clients.

With respect to registered investment companies, Ms. O'Riordan noted that the Unit is focused on valuation and fund governance/compliance. On the valuations side, Ms. O'Riordan discussed *In the Matter of Calvert Investment Management, Inc.*, in which a mutual fund advisor failed to accurately value certain bonds that were highly illiquid and held by certain of its clients (the "Calvert Funds"). This led to the Calvert Funds being priced at an incorrect net asset value. She also mentioned *In the Matter of Pacific Investment Management Co., LLC ("PIMCO")*, which involved the failure to accurately value certain mortgage-backed securities. With respect to private funds, the Unit continues to look at valuation, undisclosed fees and trade allocation. Ms. O'Riordan also discussed gatekeepers, indicating that where there is an issue with an advisor or a fund, the Unit will evaluate whether the gatekeepers failed to perform their responsibilities.

Broker-Dealer Matters

Andrew M. Calamari, Co-Chair, Broker Dealer Task Force and Regional Director, New York Regional Office, provided an update on the Task Force's churning and excessive trading initiatives. The Task Force was established in order to put a more intense focus on broker-dealers, especially in retail space but unlike an established Unit within the Commission, the Task Force is really "an incubator of ideas" which relies on the SEC's Home Office and the Regional Offices to pursue recommended enforcement actions. Identifying and investigating churning and excessive trading has been a top priority for the Office of Compliance Inspections and Exams ("OCIE") year after year and, as a result, the Task Force developed new and more efficient approaches to help identify the perpetrators. Thus, working with the Risk Analysis and Examinations Team ("RAE"), a quantitative analytics unit that processes clearing firm data, the Task Force examined two key metrics: (i) turnover ratio and (ii) cost-to-equity ratio. RAE used data from one clearing firm and analyzed trading over a two-year period. This effort identified specific introduction firms where accounts showed indicia of churning. In order to expand on RAE's efforts, the Task Force decided to collect two different types of data strains from suspect introducing firms and clearing firms. In furtherance of the initiative, the Task Force sought and obtained two sets of orders (issued under Section 21A of the Exchange Act). The first set was issued to a number of introducing firms, requiring them to provide detailed information under oath concerning business operations and activity in customer accounts. The second set of orders was issued to a number of clearing firms, requiring them to provide data concerning accounts of introducing brokers that show high cost-to-equity and high turnover ratios. The Task Force then used the data collected to help develop new and different ways to identify suspect trading.

Mr. Calamari also commented on the Task Force's monitoring of suitability. The Commission has made very clear that a broker has a duty of suitability with respect to trades and trading strategy. In order to prove unsuitability, it requires only a showing that the broker dictated the trading strategy. If the trading strategy had no reasonable chance of success given the overwhelming costs associated with the account, then the strategy was unsuitable. If a broker knew, should have known or recklessly disregarded the lack of a reasonable chance of success, then the broker may be held liable for violations of the securities laws. Mr. Calamari highlighted one case brought by the Task Force, *SEC v. Dean & Fowler*, against two registered representatives at a broker-dealer. The complaint alleged traditional churning with respect to three customer accounts and suitability of those three accounts plus a dozen other accounts. The Commission alleged that the registered representatives did almost nothing to determine whether their strategy could produce even a minimal profit. Mr. Calamari indicated that there are a number of these types of cases in the pipeline. The Task Force's data collection efforts have also lead to more referrals to OCIE for introducing firms.

Antonia Chion, Co-Chair, Broker Dealer Task Force, and Associate Director, Home Office, discussed the anti-money laundering ("AML") compliance initiative implemented by the Task Force in 2014 and

broker-dealers' obligations to file suspicious activity reports ("SARs"). The SEC has a dedicated staff that reads the SARs, which leads to hundreds of referrals to OCIE for examination and to the Division for investigation. In the past four years, the SEC has initiated 210 exams and over 270 new enforcement matters based on SARs. Ms. Chion highlighted the Task Force's first stand-alone enforcement action against a broker-dealer solely for failure to file SARs. The charges were settled without any admission or denial and a $300,000 civil penalty. In that particular case, there were various red flags and other indicia of suspicious activity that were ignored. In addition, Ms. Chion discussed a litigated action against Windsor Street Capital (*In the Matter of Windsor Street Capital, L.P., et al.*) in which the alleged violations included Section 5 registration violations and failure to file SARs.

Ms. Chion concluded her remarks by discussing the key takeaways from the AML initiative. The SAR filing requirement does not depend on absolute certainty or knowledge; rather a broker-dealer must file an SAR when it knows, suspects or has reason to suspect that a transaction does not have a legitimate purpose or was done in order to facilitate fraudulent activity. The filing requirement also applies to suspicious transactions that are attempted through the broker dealer. Ms. Chion noted that there is guidance out there, including NASD Notice to Member 02-201, which identifies various red flags. Some of these red flags include the volume of deposits of securities, trading in certain penny stock issuers when they are the subject of ongoing promotional campaigns, customer criminal background, regulatory or criminal inquiries that a firm receives about a customer or a customer's trading, issuers that are delinquent in SEC filings, executives with a history of securities fraud or an issuer that changes its business plan. Ms. Chion also indicated that the Task Force greatly values the role that compliance professionals play in developing and implementing SAR policies and procedures at broker-dealer firms.

FCPA Matters

Charles E. Cain, Deputy Chief, FCPA Unit, recapped the 2016 FCPA activity and provided insight as to points of emphasis for 2017. 2016 was another significant year in FCPA enforcement, with the largest number of actions and monetary sanctions to date—28 including the first Deferred Prosecution Agreement ("DPA") with an individual and two Non-Prosecution Agreements ("NPAs") with companies and slightly over $1 billion in disgorgement and civil penalties. Mr. Cain discussed *SEC v. Vimpelcom Ltd.*, which resulted in a $795 million global settlement. This case was significant because it was the first time the Unit had a resolution in coordination with Dutch authorities. He also discussed a case brought against a hedge fund relating to bribes paid to government officials in Africa and the parallel criminal proceeding brought in the Eastern District of New York regarding the same misconduct. In November, in *In the Matter of JP Morgan Chase & Co.*, JP Morgan agreed to pay $264 million in civil penalties relating to allegations of influencing government officials in the Asia-Pacific region by giving jobs and internships to the officials' family members and friends.

Mr. Cain also discussed the first FCPA case conducted in cooperation with Brazilian authorities (*SEC v. Embraer S.A.*) and the second (*SEC v. Braskem S.A.*), which led to a $957 million global resolution against a Brazilian petrochemical company. Mr. Cain discussed the increasing international cooperation within the FCPA space, noting that the quality of assistance continues to grow and that the Unit continues to work in cooperation with other authorities, including more than two dozen countries that assisted the Unit over the last year. The Unit is also developing relationships with law enforcement around the world, and the Unit was honored to co-host a training program for prosecutors around the world.

With respect to case development, the Unit continues to see positive results from proactive steps and

Form TCRs and whistleblower reports continue to be a good source of potential cases. About four percent of all tips that came in last year were self-identifying as FCPA violations. With respect to the two NPAs entered in 2016, both companies came in promptly to self-report and cooperated extensively with the Unit's investigation. In *In the Matter of Jun Ping Zhang*, the SEC charged Zhang, the former Chairman and CEO of Harris Corporation's Chinese subsidiary, relating to a bribery scheme in China. The company itself was not charged, however, because it came in early and self-disclosed, and had found the misconduct quickly within five months of acquisition as part of the implementation of its internal controls over financial reporting. The DPA was the result of significant cooperation with an investigation. Mr. Cain indicated that the Unit likes to see self-reporting and real-time reporting of internal investigation results. In addition, the Unit acknowledges cooperation in the form of companies providing translations of relevant documents, helping to facilitate foreign witness interviews and promptly producing documents from overseas. In 2017, the Unit will continue to focus on individual cases, more cases in the financial services sector and increased use of NPAs and DPAs as appropriate.

Financial Fraud and Audit Matters

Margaret S. McGuire, Chief, Financial Reporting and Audit Group, discussed key cases from 2016. She noted that it was another strong year for cases relating to financial reporting and audit-related matters and that control issues continue to be a significant focus of the Group. The Group's mandate is to find matters that the Division would not otherwise find. It accomplishes this through liaisons—teams of attorneys and accountants in each regional office and Home Office—that work closely with the Group to help identify matters earlier and more efficiently. Currently, there are over 300 issuers that are of interest to the work of the Group. Ms. McGuire discussed the Group's methodology, which is to identify issuers that are of interest and then have the various liaisons take a look at those issuers as well—they do a deep dive and, together with the liaisons, decide whether the issuer or auditor is worth an investigation. Ms. McGuire also discussed the various internal and external technologies that the Group is leveraging in its work. These tools allow the Group to look at more issuers more quickly and more efficiently and to see more of the transactions that are going on with these companies. The Corporate Issuer Risk Assessment Tool ("CIRA") aggregates and organizes corporate issuer financial information and provides the Group with a comprehensive view of issuers, allowing the Group to very quickly compare a specific company to its own performance and to its competitors' performance. And because CIRA is a homegrown tool, the Group is able to tailor it to whatever it want to look at. There are over 250 data and event metrics, which allows staff members to accomplish what used to take weeks or even months "with just a few clicks of a mouse."

Michael F. Maloney, Chief Accountant, Division of Enforcement, stated that the focus of the Division is still on financial reporting issues. He noted that fiscal year 2016 had similar activity to 2014 and 2015 in terms of the number of actions started and parties charged. However, there was an elevated number of accountants suspended under Rule 102(e). Mr. Maloney noted that there remain a lot of issues in the following areas: (1) revenue recognition; (2) valuation and impairment; and (3) balance sheet issues (which seemed to have increased in 2016 from prior years). Mr. Maloney also noted that the Division saw many more issues in 2016 concerning financial statement disclosures, including issues related to regulatory approvals, segment disclosures and non-GAAP disclosures.

MicroCap Fraud Matters

Jason Berkowitz, Co-Chair of the Microcap Fraud Task Force, discussed the Task Force's focus on misconduct in the OTC market by gatekeepers such as auditors and attorneys. The Task Force uses commission trading suspensions as a very effective tool to stop pump-and-dump campaigns. Over

the past year, there were 50 trading suspensions and 30 district court or administrative actions brought by the Task Force. The Task Force is also using enhanced analysis and screening of aggregate data and, through the Center for Risk and Quantitative Analytics, is developing new strategies to analyze data. In addition, the Task Force works closely with OCIE with a view towards risk-targeted exams to assess risks related to micro-cap activities at registrants. Mr. Berkowitz discussed several actions brought against gatekeepers, including cases against attorneys involved in shell company schemes where they allegedly created false business plans and financial records. In Miami, a case was brought against 10 individuals who allegedly attempted to register and sell stock in more than 12 shell companies, including by recruiting straw CEOs and falsifying Board minutes and opinion letters. The U.S. Attorney charged six of these individuals and obtained four guilty pleas. In Denver, a former CEO of a marijuana issuer settled charges relating to a false financial scheme. The Task Force is also focused on "boiler room" schemes targeted at elderly individuals. These schemes are becoming more and more sophisticated, with the perpetrators using diversion mechanisms such as burner phones and encrypted expiring data text messages.

Technology and Risk Analytics

Lori Walsh, Chief, Center for Risk and Quantitative Analytics ("CRQA") spoke about how the SEC is focusing on getting more out of the data at its disposal. CRQA aims to make highly skilled data scientists and programmers available to enforcement staff so that the SEC's frontline attorneys have access to valuable analytical tools. CRQA provides complex, cutting-edge analytical expertise, and it has been a banner year, with dozens of cases coming out of data analytics leading to hundreds of millions in disgorgement. CRQA continues to develop new ways of doing things more quickly and more effectively and is working on several proactive initiatives, including data mining large data sets in search of patterns of behavior and pulling together disparate data sets and looking for connections. CRQA also provides investigative support, and the individuals in CRQA help design more sophisticated processes to access and use data that is difficult to collect and use and to provide direct assistance on complex and technical cases such as *PIMCO*. There is also a big push to harness the power of visualizing data through timelines, geographic mapping and histograms. Through data visualization, patterns emerge that you cannot see from a spreadsheet.

Office of the General Counsel: Judicial and Legislative Developments

Speakers from the Office of the General Counsel discussed judicial and legislative developments in insider trading liability, whether statutes of limitations apply to requests for disgorgement, and recent challenges to the SEC's administrative proceedings.

The panel discussed recent developments in insider trading liability, specifically situations in which a corporate insider (tipper) provides material nonpublic information to an outsider (tippee) in breach of a fiduciary duty. *In Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court required that in such scenarios the government must show that the tipper received a personal benefit from the tippee in exchange for providing the nonpublic information, which could arise in a quid pro quo exchange or as a "gift" of confidential information to a relative or friend. This "gift" scenario became the subject of controversy in *U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014), when the Second Circuit expanded the personal benefit standard to require proof of a meaningfully close personal relationship "that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." However, in *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), the Ninth Circuit found that a close family relationship between a tipper and tippee satisfies the personal benefit standard imposed by *Dirks*.

Due to the circuit split, the Supreme Court agreed to review the *Salman* decision during its October 2016 term. On December 6, 2016, the Supreme Court affirmed the Ninth Circuit's decision upholding Salman, thereby rejecting Newman's additional requirement of proof of pecuniary gain to the tipper under the facts presented in *Salman*. *See Salman v. United States*, 137 S. Ct. 420 (2016). The Supreme Court construed the issue presented very narrowly and expressly limited its holding to whether an insider effectively receives the required personal benefit when disclosure of inside information is made as a gift to a trading relative or friend. In its unanimous decision, the Court explained that, under these circumstances, the information Salman provided was a gift that was effectively cash. *Id*. at 428. The long-standing rule set forth in *Dirks* clearly prohibits such a gift, and as a result, the Supreme Court reasoned that the insider in *Salman* should be precluded from effectively achieving the same result by disclosing the information to his brother and to Salman and by then allowing them to trade on it. *Id*.

The panel also discussed recent developments regarding whether claims for disgorgement and other forms of declaratory relief are subject to the five-year statute of limitations set forth in 28 U.S.C. § 2462 ("Section 2462"). *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016), held that claims for disgorgement are indeed subject to Section 2462's five-year limitations period. The Eleventh Circuit reasoned that Section 2462 applies to disgorgement because it is synonymous with forfeiture. The holding in *Graham* builds on the Supreme Court's unanimous decision in *Gabelli v. SEC*, 133 S. Ct. 1216 (2013), which held that Section 2462 applies to civil money penalties. Several other appellate courts, including most recently the Tenth Circuit in *SEC v. Kokesh*, 834 F.3d 1158 (10th Cir. 2016), have concluded that a disgorgement claim is not a penalty or a forfeiture within the meaning of Section 2462, but rather is a nonpunitive equitable remedy that does not fall within the statute's limitations period. In January 2017, the Supreme Court granted certiorari in *Kokesh* and will consider whether claims for disgorgement are subject to the five-year statute of limitations in Section 2462. This is noteworthy because if the Supreme Court agrees with the Eleventh Circuit's holding in *Graham*, it will be much more difficult for the Commission to recover ill-gotten gains, particularly in long-running frauds. The panel discussed how such a result would affect shareholders, as disgorgement is often sought in order to return ill-gotten gains to affected shareholders.

Lastly, the panel discussed recent developments regarding challenges to the SEC's administrative proceedings relating to whether the SEC's Administrative Law Judges are "officers" or "employees" within the meaning of the Appointments Clause in Article II of the Constitution. There is currently a circuit split on the issue. In *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016), the D.C. Circuit denied Lucia's petition for review in which he claimed that the SEC's use of ALJs was unconstitutional. Lucia argued that ALJs are "officers" within the meaning of the Appointments Clause, and he asked the court to rule that the SEC's use of ALJs was unconstitutional because those judges have not been appointed by the President. The D.C. Circuit disagreed and held that the SEC's ALJs are instead inferior officers (employees) who are not governed by the clause. However, on December 28, 2016, the Tenth Circuit ruled in *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016), that the Constitution's Appointments Clause does indeed apply to the SEC's ALJs because they exercise significant discretion in presiding over enforcement hearings, which closely resemble trials. In the wake of this decision, the Commission is working with the Department of Justice to decide on the appropriate course of action. The Commission is required to file a request for rehearing before the Tenth Circuit, should it choose to do so, by March 13, 2017.

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1 Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule, Keith F. Higgins, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission (Apr. 29, 2014).

2 In 2006, the Commission advised that it will consider two primary factors when deciding whether to assess a civil monetary penalty on a public company: (1) "the presence or absence of a direct benefit to the corporation as a result of the violation"; and (2) "the degree to which the penalty will recompense or further harm the injured shareholders." The Commission will also consider the following additional factors: (i) the SEC's perceived need to deter the particular type of offense; (ii) the extent of the injury to innocent parties, including the egregiousness of the harm done, the number of

investors injured and the harm to society if the corporation is not punished; (iii) whether complicity in the violation was widespread throughout the corporation; (iv) whether the conduct was intentional; (v) the degree of difficulty in detecting the particular type of offense; (vi) whether the issuer took any remedial steps; and (vi) whether the company truly cooperated in the Commission's investigation.
3 A respondent/defendant must show that he/she/it: (1) made a complete disclosure to the person/party relied upon; (2) sought advice as to the legality of the conduct at issue; (3) was advised that the conduct was legal; and (4) relied on such advice in good faith.

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National Law Review, Volumess VII, Number 59

Source URL:https://natlawreview.com/article/highlights-sec-speaks-2017-litigation-and-enforcement-trends