



## 2017 Mid-Year Securities Litigation and Enforcement Highlights

**BakerHostetler**

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### Welcome to the 2017 Mid-Year Report From the BakerHostetler Securities Litigation and Regulatory Enforcement Practice Team

The purpose of this report is to provide a periodic survey – in addition to our Practice Team Executive Alerts – on matters we believe to be of interest to sophisticated general counsel, chief compliance officers, compliance departments, legal departments, and members of the securities and commodities industries at financial institutions, private investment funds, and public companies.

We issue this Securities Litigation and Enforcement Highlights Report at mid-year and shortly after year-end. We hope you find the information and commentary useful, and we welcome your comments and suggestions. We encourage you to contact any of the practice team members listed at the end of the report.

This report highlights recent, significant developments, including, but not limited to the following:

**Supreme Court Cases**, including the impact of the ruling in *Kokesh* to limit the time period of the SEC's disgorgement recovery; whether the tolling rule announced under *American Pipe* applies to statutes of repose; and whether federal securities class actions may be brought in state court.

**Securities Law Cases**, including heightened standards on pleading falsity post-*Omnicare*; SLUSA's application in state-law pre-emption cases; the deepening of a circuit split concerning whether to extend Dodd-Frank's anti-retaliation protections to internal whistleblowers; the Ninth Circuit finding that CEO conduct in violation of corporate ethics is not actionable under Section 10(b) and Rule 10b-5; the Second Circuit rejecting the First Circuit's "extreme departure" materiality standard for omissions in registration statements; and the D.C. Circuit in *Lucia* teeing up the issue of administrative law judge constitutionality for Supreme Court review with respect to the SEC's practice of bringing enforcement actions using its in-house courts.

**Insider Trading Cases**, including cases reflecting the SEC's continued use of data analytics and artificial intelligence; monitoring and prosecuting the illegal use of confidential employer information; cracking down on pre-merger insider trades; securing stiff monetary sanctions for foreign traders who violate U.S. insider trading laws; and other recent, noteworthy insider trading cases.

**Settlements**, including settlements with financial institutions regarding inadequate disclosures of both investment and billing practices to clients; settlements of insider trading allegations; and other settlements stemming from the 2008 financial crisis.

**Investment Adviser and Hedge Fund Cases**, including SEC actions against hedge fund managers and investment advisers for a variety of alleged infractions stemming from members' failures to develop and implement proper written supervisory procedures, and new guidelines for investment advisers and hedge fund managers to revisit their procedures to ensure that they (1) are adequately drafted to meet all current laws and regulations; (2) have been properly implemented; and (3) are regularly tested to ensure the policies are working as designed.

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**SEC Cooperation and Whistleblower Programs**, including SEC determinations to levy reduced civil penalties (or abandon the imposition of civil penalties altogether) in recognition of cooperation efforts; legislative efforts to curtail awards to “culpable” whistleblowers; awards of significant amounts to individual whistleblowers; SEC efforts to curtail the practice of requiring departing employees to sign “bounty waivers” relinquishing their rights to whistleblower awards; and SEC and court interpretation of anti-retaliation protections applicable to internal whistleblowers who do not ultimately report to the SEC.

**Commodities and Futures and Regulation Cases**, including furthering innovative technology programs in FinTech, and enforcement cases focusing on spoofing, anti-fraud enforcement, Ponzi schemes, and compliance with regulatory requirements.

**Securities Policy and Regulatory Developments**, including analysis of priorities under new chiefs at the SEC; the House passing the Financial CHOICE Act, unwinding many Dodd-Frank regulations and policies; and amendments to SEC rules to promote efficiency and transparency, including those that affect emerging businesses and individual retail investors.

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## Supreme Court Cases Review

### Supreme Court Cases Review

This year, the Supreme Court issued several landmark decisions that will significantly impact federal securities litigation. In *Kokesh v. SEC*, No. 16-529, the Supreme Court limited the U.S. Securities and Exchange Commission's ("SEC") powers to bring disgorgement actions. Prior to this ruling, there was a circuit split as to whether the five-year statute of limitations under 28 U.S.C. § 2462 ("Section 2462") applied to disgorgement actions. The Supreme Court, however, was undivided on this issue, and ruled in a 9-0 decision that disgorgement actions are subject to the five-year limitation. This landmark decision ends the SEC's decades-long practice of seeking disgorgement for monies obtained many years in the past. And it is perhaps a sign that the Supreme Court's current conservative makeup will usher in a new era that scales back the SEC's regulatory powers, as suggested by Marc D. Powers (the national leader of BakerHostetler's Hedge Fund Industry and Securities and Regulatory Enforcement Practice Groups) at a recent hedge fund industry forum.<sup>1</sup>

Indeed, the Supreme Court's makeup made all the difference in its recent decision in *California Public Employees' Retirement System v. ANZ Securities, Inc.*, No. 16-373. There, newly appointed Justice Neil Gorsuch cast the fifth and deciding vote in a 5-4 decision, split along ideological lines, which ruled that filing a securities class action does not toll the statute of repose under the Securities Act of 1933. This ruling may force securities plaintiffs to think twice before opting into a class action, since it may be too late for them to move forward with their individual claims should class certification fail.

Also this year, the Supreme Court agreed to resolve a circuit split in *Leidos, Inc. v. Indiana Public Retirement System*, No. 16-581, over whether certain SEC regulations create a duty to disclose that can give rise to securities fraud claims. Further, in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, No. 15-1439, the Supreme Court agreed to review whether securities class actions under the Securities Act of 1933 may be brought in state courts. Finally, in *Tilton v. SEC*, No. 16-906, the Supreme Court declined to review the constitutionality of the SEC's in-house courts.

### The Supreme Court's Ruling in *Kokesh* Scales Back the SEC's Regulatory Powers

At stake in *Kokesh* was the SEC's ability to bring disgorgement actions outside of the five-year statute of limitations under Section 2462. The SEC has long adopted the view that Section 2462's five-year limitation does not apply to disgorgement, because the statutory text references actions that seek "any civil fine, penalty, or forfeiture, pecuniary or otherwise," but does not include disgorgement actions.<sup>2</sup>

In *Kokesh*, the SEC relied on this narrow interpretation when it brought a 2009 enforcement action which, in part, called for defendant Charles Kokesh to disgorge the \$34.9 million he misappropriated from his investment fund clients between 1995 and 2006. Mr. Kokesh argued that the SEC could not recover the full amount because disgorgement actions are subject to the five-year statute of limitations under Section 2462. But the District Court disagreed and instead adopted the SEC's position that Section 2462 did not apply to disgorgement actions.<sup>3</sup> After trial, the jury ordered Kokesh to disgorge all \$34.9 million of the misappropriated funds.

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<sup>1</sup> See *100 Days In: What Hedge Funds Can Expect from Congress, the SEC, and the Trump Administration*, BakerHostetler, at 4-6 (May 23, 2017), <https://www.bakerlaw.com/webfiles/Litigation/2017/Briefs/05-23-2017-Hedge-Funds-Brief.pdf>.

<sup>2</sup> 28 U.S.C. § 2462.

<sup>3</sup> *SEC v. Kokesh*, No. 09-cv-1021 SMV/LAM, 2015 WL 11142470, at \*9-10 (D.N.M. Mar. 30, 2015).

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On appeal, the Tenth Circuit Court of Appeals joined the D.C. Circuit Court of Appeals and the First Circuit Court of Appeals in adopting the SEC's position that disgorgement actions are not subject to the five-year statute of limitations under Section 2462.<sup>4</sup> Specifically, the Tenth Circuit held that a narrow interpretation of this statute was necessary, in part, to empower federal agencies like the SEC to remediate wrongs and protect the public.<sup>5</sup> It also rejected Mr. Kokesh's argument that actions seeking disgorgement are similar to actions seeking a "penalty" under Section 2462 and, hence, subject to the five-year statute of limitations.<sup>6</sup> In so doing, the Tenth Circuit held that disgorgement is not punitive by nature but, rather, remedial since it seeks only "to eliminate profit from wrongdoing while avoiding, so far as possible, the imposition of a penalty."<sup>7</sup>

These SEC-friendly decisions are in direct conflict with the Eleventh Circuit Court of Appeals' decision in *SEC v. Graham*.<sup>8</sup> There, the Eleventh Circuit held that disgorgement was synonymous with forfeiture and, therefore, the five-year statute of limitations under Section 2462 should apply to disgorgement actions because the statute covers enforcement actions seeking "any . . . forfeiture."<sup>9</sup> The Eleventh Circuit relied on dictionary definitions of disgorgement and forfeiture, both of which provide that a party must return something that they previously acquired.<sup>10</sup> The SEC argued that forfeiture had a broader meaning than disgorgement, since the former includes the return of both ill-gotten gains and any additional profit earned on those gains, whereas disgorgement includes only the return of ill-gotten gains. But the Eleventh Circuit held that even under this definition, disgorgement was still a subset of forfeiture and, hence, still subject to the five-year statute of limitations under Section 2462.<sup>11</sup> The Eleventh Circuit found "no meaningful difference in the definitions of disgorgement and forfeiture."<sup>12</sup>

On May 30, 2017, the Supreme Court in *Kokesh* took a different route. In a unanimous decision authored by Justice Sonia Sotomayor, the Supreme Court held that disgorgement is akin to a "penalty" under Section 2462 (as opposed to a "forfeiture" as the Eleventh Circuit held in *Graham*).<sup>13</sup> The Supreme Court provided three reasons for this holding.<sup>14</sup> First, disgorgement, like a penalty, seeks to redress a wrong made to the public, rather than an individual.<sup>15</sup> Second, disgorgement is punitive in nature, because it is designed to deter wrongdoers from future violations.<sup>16</sup> Third, disgorgement is not compensatory, i.e., it does not return everyone to the status quo.<sup>17</sup> While some funds may be dispersed to the victims, other funds are typically dispersed to the United States Treasury, and sometimes disgorgement exceeds the profits gained as

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4 See *SEC v. Kokesh*, 834 F.3d 1158 (10th Cir. 2016).

5 *Id.* at 1166-67.

6 *Id.* at 1164-65.

7 *Id.* at 1164 (citation omitted).

8 *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016).

9 *Id.* at 1363-64.

10 *Id.*

11 *Id.*

12 *Id.* at 1363.

13 *Kokesh v. SEC*, 137 S.Ct. 1635, 1641-42 (2017).

14 *Id.* at 1643-44.

15 *Id.* at 1643.

16 *Id.*

17 *Id.* at 1644.

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result of the violation.<sup>18</sup> According to the Supreme Court, when a defendant “is made to pay a noncompensatory sanction to the Government as a consequence of a legal violation, the payment operates as a penalty.”<sup>19</sup>

The primary takeaway from *Kokesh* is that the Supreme Court has once again curbed the SEC’s liberal practice of bringing enforcement actions outside the five-year limitations period under Section 2462. The Court previously addressed Section 2462’s reach in *Gabelli v. SEC*, where it ruled that Section 2462 applies to enforcement actions that seek civil monetary penalties.<sup>20</sup> Although *Gabelli* set a clear limitations rule for monetary penalties, in the years following *Gabelli* the SEC had become increasingly reliant on disgorgement actions. *Kokesh* will undoubtedly put an end to this trend.

### The Supreme Court Rules That the Securities Act of 1933’s Statute of Repose Cannot Be Tolled

On June 26, 2017, in *California Public Employees’ Retirement System v. ANZ Securities, Inc.*, the Supreme Court ruled that the filing of a securities class action does not toll the statute of repose under Section 13 of the Securities Act of 1933 (“Section 13”).<sup>21</sup>

The Supreme Court previously held in *American Pipe & Construction Co. v. Utah* that the filing of a class action tolls the one-year statute of limitations period for class members, until the issue of class certification is decided.<sup>22</sup> This ruling allowed class members to wait and see if the putative class became certified before deciding whether to bring their individual claims under the Securities Act of 1933.

In *ANZ Securities*, the Supreme Court considered whether *American Pipe* should also apply to Section 13’s three-year statute of repose. This litigation arose when California Public Employees’ Retirement System (“CalPERS”) and other pension funds brought claims under Section 11 of the Securities Act of 1933 (“Section 11”) against the defendants after opting out of a securities class action that asserted the same claims.

Section 13 provides two limitations periods for Section 11 suits under the Securities Act of 1933: a one-year statute of limitations that runs from the discovery of the claim, and a three-year statute of repose that provides that claims may not be brought more than three years after the claim arose (regardless of when/if it was discovered).<sup>23</sup> Defendants moved to dismiss the action on the grounds that the claims were untimely because they were asserted more than three years after the alleged violations occurred. Plaintiffs argued that its claims were timely because the aforementioned class action had effectively tolled the statute of repose under Section 13, similar to how *American Pipe* held that putative class actions effectively tolled the statutes of limitations. Ultimately, the District Court for the Southern District of New York dismissed the lawsuit as untimely.<sup>24</sup>

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.* (citation omitted).

<sup>20</sup> *Gabelli v. SEC*, 568 U.S. 442, 454 (2013).

<sup>21</sup> *Cal. Pub. Employees’ Ret. Sys. v. ANZ Sec., Inc.*, 137 S.Ct. 2042 (2017).

<sup>22</sup> *Am. Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 553-556 (1974).

<sup>23</sup> *See id.* at 2047.

<sup>24</sup> *In re Lehman Bros. Sec. & ERISA Litig.*, 799 F. Supp. 2d 258, 309-310 (S.D.N.Y. 2011).



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On appeal, the Second Circuit Court of Appeals affirmed the District Court's ruling.<sup>25</sup> In so doing, the Second Circuit held that *American Pipe* "does not affect the statute of repose embodied" under Section 13, relying on a 2013 Second Circuit Court of Appeals decision in *Police & Fire Retirement Systems of City of Detroit v. IndyMac MBS, Inc.* that reached the same conclusion.<sup>26</sup> The Second Circuit reasoned that the equitable principles underlying tolling doctrines are simply unavailable to CalPERS with respect to Section 13's statute of repose.<sup>27</sup> CalPERS appealed to the Supreme Court, and on January 13, 2017, the Court granted certiorari.<sup>28</sup>

In a 5-4 decision authored by Justice Anthony Kennedy, the Supreme Court ruled that Section 13's statute of repose cannot be tolled. The majority decision focused on Section 13's statutory text, which provides that "[i]n no event" shall an action be brought more than three years after the securities offering on which it is based.<sup>29</sup> The decision also noted that statutes of repose, unlike statutes of limitation, are meant "to create an absolute bar on a defendant's temporal liability," and therefore should not be tolled unless it is clear from the statutory text or legislative history that Congress so intended.<sup>30</sup> For this reason, the Supreme Court distinguished this case from *American Pipe*, holding that the equitable principles that allowed for the statute of limitations under Section 13 to be tolled in *American Pipe* simply could not be used here with respect to Section 13's statute of repose.<sup>31</sup> As Justice Kennedy put it: "[T]he object of a statute of repose, to grant complete peace to defendants, supersedes the application of a tolling rule based in equity."<sup>32</sup>

The dissenting opinion, authored by Justice Ruth Bader Ginsburg, argued that the filing of a class action *should* toll Section 13's statute of repose because the defendants in those cases have notice that there are individuals who may have individual claims against them. According to the dissent, the purpose of a statute of repose is to not disturb a defendant from its rest with an unexpected, untimely suit. The dissenting justices argued that CalPERS's rest would not be disturbed in this manner, because it knew since the filing of the class action that these individual plaintiffs purported to have individual claims against it.<sup>33</sup>

This landmark decision will force members of putative securities class actions to reconsider whether it is in their interests to opt out of the class in actions brought under the Securities Act of 1933. Previously, it was prudent to stay in the class until class certification was decided, but now doing so assumes the risk that it may be too late to move forward on an individual basis if class certification is denied. Perhaps one workaround will be for securities plaintiffs to file protective actions that preserve their individual claims so that they can opt into the class and still have a timely individual action to fall back to, if necessary. Such an outcome would result in increased litigation, which may very well "gum up the works of class litigation" as the dissenting opinion warns.<sup>34</sup>

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25 *In re Lehman Bros. Sec. & ERISA Litig.*, 655 F. App'x 13, 16 (2d Cir. 2016).

26 *Id.* at 15 (citation omitted).

27 *Id.* at 15-16.

28 *Cal. Pub. Employees' Ret. Sys. v. ANZ Sec., Inc.*, 137 S.Ct. 811 (2017).

29 *ANZ Sec., Inc.*, 137 S.Ct. at 2047 (citation omitted).

30 *Id.* at 2050.

31 *Id.* at 2052.

32 *Id.*

33 *Id.* at 2056-57.

34 *Id.* at 2058.

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### The Supreme Court Agrees to Review Whether SEC Regulations Create a Duty to Disclose That Can Give Rise to Securities Fraud Claims

On March 27, 2017, the Supreme Court granted certiorari in *Leidos, Inc. v. Indiana Public Retirement System*.<sup>35</sup> At stake is whether a company's failure to disclose the information required by Item 303 of the SEC's Regulation S-K ("Item 303") is actionable under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 thereunder.

Item 303 requires covered entities to disclose their financial condition, including "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact" in SEC filings.<sup>36</sup> The plaintiffs in *Leidos* contend that the defendant company violated this requirement when it failed to disclose its liability in an overbilling scheme as a "known trend or uncertainty" that could be "reasonably expected" to have a material impact on its financial condition.<sup>37</sup> The plaintiffs further contend that the defendant's omission of such information required under Item 303 amounts to securities fraud.

The District Court for the Southern District of New York dismissed plaintiffs' securities fraud claims in their entirety based on insufficient pleading.<sup>38</sup> But the Second Circuit Court of Appeals reversed, holding that Item 303 imposes an affirmative duty to disclose that can serve as the basis for a securities fraud claim.<sup>39</sup> The Second Circuit then vacated the District Court's order and remanded for further proceedings consistent with its decision.<sup>40</sup>

The Second Circuit decision in *Leidos* is in direct conflict with prior decisions by the Third and Ninth Circuit Courts of Appeals. In a decision authored by then-Judge Samuel Alito, the Third Circuit previously held that failure to comply with Item 303 does not automatically give rise to a securities fraud claim because the materiality standard for securities fraud is narrower than that in Item 303.<sup>41</sup> The Ninth Circuit Court of Appeals similarly held that the duty to disclose in Item 303 "is much broader than what is required" for securities fraud.<sup>42</sup>

Given the circuit split, it is not surprising that the Supreme Court granted certiorari in *Leidos*. Indeed, the recent trend limiting private rights of action makes it likely that the Supreme Court will overrule the Second Circuit in this case. Either way, the highly anticipated ruling will provide clarity as to how much covered entities should disclose to comply with securities laws. Oral argument should occur in the next few months.

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<sup>35</sup> *Leidos, Inc. v. Ind. Pub. Ret. Sys.*, 137 S.Ct. 1395 (2017).

<sup>36</sup> 17 C.F.R. § 229.303.

<sup>37</sup> *In re SAIC, Inc. Sec. Litig.*, No. 12 Civ. 1353 (DAB), 2013 WL 5462289, at \*11 (S.D.N.Y. Sept. 30, 2013).

<sup>38</sup> *Id.*

<sup>39</sup> *Ind. Pub. Ret. Sys. v. SAIC, Inc.*, 818 F.3d 85, 94-97 (2d Cir. 2016).

<sup>40</sup> *Id.* at 98.

<sup>41</sup> *Oran v. Stafford*, 226 F.3d 275, 286 n.6 (3d Cir. 2000).

<sup>42</sup> *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1055 (9th Cir. 2014).

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### The Supreme Court Will Determine Whether State Courts Have Concurrent Jurisdiction to Preside Over Covered Class Actions Under the Securities Act of 1933

On June 27, 2017, the Supreme Court granted certiorari in *Cyan, Inc. v. Beaver County Employees Retirement Fund*.<sup>43</sup> This appeal arises from a securities class action filed in California state Superior Court, which alleges that petitioner Cyan, Inc. (“Cyan”) violated Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 by filing an inaccurate and misleading registration statement and prospectus that failed to disclose revenue deficiencies (which later became public).

Cyan moved to dismiss this litigation on the grounds that it is pre-empted by the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”). Specifically, Cyan argued that SLUSA amended the Securities Act of 1933’s concurrent jurisdiction provision so as to ensure that securities plaintiffs could file covered class actions under the Securities Act of 1933 only in federal court. The plaintiffs argued that the state court had jurisdiction to adjudicate these claims because SLUSA amendments to the concurrent jurisdiction provision under the Securities Act of 1933 only reached covered class actions that concern covered securities, and this was not such a case. The court denied Cyan’s motion to dismiss without issuing a written opinion,<sup>44</sup> ruling instead at oral argument that the 2011 California appellate court decision in *Luther v. Countrywide Financial Corp.* permitted the suit to be brought in state court.<sup>45</sup>

The *Countrywide Financial* decision holds that SLUSA continued state-court jurisdiction over class actions brought under the Securities Act of 1933 in certain cases. Specifically, the decision interprets SLUSA’s amendments to the concurrent jurisdiction provision under the Securities Act of 1933 as having only stripped state courts of jurisdiction to hear covered class actions that concern a “covered security.”<sup>46</sup> A “covered security” under the Securities Act of 1933 is one traded nationally and listed on a regulated national exchange. The California appellate court acknowledged that its decision directly conflicts with those from the majority of federal courts that have decided this issue.<sup>47</sup>

The California appellate court declined to review the lower court’s decision in *Cyan*, leading to this Supreme Court appeal. Cyan argued in its petition for certiorari that Supreme Court review is paramount to resolve the “chaos” created by the Superior Court decision and the earlier *Countrywide Financial* decision.<sup>48</sup> Cyan notes that California state court securities class action filings have spiked by 1,400 percent, and that there is a clear conflict between *Countrywide Financial* (and the four California trial courts that have since followed it) and the federal courts that have held that state courts lack subject matter jurisdiction to adjudicate federal securities claims under SLUSA. In response, the plaintiffs argue that the *Countrywide Financial* ruling accurately interprets the text of SLUSA’s amendments to the Securities Act of 1933, which on their face appear to strip state courts of concurrent jurisdiction only as to covered class actions that concern

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43 *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, No. 15-1439, 2017 WL 2742854 (U.S. June 27, 2017).

44 *Beaver Cty. Emps. Ret. Fund v. Cyan, Inc.*, No. CGC14538355 (Cal. Sup. Ct. Oct. 23, 2015) (Order Denying Defendants’ Motion for Judgment on the Pleadings).

45 *Luther v. Countrywide Fin. Corp.*, 195 Cal. App. 4th 789 (Cal. App. 2011).

46 *Id.* at 797.

47 *Id.*

48 Petition for a Writ of Certiorari, *Cyan, Inc. v. Beaver County Employees Retirement Fund*, No. 15-1439, 2016 WL 3040512 (U.S. May 24, 2016).

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covered securities. The acting solicitor general agreed with the plaintiffs' position, arguing in an *amicus curae* brief that they had the better of the statutory interpretation argument.

The Supreme Court's final decision on this issue, expected in a year, could significantly change the landscape of securities class action litigation. For example, if the Supreme Court affirms the Superior Court ruling, the rest of the country can also expect to see a spike in state securities class action litigation, similar to the recent increase in California state courts. Conversely, if the Supreme Court overturns the Superior Court's ruling, it will cause the abrupt end to the current state securities class action litigation pending in California and throughout the United States, forcing plaintiffs back to federal court.

### The Supreme Court Declines to Review Constitutionality of SEC's In-House Courts

On May 30, 2017, the Supreme Court, without comment, denied the petition for certiorari in *Tilton v. SEC*, No. 16-906.<sup>49</sup> Lynn Tilton, the founder of Patriarch Partners, brought this petition to challenge the Second Circuit Court of Appeals' ruling that she could not bring her constitutional challenge to the SEC's in-house administrative courts until she exhausted the remedies available to her in the SEC's enforcement action.<sup>50</sup>

The SEC brought an enforcement action against Ms. Tilton in March 2015 alleging that she violated the Investment Advisers Act. Two days later, Ms. Tilton filed a lawsuit in the District Court for the Southern District of New York, seeking to enjoin the enforcement action on the grounds that, among other things, it is unconstitutional for an SEC administrative law judge to adjudicate the SEC's claims against her. On June 30, 2015, the District Court ruled against Tilton and fully dismissed her constitutional challenge on the ground that it was not ripe for review.<sup>51</sup> On June 1, 2016, the Second Circuit affirmed this ruling.<sup>52</sup> On January 18, 2017, Ms. Tilton petitioned the Supreme Court for certiorari review.<sup>53</sup>

Historically, the SEC sought civil penalties against an individual or a nonregulated entity in federal court. But Section 929P(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 recently allowed the SEC to seek these penalties in its in-house courts. Targets of those investigations, like Ms. Tilton, have since argued that this practice violates the Appointments Clause under Article II of the U.S. Constitution because the administrative law judges who preside over these proceedings are not appointed by the president, but are instead hired by the SEC. The SEC has responded by arguing that its administrative law judges are mere employees who do not issue final decisions and thus need not be appointed by the president.

In dismissing Ms. Tilton's constitutional challenge, the Second Circuit held that Ms. Tilton's challenge was not yet ripe, because the administrative proceeding against her had not yet concluded and federal appellate review was proper only at the conclusion of that proceeding.<sup>54</sup>

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<sup>49</sup> *Tilton v. SEC*, No. 16-906, 2017 WL 237477 (U.S. May 30, 2017).

<sup>50</sup> *Tilton v. SEC*, 824 F.3d 276, 291 (2d Cir. 2016).

<sup>51</sup> *Tilton v. SEC*, No. 15-CV-2472 (RA), 2015 WL 4006165 (S.D.N.Y. June 30, 2015).

<sup>52</sup> *Tilton*, 824 F.3d at 291.

<sup>53</sup> Petition for a Writ of Certiorari, *Tilton v. SEC*, No. 16-906, 2017 WL 281861 (U.S. Jan. 18, 2017).

<sup>54</sup> *Tilton*, 824 F.3d at 281-91.

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In so doing, the Second Circuit held that Ms. Tilton will obtain “meaningful judicial review” of her constitutional claims if she pursues a federal court appeal at the conclusion of her enforcement action.<sup>55</sup> Now that the Supreme Court has declined to review the Second Circuit’s decision, Ms. Tilton must wait until the enforcement action against her concludes before she can bring her constitutional challenge to the Second Circuit.

Because there is no circuit split on the issue of whether a defendant in an enforcement action can seek immediate review of the constitutionality of that action in federal court, it is not surprising that the Supreme Court refused to take Ms. Tilton’s appeal. However, the Court may soon have the opportunity to decide once and for all whether the SEC’s practice of bringing enforcement actions against individuals in its in-house courts is constitutional. On December 27, 2016, the Tenth Circuit Court of Appeals issued a ruling in *Bandimere v. SEC* which held that this practice violated the Appointments Clause under Article II of the U.S. Constitution.<sup>56</sup> The *Bandimere* holding creates a circuit split because it lies in direct conflict with the D.C. Circuit decision in *Raymond J. Lucia Cos., Inc. v. SEC*.<sup>57</sup>

*For more information on this circuit split, please review BakerHostetler’s January 11, 2017, Executive Alert titled “Tenth Circuit Creates Circuit Split on the Constitutionality of SEC Administrative Law Judges.”*<sup>58</sup>

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<sup>55</sup> *Id.* at 282-84.

<sup>56</sup> *Bandimere v. SEC*, 844 F.3d 1168, 1179-82 (10th Cir. 2016); *see infra* p. 27.

<sup>57</sup> *Raymond J. Lucia Cos., Inc. v. SEC*, 832 F.3d 277, 283 (D.C. Cir. 2016); *see infra* p. 27.

<sup>58</sup> *See* Mark A. Kornfeld, Jessie M. Gabriel and David Choi, *Tenth Circuit Creates Circuit Split on the Constitutionality of SEC Administrative Law Judges*, BakerHostetler, Jan. 11, 2017, <https://www.bakerlaw.com/alerts/tenth-circuit-creates-circuit-split-on-the-constitutionality-of-sec-administrative-law-judges>.



## Securities Law Cases

### Securities Law Cases

With significant Supreme Court decisions like *Kokesh v. SEC*<sup>59</sup> coming down in the first half of the year, the development focus for securities litigation will naturally shift to the circuit and district courts. The first half of 2017 saw a number of case law developments in the circuit courts that will likely impact the securities industry, particularly with regard to class action litigation.

The Seventh Circuit Court of Appeals deepened the circuit split concerning when the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) pre-empts state law claims for breach of contract and breach of fiduciary duty by dismissing a proposed shareholder class action. The First Circuit Court of Appeals affirmed the dismissal of a securities fraud class action based on forward-looking statements. The Ninth Circuit Court of Appeals found that CEO conduct in violation of corporate ethics is not actionable under Section 10(b) and Rule 10b-5. And the Ninth Circuit extended Supreme Court precedent, finding that a pending uncertified class action tolls the statute of limitations for *both* later-filed individual claims *and* subsequent class actions. These decisions are likely to impact the number of securities class action filings, which has seen record increases in recent years.

Federal securities class action filings rose to their highest level in 20 years in 2016,<sup>60</sup> and current data shows the trend will likely continue. According to Cornerstone Research (“Cornerstone”), a litigation consulting boutique that provides economic and financial analysis, plaintiffs “filed a record 127 federal class action securities cases in the first quarter of 2017,” almost double the number filed in 2016 during the same period.<sup>61</sup> Additionally, according to a securities class action archive maintained by Stanford Law School in collaboration with Cornerstone, federal securities class actions have already totaled 214 filings for the first half of the year.<sup>62</sup>

Beyond class action litigation, the Ninth Circuit followed the Second Circuit Court of Appeals in applying a heightened standard for pleading the falsity of an “opinion statement” under the Private Securities Litigation Reform Act (“PSLRA”). The Ninth Circuit also took an expansive view of what constitutes a “whistleblower,” finding that the Dodd-Frank Wall Street Reform and Consumer Protection Act’s (“Dodd-Frank”) anti-retaliation provisions extend beyond those who disclose information to the SEC. Further, the Second Circuit rejected the First Circuit’s materiality standard for omissions in registration statements. And the D.C. Circuit Court of Appeals was evenly split, 5-5, on the constitutionality of SEC administrative law judges.

As further discussed below, these and other decisions will have wide-ranging implications for litigating securities actions in the second half of the year and beyond.

### **The First Circuit Dismisses Challenges to Forward-Looking Statements as a Basis for Securities Fraud Claims Under Section 10(b) and Rule 10b-5**

The First Circuit affirmed the dismissal of a securities fraud class action based on forward-looking statements concerning aggressive timelines and estimates for proposed action. On January 9, 2017, the First Circuit affirmed a United States District Court for the District of Massachusetts

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59 See *Kokesh*, 137 S.Ct. at 1644.

60 Press Release, Cornerstone Research, *Securities Class Action Filings Rise to Highest Levels in 20 Years* (Jan. 31, 2017), <http://securities.stanford.edu/research-reports/1996-2016/Cornerstone-Research-Securities-Class-Action-Filings-2016-YIR-Press-Release.pdf>.

61 See Joseph Grundfest, *Record Number of Federal Securities Class Actions Filed in First Quarter of 2017*, Cornerstone Research, <https://www.cornerstone.com/Publications/Research/1Q-2017-Filings-Record-Number-of-Actions> (accessed June 27, 2017).

62 See Archive of 2017 Securities Class Action Filings, Stanford Law School: Securities Class Action Clearinghouse, <http://securities.stanford.edu/list-mode.html?filter=2017> (accessed June 27, 2017).

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decision in *Ganem v. Invivo Therapeutics Holdings Corp.*, dismissing a putative shareholder class for, among other things, failing to “allege false or misleading statements sufficient to state a claim under Section 10(b) and Rule 10b-5.”<sup>63</sup> The plaintiff, on behalf of himself and the putative shareholder class, alleged that InVivo Therapeutics Holdings Corp. (“InVivo”) and its CEO “inflated the value of InVivo’s common stock for about five months in 2013 by issuing false or materially misleading press releases concerning the approval of human clinical trials for a new medical device the company was developing.”<sup>64</sup> Plaintiff claimed InVivo failed to “identify the caveats and conditions imposed by the Food and Drug Administration (“FDA”) for the clinical trials.”<sup>65</sup>

On April 5, 2013, InVivo issued a press release stating that the FDA had approved InVivo’s Investigational Device Exemption (“IDE”) to begin studies to test a product developed to treat patients with traumatic SCI.<sup>66</sup> InVivo announced that it expected the study “to occur over approximately 15 months” and that it intended to commence a clinical study to test safety and performance in five patients.<sup>67</sup> The April 5 release failed to note that FDA approval was conditional, but included a “Safe Harbor Statement” for forward-looking statements.<sup>68</sup>

In a May 9, 2013, press release, InVivo announced that it “expects to commence the study in mid-2013 and submit data to the FDA by the end of 2014.”<sup>69</sup> On August 27, 2013, however, InVivo issued a press release noting that “based on the judgment of new management, it will enroll the first patient during the first quarter of 2014.”<sup>70</sup> The August 27 release noted that the “five-person pilot trial will be staggered such that each patient will be followed for three months prior to requesting approval to enroll the next patient.”<sup>71</sup> InVivo announced that because FDA approval was required to enroll each patient thereafter, it “anticipates that from the date of the first enrolled patient, it will take at least 21 months to complete enrollment.”<sup>72</sup>

According to the plaintiff, after the August 27 press release, InVivo’s stock price dropped due to the revised 2014 start date and 21-month competition period. Plaintiff also claimed that the statements in the April 5 and May 9 press releases were materially false or misleading<sup>73</sup> and that InVivo and its CEO deceived investors, from April 5, 2013, through August 26, 2013, “into buying common stock at high prices, artificially boosted by the false or misleading press releases,” in violation of Section 10(b) and Rule 10b-5.<sup>74</sup> The District Court for the District of Massachusetts rejected both claims, concluding that plaintiff failed to adequately plead scienter or material misrepresentations under Section 10(b) and Rule 10b-5, and that plaintiff’s control person claim must also be dismissed.<sup>75</sup>

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63 *Ganem v. Invivo Therapeutics Holdings Corp.*, 845 F.3d 447, 450 (1st Cir. 2017).

64 *Id.*

65 *Id.*

66 845 F.3d at 451.

67 845 F.3d at 451-52.

68 845 F.3d at 452.

69 845 F.3d at 452-53.

70 845 F.3d at 453.

71 *Id.*

72 *Id.*

73 845 F.3d at 455.

74 845 F.3d at 453.

75 *Id.*



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The First Circuit ultimately found that InVivo's forward-looking statements were not materially misleading, because "the FDA erected no material barriers to an immediate enrollment of the first patient for the exploratory study."<sup>76</sup> The court emphasized that plaintiff alleged no facts to suggest that InVivo would be unable to meet its internal projections and FDA deadlines.<sup>77</sup>

According to the First Circuit, plaintiff was "left only with the inference that because, in retrospect, [InVivo's study] lagged significantly behind the proposed timeline, the timeline must have always been impossible to achieve."<sup>78</sup> The panel ultimately concluded, however, that "'fraud by hindsight' does not satisfy the pleading requirements in a securities fraud case," i.e., a plaintiff cannot "simply contrast a defendant's past optimism with less favorable actual results' in support of a claim of securities fraud."<sup>79</sup>

### The Ninth Circuit Finds That CEO Conduct in Violation of Corporate Ethics Is Not Actionable Under Section 10(b) and Rule 10b-5

On January 19, 2017, in an issue of first impression, the Ninth Circuit affirmed the District Court for the Northern District of California's dismissal of a securities class action in *Retail Wholesale & Department Store Union Local 338 Retirement Fund v. Hewlett-Packard*, finding that Retail Wholesale & Department Store Union Local 338 Retirement Fund ("Retail Wholesale"), the lead plaintiff for the putative class action, "failed to state a claim under the Securities Exchange Act of 1934."<sup>80</sup> Plaintiff, and the putative class consisting of Hewlett-Packard Company ("HP") shareholders who purchased shares between November 13, 2007, and August 6, 2010, brought claims against HP and its CEO under Section 10(b) and Rule 10b-5.<sup>81</sup>

At issue was whether HP's shareholders "may bring a claim for securities fraud when a CEO and Chairman violates the corporate code of ethics after publicly touting the business's high standards for ethics and compliance."<sup>82</sup> Through press releases, public letters to employees and investor briefings, HP's CEO had made comments concerning HP's integrity and its intention to enforce its Standards of Business Conduct ("SBC").<sup>83</sup> The plaintiff alleged that HP's CEO misrepresented his relationship with a former independent contractor, with whom he had a personal relationship, and that the CEO doctored expense reports to prevent the discovery of their relationship.<sup>84</sup>

After an internal investigation, the CEO resigned and HP's share price dropped significantly.<sup>85</sup> The plaintiff based the complaint on the conflict between the CEO publicly touting HP's high standards for ethics and compliance with its corporate code of ethics, and the CEO's unethical behavior.<sup>86</sup> The Ninth Circuit approached plaintiff's allegations "by first analyzing falsity, to determine whether

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76 845 F.3d at 455.

77 845 F.3d at 456.

78 845 F.3d at 457.

79 845 F.3d at 457 (citation omitted).

80 *Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett-Packard*, 845 F.3d 1268, 1271 (9th Cir. 2017).

81 845 F.3d at 1271.

82 *Id.*

83 845 F.3d at 1272.

84 *Id.*

85 845 F.3d at 1272.

86 845 F.3d at 1271.

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an ethical code and statements made about the code contain[ed] any misrepresentations of fact, and then, if there was a misrepresentation, determining its materiality,” i.e., “its significance to stockholder decision making.”<sup>87</sup>

The court emphasized that for a statement to be misleading, it “must be ‘capable of objective verification,’” and found that defendants “made no objectively verifiable statements during the Class Period.”<sup>88</sup> The court also noted that “puffing,” i.e., “expressing an opinion rather than a knowingly false statement of fact,” is not misleading.<sup>89</sup> According to the Ninth Circuit, a code of conduct “is inherently aspirational” and “expresses opinions as to what actions are preferable, as opposed to implying that all staff, directors, and officers always adhere to its aspirations.”<sup>90</sup>

The panel highlighted one of the statements that prefaced HP’s SBC, which read: “We know actions speak louder than words. We must make decisions and behave in ways that we can be proud of, that reflect our commitment to doing the right thing.”<sup>91</sup>

The Ninth Circuit found that the “aspirational nature of [HP’s] statements [was] evident,” and ultimately held that they provided a “‘vague statement of optimism,’ not capable of objective verification.”<sup>92</sup> The panel emphasized that HP’s promotion of business ethics was nothing unusual, because the “substance and online publication of the SBC were mandated by the SEC.”<sup>93</sup>

The Ninth Circuit found that it “simply cannot be that a reasonable investor’s decision would conceivably have been affected by HP’s compliance with SEC regulations requiring publication of ethics standards.”<sup>94</sup> The court found that it could not be said that there was a substantial likelihood that HP’s representations “altered the ‘total mix’ of information made available” for investors.<sup>95</sup> According to the court, there was also “no omission that could have been actionable as misleading,” because “[a]bsent a duty to disclose, an omission does not give rise to a cause of action under § 10(b) and Rule 10b-5.”<sup>96</sup>

The Ninth Circuit concluded that “a duty to provide information exists only where statements were made which were misleading in light of the context surrounding the statements,” and defendants had no duty to disclose because HP and its CEO’s “failures to speak did not ‘affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists.’”<sup>97</sup> Moreover, HP’s statements “were aspirational, and neither [HP’s CEO] nor HP warranted total compliance with the SBC.”<sup>98</sup>

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87 845 F.3d at 1275.

88 *Id.* at 1275-76 (citation omitted).

89 *Id.*

90 845 F.3d at 1276.

91 *Id.*

92 845 F.3d at 1276 (citation omitted).

93 845 F.3d at 1277.

94 *Id.*

95 *Id.*

96 845 F.3d at 1278 (citation omitted).

97 *Id.*

98 845 F.3d at 1278.

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### Seventh Circuit Deepens Circuit Split on SLUSA Pre-emption With Dismissal of State-Law Claims for Breach of Contract and Fiduciary Duty

On January 23, 2017, the Seventh Circuit in *Goldberg v. Bank of America, N.A.* affirmed the District Court for the Northern District of Illinois's decision to dismiss a proposed shareholder class action against Bank of America and LaSalle Bank (the "Bank") alleging state-law claims for breach of contract and fiduciary duty.<sup>99</sup> Plaintiff, who proposed to represent a class of investors who had custodial accounts at the Bank, alleged that the Bank had "broken its contract" and "violated its fiduciary duties" by collecting fees unbeknownst to customers that were not mentioned in the Bank's contract schedule.<sup>100</sup> According to plaintiff's complaint, "some mutual funds paid the Bank a fee based on the balances it transferred, and the Bank did not deposit these fees in the custodial accounts or notify customers that it was retaining them."<sup>101</sup>

Plaintiff sued in state court, and thereafter the Bank removed the suit to federal court, arguing that plaintiff's claims were pre-empted by SLUSA. The Seventh Circuit agreed with the Bank, finding that "[t]he statute . . . requires such state-law claims to be dismissed," and affirmed the District Court's dismissal.<sup>102</sup>

The Seventh Circuit found that SLUSA "does not say what kind of connection must exist between the false statement or omission and the purchase or sale of a security," and only asks "whether the complaint alleges 'a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security.'"<sup>103</sup> Plaintiff's complaint "alleged a material omission in connection with sweeps to mutual funds that are covered securities," and according to the court, "no more is needed."<sup>104</sup>

The Seventh Circuit found that the Bank's omission "was in connection with a purchase or sale of a 'covered security.'"<sup>105</sup> The Seventh Circuit also found that plaintiff's claim depended "on the omission of a material fact – that some mutual funds paid, and the Bank kept, fees extracted from the 'swept' balances."<sup>106</sup> Further, plaintiff conceded that his suit was a "covered class action," i.e., a "class [with] more than 50 members."<sup>107</sup>

Citing a similar decision by the Seventh Circuit in *Holtz v. JPMorgan Chase Bank, N.A.*, the *Goldberg* court noted that a claim that involves "a fiduciary that trades in securities for a customer's account" who has allegedly "taken secret side payments is well inside the bounds of securities law."<sup>108</sup> The Seventh Circuit also noted that the plaintiff "may have had a good claim under federal securities law. But he chose not to pursue it, and SLUSA prevents him from using a state-law theory instead."<sup>109</sup>

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99 *Goldberg v. Bank of America, N.A.*, 846 F.3d 913 (7th Cir. 2017).

100 *Id.* at 915.

101 *Id.*

102 *Id.*

103 846 F.3d at 916.

104 *Id.*

105 *Id.*

106 846 F.3d at 916.

107 *Id.*

108 *Id.* (citing *Holtz v. JPMorgan Chase Bank, N.A.*, 846 F.3d 928, 930-33 (7th Cir. 2017)).

109 *Id.*

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The dissenting opinion in *Goldberg* highlighted the circuit split concerning SLUSA pre-emption. According to the dissent, the majority opinions in both *Goldberg* and *Holtz* “shelter the wrongful conduct of powerful financial institutions from the only viable means to enforce contractual and fiduciary duties,” and only “widen an already existing circuit split under SLUSA.”<sup>110</sup> The dissent argued that the Seventh Circuit “should instead apply the standard adopted in the Second, Third, and Ninth Circuits, which allows class actions under state contract and fiduciary law where the plaintiffs can prevail on their claims without proving the defendants engaged in deceptive misrepresentations or omissions.”<sup>111</sup> According to the dissent, this would essentially bar claims “that are, in substance, for fraud or negligent misrepresentation,” but allow “contract and fiduciary claims to go forward.”<sup>112</sup>

The concurring opinion in *Goldberg* also highlighted the challenge concerning “the scope of SLUSA’s ‘misrepresentation or omission of a material fact’ prohibition,” but emphasized that “SLUSA does not preempt all contract claims – just those that allege misrepresentations or omissions.”<sup>113</sup> The concurring opinion referenced three approaches used by the courts in SLUSA pre-emption cases: (1) “the Sixth Circuit’s ‘literalist’ approach, where the court asks simply whether the complaint can reasonably be interpreted as alleging a material misrepresentation or omission”;<sup>114</sup> (2) “the Third Circuit’s ‘looser’ approach, where the court asks whether proof of a material misrepresentation or omission is inessential . . . or essential”;<sup>115</sup> and (3) “the Ninth Circuit’s ‘intermediate’ approach, where the court dismisses preempted suits without prejudice, permitting plaintiffs to file complaints devoid of any prohibited allegations.”<sup>116</sup>

With the obvious split in the circuits concerning SLUSA pre-emption, it is likely to be reviewed by the Supreme Court in an upcoming term. Nonetheless, in-house and outside counsel alike should be sure to incorporate SLUSA into defense strategies against would-be class action plaintiffs, where possible.

### Ninth Circuit Finds That Internal Reports Are Protected by Dodd-Frank’s Whistleblower Provisions, Further Widening the Circuit Split on Whistleblower Protections

On March 8, 2017, a divided Ninth Circuit panel in *Somers v. Digital Realty Trust Inc.* concluded that the protections afforded to whistleblowers under Dodd-Frank’s anti-retaliation protections apply not only to whistleblowers who disclose information to the SEC, but also to whistleblowers who solely disclose information internally.<sup>117</sup> The issue before the panel was whether, in using the term “whistleblower,” Congress intended to limit the protections of the anti-retaliation provisions to those who come within Dodd-Frank’s formal definition of “whistleblower,” which would include only those who disclose information to the SEC. The Ninth Circuit acknowledged that this issue “has divided the federal district and circuit courts.”<sup>118</sup>

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110 846 F.3d at 921.

111 *Id.*

112 846 F.3d at 922.

113 846 F.3d at 917, 919.

114 846 F.3d at 918 (citation omitted).

115 *Id.* (citation omitted).

116 *Id.* (citation omitted).

117 *Somers v. Digital Realty Trust Inc.*, 850 F.3d 1045 (9th Cir. 2017), *cert. granted*, No. 16-1276, 2017 WL 1480349 (U.S. June 26, 2017).

118 *Id.*

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According to the Ninth Circuit, the divisions can be attributed to a last-minute addition to the anti-retaliation provisions in Dodd-Frank, which extends protection to whistleblowers who make disclosures under the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) and other laws, rules and regulations.<sup>119</sup> Indeed, although Dodd-Frank defined the term “whistleblower” as “any individual who provides . . . information relating to a violation of the securities laws to the Commission,”<sup>120</sup> Dodd-Frank’s anti-retaliation provisions provide broader protections, including to whistleblowers who make disclosures under Sarbanes-Oxley.<sup>121</sup>

The *Somers* plaintiff brought suit against Digital Realty Trust Inc. (“Digital Realty”) for various violations of state and federal laws, including Section 21F of the Securities Exchange Act of 1934, which includes Dodd-Frank’s anti-retaliation protections.<sup>122</sup> Plaintiff was employed as defendant’s vice president from 2010 to 2014, but was fired after making “several reports to senior management regarding possible securities law violations by the company.”<sup>123</sup> Plaintiff was ultimately fired before he could report his concerns to the SEC.<sup>124</sup> Digital Realty moved to dismiss plaintiff’s claims on the grounds that plaintiff was not a “whistleblower” entitled to Dodd-Frank protection, because he reported the alleged violations only internally and not to the SEC.<sup>125</sup>

The anti-retaliation provision highlighted in *Somers* can be found at subdivision (iii) of Section 21F.<sup>126</sup> Subdivision (iii) provides that no employer “may discharge, demote, suspend . . . or in any other manner discriminate against, a whistleblower . . . because of any lawful act done by the whistleblower . . . in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 . . . and any other law, rule, or regulation subject to the jurisdiction of the Commission.”<sup>127</sup>

In 2011, the SEC issued Exchange Act Rule 21F-2 pursuant to the SEC’s rule-making authority, which provides that “anyone who does any of the things described in subdivisions (i), (ii), and (iii) of the anti-retaliation provision is entitled to protection, including those who make internal disclosures under Sarbanes-Oxley.”<sup>128</sup> The District Court examined the tension between the “whistleblower” definition, which was more narrow in scope, and the broader anti-retaliation provisions, and ultimately deferred to the SEC interpretation stating that individuals who solely report internally are also protected under Dodd-Frank.<sup>129</sup>

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119 850 F.3d at 1046.

120 15 U.S.C. § 78u-6(a)(6) (emphasis added).

121 15 U.S.C. § 78u-6(h)(1)(A).

122 *Somers*, 850 F.3d at 1047.

123 850 F.3d at 1047.

124 *Id.*

125 *Id.*

126 850 F.3d at 1048 (citation omitted).

127 *Id.*

128 850 F.3d at 1050.

129 *Id.*

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The Fifth Circuit was the first to address this issue, and concluded that whistleblower protection applied only to whistleblowers who disclosed to the SEC.<sup>130</sup> The Ninth Circuit disagreed. Although the Fifth Circuit applied a strict interpretation of Dodd-Frank's "whistleblower" definition, the Ninth Circuit followed the Second Circuit's approach, which extended "whistleblower" protection to those who make internal disclosures as well as to those who disclose to the SEC.<sup>131</sup> *Somers* ultimately concluded that "subdivision (iii) of section 21F should be read to provide protections to those who report internally as well as to those who report to the SEC."<sup>132</sup>

The Ninth and Second Circuits' interpretation will allow for broader protection for whistleblowers, because one need not report to the SEC to be afforded "whistleblower" protection.

In light of *Somers*, companies should install protocols to ensure consideration of internal reports and complaints by employees before final employment decisions are made. Whistleblower expansion will be sure to increase the risk involved in making personnel decisions, and companies, particularly those exposed to the holding in *Somers* and like-minded circuit courts, should be prepared for this shift.

On June 26, 2017, the Supreme Court granted a petition for writ of certiorari in *Somers*, paving the way for the Supreme Court to resolve the circuit split and provide clarity on the boundaries of "whistleblower" protection.<sup>133</sup>

### The Ninth Circuit Follows the Second Circuit in Applying Heightened Standard for Pleading the Falsity of Opinion Statements Under Section 10(b) and Rule 10b-5

In *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.*, plaintiff alleged that Align Technology, Inc. ("Align"), an orthodontics and dental products maker, and its officers violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, by misleading investors concerning the goodwill valuation of Cadent Holdings, Inc., a company it recently acquired.<sup>134</sup>

On May 5, 2017, the Ninth Circuit upheld the District Court for the Central District of California's decision dismissing plaintiff's putative securities fraud class action.<sup>135</sup> At issue was whether "opinion statements" are actionable as false and misleading statements under federal securities laws. *City of Dearborn Heights Act 345 Police & Fire Retirement System* – the plaintiff-appellant representing all investors who purchased stock in Align between January 31, 2012, and October 17, 2012 – alleged that the defendants "violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and SEC Rule 10b-5 in connection with statements regarding Align's goodwill valuation of its subsidiary, Cadent Holdings, Inc."<sup>136</sup>

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130 See *id.* (citing *Asadi v. G.E. Energy (USA), L.L.C.*, 720 F.3d 620 (5th Cir. 2013)).

131 *Somers*, 850 F.3d at 1046-50 (citing *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145 (2d Cir. 2015); cf. *Asadi v. G.E. Energy (USE), L.L.C.*, 720 F.3d 620 (5th Cir. 2013)).

132 *Somers*, 850 F.3d 1050.

133 See *Digital Realty Trust, Inc. v. Somers*, No. 16-1276, 2017 WL 1480349 (U.S. June 26, 2017).

134 *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc.*, 856 F.3d 605, 610 (9th Cir. 2017).

135 *Id.* at 610.

136 *City of Dearborn Heights*, 856 F.3d at 609-10.

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The District Court dismissed plaintiff's complaint for failure to adequately plead falsity and scienter, and the Ninth Circuit affirmed.<sup>137</sup> The Ninth Circuit ultimately found that "the three standards for pleading falsity of opinion statements" under Section 11, as set forth by the Supreme Court in *Omnicare, Inc.*, are also applicable to pleading the falsity of "opinion statements" under Section 10(b) and Rule 10b-5.<sup>138</sup> The plaintiff would have had to sufficiently plead either falsity or scienter, and the Ninth Circuit held that the plaintiff failed to adequately plead either of the two.<sup>139</sup>

Only allegations regarding scienter and falsity were at issue on appeal. The court concluded that "[a]lthough *Omnicare* concerned Section 11 claims . . . the Supreme Court's reasoning is equally applicable to Section 10(b) and Rule 10b-5 claims."<sup>140</sup> The Ninth Circuit emphasized that the Second Circuit reached the same result, concluding that: "The only other circuit to have considered *Omnicare*'s effect on the falsity pleading standard for Section 10(b) claims based on opinion statements has held that the reasoning of *Omnicare* applies. . . . We are likewise so persuaded, and we therefore hold that the three standards for pleading falsity under *Omnicare* also apply to Section 10(b) and Rule 10b-5 claims."<sup>141</sup>

The three *Omnicare* standards for pleading falsity of opinion statements under Section 10(b) and Rule 10b-5, as construed by the Ninth Circuit, are as follows:

1. If a plaintiff "relies on a theory of material misrepresentation," the plaintiff must allege both that (a) "the speaker did not hold the belief she professed" and (b) "the belief is objectively untrue."<sup>142</sup>
2. If a plaintiff "relies on a theory that a statement of fact contained within an opinion statement is materially misleading," the plaintiff must allege that "the supporting fact [the speaker] supplied [is] untrue."<sup>143</sup>
3. If a plaintiff "relies on a theory of omission," the plaintiff must allege "facts going to the basis for the issuer's opinion . . . whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."<sup>144</sup>

According to the Ninth Circuit, *Omnicare* clarified that "pleading falsity by alleging that 'there is no reasonable basis for the belief' is permissible only under an omissions theory of liability."<sup>145</sup>

Currently, only the Second and Ninth Circuits have considered this issue, and both have followed the same heightened standard outlined in *Omnicare*. Therefore, unless another circuit court departs from this view, thus requiring Supreme Court intervention, the application of the *Omnicare* standard to Section 10(b) and Rule 10b-5 claims shall remain good law in these jurisdictions.

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<sup>137</sup> *Id.*

<sup>138</sup> *City of Dearborn Heights*, 856 F.3d at 610, 615-16; *cf. Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015).

<sup>139</sup> 856 F.3d at 610.

<sup>140</sup> 856 F.3d at 616.

<sup>141</sup> *Id.* at 616 (citing *Tongue v. Sanofi*, 816 F.3d 199, 209-10 (2d Cir. 2016)).

<sup>142</sup> *City of Dearborn Heights*, 856 F.3d at 616 (citing *Omnicare*, 135 S. Ct. at 1327).

<sup>143</sup> *Id.* at 616.

<sup>144</sup> *Id.* at 616 (citing *Omnicare*, 135 S. Ct. at 1332).

<sup>145</sup> *Id.*

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### The Ninth Circuit Extends Supreme Court Precedent to Allow Tolling of Statute of Limitations for Subsequent Class Actions

On May 24, 2017, the Ninth Circuit in *Resh v. China Agritech, Inc.*, addressed whether unnamed plaintiffs from prior would-be class actions could toll the statute of limitations and file subsequent *class actions* – relief which had been previously reserved only for the filing of subsequent *individual claims*.<sup>146</sup> The panel found that plaintiffs were “not time-barred from bringing a class action,” thereby extending Supreme Court precedent in *American Pipe & Construction Co. v. Utah* and *Crown, Cork & Seal Co. v. Parker*, respectively.<sup>147</sup>

Plaintiffs alleged that China Agritech, Inc. (“China Agritech”) and its managers and directors violated the Securities Exchange Act of 1934 by materially misstating net revenues and income, leading to artificially inflated stock prices.<sup>148</sup> Three attempts at certifying a plaintiff class ensued in connection with China Agritech’s practices.

The first action was *Dean v. China Agritech, Inc.*<sup>149</sup> On February 11, 2011, plaintiffs filed a would-be class action against China Agritech and its officers, alleging that China Agritech had “materially misstated its net revenue and income for the third quarter in 2009 on its SEC Form 10-Q filing, and had materially misstated its net revenue and income for fiscal years 2008 and 2009 in its 2009 SEC Form 10-K filing.”<sup>150</sup> The *Dean* plaintiffs’ request to certify their class was ultimately denied, because the court concluded that they failed to meet the predominance requirement under Rule 23(b)(3).<sup>151</sup> The court found that plaintiffs were unable to establish the requisite showing of market efficiency for a fraud-on-the-market theory, and therefore plaintiffs had to establish individualized reliance to support their claims.<sup>152</sup> As a result, the plaintiffs continued litigating their cases as individuals, and their claims were ultimately dismissed with prejudice in connection with a September 14, 2012 settlement.<sup>153</sup>

The second action was *Smyth v. Chang*.<sup>154</sup> On October 4, 2012, three weeks after the *Dean* action settled, the plaintiffs in *Smyth* filed a nearly identical class action against China Agritech.<sup>155</sup> The action, which was filed on behalf of the same would-be class, differed from *Dean* only in that it did not include several defendants named in the *Dean* action, and it solely alleged violations under the Securities Exchange Act of 1934.<sup>156</sup> The court equally denied class certification for the *Smyth* plaintiffs. The court reasoned that “the *Smyth* plaintiffs’ personal claims failed the typicality requirement of Rule 23(a)(3) because their prior relationship with named plaintiffs in [*Dean*] . . . subjected them to a claim preclusion defense that was not available against unnamed class members.”<sup>157</sup> The parties in *Smyth* agreed to dismiss the action with prejudice on January 8, 2014.<sup>158</sup>

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146 *Resh v. China Agritech, Inc.*, 857 F.3d 994 (9th Cir. 2017).

147 857 F.3d at 1000-05 (citing *American Pipe & Constr. Co. v. Utah*, 414 U.S. 538 (1974); *Crown, Cork & Seal Co. v. Parker*, 462 U.S. 345 (1983)).

148 857 F.3d at 996-97.

149 857 F.3d at 997 (citing *Dean v. China Agritech, Inc.*, 2011 WL 607174 (C.D. Cal. Feb. 11, 2011)).

150 857 F.3d at 997.

151 857 F.3d at 997-98.

152 857 F.3d at 998.

153 *Id.*

154 *Resh*, 857 F.3d at 998 (citing *Smyth v. Chang*, 2012 WL 4963062 (D. Del. Oct. 4, 2012)).

155 857 F.3d at 998.

156 *Id.*

157 *Id.*

158 *Id.*



### Securities Law Cases

The third and final action, which formed the basis of the Ninth Circuit's decision, was *Resh v. China Agritech, Inc.*<sup>159</sup> On June 30, 2014, plaintiffs in *Resh* filed a would-be class action against China Agritech and several individual defendants.<sup>160</sup> The *Resh* plaintiffs alleged violations of "Sections 10(b) and 20(a) of the [Exchange Act of 1934] based on the same facts and circumstances, and on behalf of the same would-be class, as in the *Dean* and *Smyth* Actions."<sup>161</sup> Defendants moved to dismiss plaintiffs' claims on the grounds that their would-be class action "was time-barred under the Exchange Act's two-year statute of limitations."<sup>162</sup> The District Court granted defendants' motion dismissing plaintiffs' claims, finding that "the statute of limitations was tolled for the individual claims of the named plaintiffs in the *Resh* Action, but was not tolled for plaintiffs' would-be class action."<sup>163</sup> Plaintiffs subsequently appealed after the District Court denied their motion for reconsideration, and the Ninth Circuit reversed.<sup>164</sup>

The Ninth Circuit concluded that "permitting future class action named plaintiffs, who were unnamed class members in previously uncertified classes, to avail themselves of *American Pipe* tolling would advance the policy objectives that led the Supreme Court to permit tolling in the first place."<sup>165</sup> According to *American Pipe*, "unnamed members of an uncertified class could intervene as individual plaintiffs in the individual suit that remained even if the statutory limitations period had passed."<sup>166</sup>

The Ninth Circuit concluded that (1) the *Resh* class action complaint was not time-barred; (2) the *Resh* plaintiffs' individual claims were tolled under *American Pipe* during the pendency of the *Dean* and *Smyth* Actions; and (3) so long as the *Resh* plaintiffs "can satisfy the criteria of Rule 23, and can persuade the district court that comity or preclusion principles do not bar their action, they are entitled to bring their timely individual claims as named plaintiffs in a would-be class action."<sup>167</sup>

The panel emphasized that its ruling would not lead to an "unfair surprise" for defendants, because the prior class would have alerted them not only to the substantive claims against them, but also to the number of would-be plaintiffs who may participate in the judgment.<sup>168</sup> The Ninth Circuit also noted that under Rule 23, potential plaintiffs would have "little to gain from repeatedly filing new suits."<sup>169</sup> Despite the court's assurances, corporate defendants should take note of the Ninth Circuit's ruling, as it opens the door to multiple attempts by plaintiffs to certify a class, and ultimately makes defending class action suits a much taller order.

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159 857 F.3d at 998-99.

160 857 F.3d at 999.

161 857 F.3d at 998-99.

162 857 F.3d at 999.

163 *Id.*

164 857 F.3d at 999-1004.

165 857 F.3d at 1004.

166 *Resh*, 857 F.3d at 1000 (citing *American Pipe & Constr. Co.*, 414 U.S. at 550-56).

167 *Id.* at 1005 (citations omitted).

168 857 F.3d at 1004.

169 857 F.3d at 1005.

### Securities Law Cases

### Second Circuit Rejects First Circuit Standard for Assessing the Materiality of Omissions in Registration Statements

On June 21, 2017, the Second Circuit in *Stadnick v. Vivint Solar, Inc.* rejected the First Circuit’s “extreme departure test” for determining when an omission in a registration statement is material in connection with claims under Section 11 of the Securities Act.<sup>170</sup> Rather, the Second Circuit decided that the law of the court with regard to such omissions is the “materiality test,” i.e., “whether there is a ‘substantial likelihood that the disclosure of the omitted information would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.’”<sup>171</sup> The decision makes clear that there is a split among the circuits as to what the appropriate materiality standard should be in these circumstances, and makes the issue ripe for Supreme Court review.

Vivint Solar, Inc. (“Vivint”) is a “residential solar energy unit installer that leases solar energy systems to homeowners.”<sup>172</sup> Vivint’s business model “is predicated upon continued ownership of the solar energy equipment it installs, which allows Vivint to qualify for various tax credits and other government incentives.”<sup>173</sup> Because Vivint incurs significant upfront costs, it must secure financing from outside investors who make cash contributions to “investment funds jointly owned by the investors and Vivint.”<sup>174</sup> Each investment fund finances Vivint’s purchase and installation of particular solar energy systems. Once the system is installed, “its title is transferred to the fund that contributed the capital,” and the fund receives most of Vivint’s customers’ monthly payments until the fund “achieves a targeted rate of return or the recapture period associated with certain tax credits expires.”<sup>175</sup> Thereafter, Vivint receives the majority of the revenue. Given the funds’ role, Vivint allocates its income between its outside investors, which Vivint refers to as “non-controlling interests or redeemable non-controlling interests,” and its public shareholders.<sup>176</sup> Vivint calculated the income available to shareholders by calculating its overall income, then subtracting noncontrolling interests allocated to outside investors. However, due to Vivint’s business model and accounting methods, its allocations of income between its public shareholders and outside investors may vary substantially from one quarter to the next.

On October 1, 2014, Vivint issued an IPO, and its accompanying registration statement disclosed the financial results for six quarters that immediately preceded the third quarter of 2014. These results revealed “increasing net losses” and the impact that Vivint’s “business model and accounting practices could have” on its income allocation between shareholders and outside investors.<sup>177</sup> The registration statement also identified certain key operating metrics for assessing Vivint’s performance.

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170 *Stadnick v. Vivint Solar, Inc.*, No. 16-65-cv, 2017 WL 2661597 (2d. Cir. June 21, 2017).

171 *Id.* at \*5 (quoting *DeMaria v. Andersen*, 318 F.3d 170, 180 (2d Cir. 2003)).

172 2017 WL 2661597 at \*1.

173 2017 WL 2661597 at \*2.

174 *Id.*

175 2017 WL 2661597 at \*2.

176 2017 WL 2661597 at \*2.

177 2017 WL 2661597 at \*2.

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On November 10, 2014, Vivint issued a press release that showed there had been a significant decline in income to shareholders. However, the results also showed that despite this loss, Vivint's "key operating metrics" that it had previously identified in its registration statement were surpassing analysts' expectations.<sup>178</sup> On November 12, Vivint released "its Form 10-Q for the third quarter of 2014," 43 days after its IPO.<sup>179</sup>

After the November 10 press release, Vivint's stock price declined approximately 22.5 percent. After the release of Vivint's November 12 10-Q, Vivint's stock price witnessed an additional 5 percent decrease.

Thereafter, plaintiff brought a securities class action against Vivint, alleging violations of Section 11 of the Securities Act ("Section 11"). Plaintiff argued that "Vivint violated Section 11 in failing to disclose the 2014 third-quarter financial information in its registration statement, which was issued the day after the third-quarter ended."<sup>180</sup> According to plaintiff, "Vivint's third-quarter performance, measured by income available to shareholders and earnings-per-share, should have been disclosed because it was an 'extreme departure' from previous performance, under the test articulated by the First Circuit."<sup>181</sup>

The Second Circuit rejected plaintiff's argument on appeal, finding that the First Circuit's "extreme departure" standard is not the law of the Circuit with regard to assessing the materiality of an omission of interim financial information.<sup>182</sup> The Second Circuit found that the appropriate test for assessing whether an omission violated Section 11 was the "traditional materiality test" set forth in *DeMaria v. Andersen*.<sup>183</sup>

The Second Circuit outlined three reasons why it refused to adopt the "extreme departure" test.<sup>184</sup> First, *DeMaria* relies upon "the classic materiality standard in the omission context"; second, the First Circuit's "extreme departure" test leaves too many open questions, including "the degree of change necessary for an 'extreme departure,'" and "which metrics courts should look to in assessing whether such a departure has occurred"; and third, "in some situations the 'extreme departure' test can be analytically counterproductive."<sup>185</sup>

The panel found that although "traditional metrics, standing alone," lend support to plaintiff's claim, the metrics that plaintiff identified "are not fair indicators of Vivint's performance," because the fluctuation in Vivint's performance "is attributable to the normal operation of the company's business model."<sup>186</sup> The court found the "extreme departure" test "makes little sense in this context and confuses the analysis, while the *DeMaria* test, which examines omissions in the context of the total mix of available investor information, does not."<sup>187</sup> Ultimately, the court concluded

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178 2017 WL 2661597 at \*2.

179 *Id.*

180 2017 WL 2661597 at \*4.

181 *Id.* (citation omitted).

182 *Id.*

183 2017 WL 2661597 at \*5 (quoting *DeMaria v. Andersen*, 318 F.3d 170, 180 (2d Cir. 2003)).

184 2017 WL 2661597 at \*5.

185 *Id.*

186 *Id.*

187 *Id.*

### Securities Law Cases

that plaintiff's view was "too myopic, both temporally and with regard to the number of relevant metrics," and when viewed in light of the total mix of publicly available information, "it is plain that the omissions relating to [Vivint's] income and earnings-per-share for the third quarter of 2014 did not render the publicly available information misleading."<sup>188</sup>

The Second Circuit's rejection of the First Circuit's "extreme departure" test raises the possibility that Supreme Court review may be forthcoming. In the interim, the Second Circuit has made clear that the law of the Circuit in connection with assessing the materiality of an omission of interim financial information, is whether the alleged omission "significantly alters" the total mix of information available to reasonable investors. Therefore, in preparing an IPO, in-house legal departments and outside counsel should analyze registration statements keeping the varying standards in mind.

### An Equally Divided D.C. Circuit Makes Administrative Law Judge Constitutionally Ripe for Supreme Court Review

As noted in the Supreme Court Cases Review section, on June 26, 2017, the D.C. Circuit 10-judge en banc panel in *Raymond J. Lucia Cos., Inc. v. SEC* was evenly split, 5-5, on the question of whether the SEC could bring enforcement actions seeking civil penalties using administrative law judges ("ALJs").<sup>189</sup> The split led to the denial of plaintiff's bid to overturn an earlier decision rendered by the D.C. Circuit in a three-judge panel on August 9, 2016.<sup>190</sup>

The D.C. Circuit had upheld the constitutionality of SEC administrative courts in 2016 with a three-judge panel in *Raymond J. Lucia Cos., Inc. v. SEC*, while the Tenth Circuit in *Bandimere v. SEC* held that the ALJs who preside over the SEC's in-house courts are "inferior officers" subject to the Appointments Clause under Article II of the Constitution.<sup>191</sup>

With the D.C. Circuit's en banc panel equally divided, there continues to be a clear split between the Tenth and D.C. Circuits on this issue, which ultimately will need to be resolved by the Supreme Court.

*For more information on the circuit split between the D.C. Circuit and the Tenth Circuit, please review the Supreme Court Cases Review found in BakerHostetler's 2016 Year-End Securities Litigation and Enforcement Highlights<sup>192</sup> and our practice group article, "Tenth Circuit Creates Circuit Split on the Constitutionality of SEC Administrative Law Judges."<sup>193</sup>*

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188 2017 WL 2661597 at \*6.

189 *Raymond J. Lucia Cos., Inc. v. SEC*, No. 15-1345, 2017 WL 2727019 (D.C. Cir. June 26, 2017).

190 *Raymond J. Lucia Cos., Inc. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016).

191 *Raymond J. Lucia Cos., Inc.*, 832 F.3d at 277; cf. *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016).

192 Marc D. Powers, Mark A. Kornfeld and Melissa L. Kosack et al., *2016 Year-End Securities Litigation and Enforcement Highlights: Supreme Court Cases Review*, BakerHostetler, January 2017, at 10-11, <https://www.bakerlaw.com/webfiles/Litigation/2017/Briefs/2016-Year-End-Securities-Litigation-and-Enforcement-Highlights.pdf>.

193 *Supra* note 59; see also Mark A. Kornfeld, Jessie M. Gabriel, and David Choi, *Administrative Proceedings Remain Likely for SEC Enforcement Actions*, New York Law Journal (Sept. 21, 2016), <http://www.newyorklawjournal.com/id=1202767976167>.



## Insider Trading Cases

### Insider Trading Cases

### Recent Insider Trading Actions and Trends

As suggested by former SEC Commissioner Troy Paredes at a recent hedge fund industry forum hosted by BakerHostetler, the SEC has maintained its focus on enforcement and misconduct, despite recent personnel and leadership changes.<sup>194</sup> Indeed, through the end of 2016, the SEC continued its trend of strong enforcement of insider trading laws.<sup>195</sup> As expected, enforcement actions overall continued to tick upward, with the SEC having brought 868 actions in fiscal year 2016 – up from 807 in fiscal year 2015.<sup>196</sup> Of those, 78 parties were charged in insider trading cases in fiscal year 2016, and an increasing number of these cases continue to involve the SEC's use of data analytics.<sup>197</sup>

These trends have continued through the first half of 2017.<sup>198</sup> Despite a modest drop to 14 insider trading cases filed, from 21 filed at the same point last year,<sup>199</sup> there is no clear sign of an upcoming decline in insider trading actions. By contrast, the SEC has continued its trend of monitoring and prosecuting illegal use of confidential information, and cracking down on pre-merger insider trades. It also continues to send a clear message that it will aggressively prosecute foreign traders who come to the U.S. and violate insider trading laws.

As noted by Mr. Paredes, "SEC regulators will likely continue to focus on data, analytics, and artificial intelligence, among other things, which will have profound implications for compliance professionals."<sup>200</sup> A selection of noteworthy insider trading cases follows.

### Prosecuting Employee Use of Confidential Information

**SEC v. Dubuc**, No. 1:17-cv-11180 (D. Ma. Jun. 27, 2017); **SEC v. Curran**, No. 1:17-cv-11179 (D. Ma. Jun. 27, 2017); **SEC v. Altvater**, 1:17-cv-11178 (D. Ma. Jun. 27, 2017)

On June 27, 2017, the SEC brought insider trading charges against Susan Dubuc and Maureen Curran, two former Ariad Pharmaceuticals, Inc. employees, and Harold Altvater, the spouse of an employee.<sup>201</sup> In the complaints, the SEC alleged that the three individuals engaged in illegal trades and tipping about the leukemia drug Iclusig.<sup>202</sup>

In Dubuc's case, the SEC alleged that she had "obtained material, nonpublic information concerning Ariad's communications with the United States Food & Drug Administration ("FDA") about the safety profile of Ariad's only FDA-approved drug, Iclusig."<sup>203</sup> Dubuc tipped relatives, who

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194 See *100 Days In: What Hedge Funds Can Expect from Congress, the SEC, and the Trump Administration*, BakerHostetler, at 4-6 (May 23, 2017), <https://www.bakerlaw.com/webfiles/Litigation/2017/Briefs/05-23-2017-Hedge-Funds-Brief.pdf>.

195 Press Release, U.S. Sec. & Exch. Comm'n., *SEC Announces Enforcement Results for FY 2016*, Rel. No. 2016-212 (Oct. 11, 2016), <https://www.sec.gov/news/pressrelease/2016-212.html>.

196 *Id.*

197 *Id.*

198 Report, SEC Enforcement Activity – First Half FY 2017 Update, Cornerstone Research, <https://www.cornerstone.com/Publications/Research/SEC-Enforcement-Activity-First-Half-FY-2017-Update> (accessed June 27, 2017).

199 *Id.*

200 *Supra* note 194.

201 Compl. at 1, *SEC v. Dubuc*, No. 1:17-cv-11180 (D. Ma. Jun. 27, 2017); Compl. at 1, *SEC v. Curran*, No. 1:17-cv-11179 (D. Ma. Jun. 27, 2017); Compl. at 1, *SEC v. Altvater*, No. 1:17-cv-11178 (D. Ma. Jun. 27, 2017).

202 *Id.*

203 Compl. at 1, *SEC v. Dubuc*, No. 1:17-cv-11180 (D. Ma. Jun. 27, 2017).

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sold 235 shares of stock prior to Ariad's announcement that it would pause the process leading up to the drug's clinical trials.<sup>204</sup> The sales allowed Dubuc's relatives to avoid \$2,888.10 in losses.

In Curran's case, the SEC alleged that she, too, obtained material, nonpublic information regarding Iclusig.<sup>205</sup> Curran sold shares ahead of a December 14, 2012 public announcement that the drug's FDA approval was conditioned upon including a safety warning about the blood clots and liver toxicity risks.<sup>206</sup> Curran's trading ahead of the announcement saved her approximately \$9,420 in losses.<sup>207</sup>

In Altvater's case, the SEC alleged that he "misappropriated information" he received from his wife, an Ariad employee, who obtained material, nonpublic information about Ariad's FDA communications concerning Iclusig's safety profile.<sup>208</sup> Altvater's trades in advance of three separate announcements allowed him to avoid losses and obtain illegal profits totaling more than \$102,000.<sup>209</sup> Altvater also tipped a friend about the nonpublic information, and the friend made illicit profits of almost \$5,000.<sup>210</sup> The cases are each pending in the District Court of Massachusetts.

#### **SEC v. Sabrdaran**, No. 3:14-cv-04825 (N.D. Cal. Jun. 16, 2017)

On June 16, 2017, a California federal court ordered Dr. Sasan Sabrdaran, a former director of InterMune, Inc., to pay \$288,968.19 and ordered his friend Farhang Afsarpour to pay \$456,591.92 for disgorgement and prejudgment interest following their November 2016 insider trading convictions.<sup>211</sup>

In the complaint, the SEC alleged that Sabrdaran tipped Afsarpour with material, nonpublic information about the imminent approval of InterMune's lung disease drug – approval that Sabrdaran learned while employed at InterMune as its Director of Drug Safety Risk Management.<sup>212</sup> Afsarpour bet on the drug's approval in December 2010, despite the fact that the decision was not scheduled to be made public until the following year.<sup>213</sup> The bet allegedly earned him \$1 million.<sup>214</sup> At trial, the SEC argued that the timing of Afsarpour's bets coincided with phone calls and text message exchanges with Sabrdaran.<sup>215</sup> Following a three-week trial and less than six hours of deliberation, the jury returned a verdict in favor of the SEC.<sup>216</sup>

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204 *Id.*

205 Compl. at 1, *SEC v. Curran*, No. 1:17-cv-11179 (D. Ma. Jun. 27, 2017).

206 *Id.*

207 *Id.* at 2.

208 Compl. at 1, *SEC v. Altvater*, No. 1:17-cv-11178 (D. Ma. Jun. 27, 2017).

209 *Id.* at 1-2.

210 *Id.* at 2.

211 Final Judgment at 1, *SEC v. Sabrdaran*, No. 3:14-cv-04825 (N.D. Cal. Jun. 16, 2017).

212 Compl. at 1-2, *SEC v. Sabrdaran*, No. 3:14-cv-04825 (N.D. Cal. Oct. 30, 2014).

213 *Id.*

214 *Id.*

215 Cara Mannion, *Ex-InterMune Exec, Friend Must Pay \$746K for Insider Trading*, Law360 (Jun. 16, 2017), [https://www.law360.com/securities/articles/935281/ex-intermune-exec-friend-must-pay-746k-for-insider-trading?nl\\_pk=7fd1d76e-eccc-42dc-a266-3e69c6707eb6&utm\\_source=newsletter&utm\\_medium=email&utm\\_campaign=securities](https://www.law360.com/securities/articles/935281/ex-intermune-exec-friend-must-pay-746k-for-insider-trading?nl_pk=7fd1d76e-eccc-42dc-a266-3e69c6707eb6&utm_source=newsletter&utm_medium=email&utm_campaign=securities).

216 *Id.*

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In addition to the order to pay disgorgement and interest, the court also permanently barred Sabrdaran from acting as an officer or a director of any publicly traded company.<sup>217</sup>

**SEC v. Blaszcak**, No. 1:17-cv-03919 (S.D.N.Y. May 24, 2017)

On May 24, 2017, the SEC announced charges against David Blaszcak, a former Centers for Medicare and Medicaid Services (“CMS”) employee who ultimately left the agency to become a political intelligence consultant.<sup>218</sup> The SEC alleged that Blaszcak participated in an insider trading scheme “involving tips of nonpublic information about government plans to cut Medicare reimbursement rates, which affected the stock prices of certain publicly traded medical providers or suppliers.”<sup>219</sup> The alleged scheme eventually resulted in more than \$3.9 million in illegal profits, of which Blaszcak’s firms received at least \$193,000.<sup>220</sup>

The SEC alleged that Blaszcak tipped two hedge fund advisory firm analysts, Theodore Huber and Jordan Fogel, with confidential information concerning upcoming CMS decisions.<sup>221</sup> The analysts were Blaszcak’s clients and paid him for consulting services.<sup>222</sup> According to the SEC, the analysts used the nonpublic information Blaszcak provided to recommend that their hedge fund “trade in the stocks of four healthcare companies whose stock prices would likely be affected by the decisions once CMS announced them publicly.”<sup>223</sup>

According to the complaint, Blaszcak obtained confidential details about at least three pending CMS decisions from Christopher Worrall, a former colleague at the agency and close friend.<sup>224</sup> The decisions affected the amount of money that companies would receive from Medicare to provide services or products related to cancer treatments or kidney dialysis.<sup>225</sup> The U.S. Attorney’s Office for the Southern District of New York also brought a parallel criminal action with related charges against Blaszcak and the two analysts.<sup>226</sup>

**U.S. v. Little**, No. 17-mg-3408 (S.D.N.Y. May 11, 2017)

On May 11, 2017, the SEC charged former law firm attorneys Walter C. Little and his associate Andrew Berke with “making more than \$1 million in illicit profits by insider trading around corporate announcements.”<sup>227</sup> The insider trading allegedly occurred between February 2015 and February 2016.<sup>228</sup> The SEC alleged that Little traded with the benefit of improperly obtained nonpublic

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217 See Final Judgment at 2, *SEC v. Sabrdaran*, No. 3:14-cv-04825 (N.D. Cal. Jun. 16, 2017).

218 Press Release, U.S. Sec. & Exch. Comm’n, *SEC Files Charges in Trading Scheme Involving Confidential Government Information*, Rel. No. 2017-109 (May 24, 2017), <https://www.sec.gov/news/press-release/2017-109>.

219 *Id.*

220 *Id.*

221 *Id.*

222 *Id.*

223 *Id.*

224 Compl. at 2, 4, *SEC v. Blaszcak*, No. 1:17-cv-0319 (S.D.N.Y. May 24, 2017), <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-109.pdf>.

225 *Id.*

226 *USA v. Fogel*, No. 1:17-cr-00308 (S.D.N.Y. May 24, 2017).

227 Press Release, U.S. Sec. & Exch. Comm’n, *SEC Charges Law Firm Partner and His Neighbor in \$1 Million Insider Trading Scheme*, Rel. No. 23833 (May 11, 2017), <https://www.sec.gov/litigation/litreleases/2017/lr23833.htm>; Press Release, U.S. Dep’t of Justice, *Acting Manhattan U.S. Attorney and FBI Assistant Director Announce Insider Trading Charges Against Law Firm Partner*, Rel. No. 17-128 (May 11, 2017), <https://www.justice.gov/usao-sdny/pr/acting-manhattan-us-attorney-and-fbi-assistant-director-announce-insider-trading-0>.

228 *Id.*



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information by accessing “confidential documents on his law firm’s internal computer network related to at least 11 impending announcements involving law firm clients, none of which he personally advised or billed for services.”<sup>229</sup> According to the SEC, Little would then tip Berke “with material nonpublic information so he could similarly trade in company stocks before the announcements were made publicly.”<sup>230</sup>

According to the complaint, Little made profitable trades on Austin-based prosthetics maker Hanger, Inc. in February 2016 after accessing confidential information from his law firm’s document management system.<sup>231</sup> The SEC seeks disgorgement, prejudgment interest, penalties and permanent injunctions from the defendants.<sup>232</sup>

There is currently a parallel criminal case brought by the U.S. Attorney’s office pending in the Southern District of New York.<sup>233</sup>

#### **U.S.A. v. Klein**, No. 2:16-cr-00442 (E.D.N.Y. Mar. 15, 2017)

On March 15, 2017, Robert Schulman, a former patent attorney, was convicted of insider trading charges including conspiracy and securities fraud.<sup>234</sup> He was accused of sharing nonpublic information with close friend and investment adviser Tibor Klein, who then traded securities in his own accounts and on behalf of Schulman and other clients.<sup>235</sup> Klein also tipped another adviser who pled guilty to insider trading in 2014 and testified in Schulman’s trial.<sup>236</sup> According to the sealed indictment, the conspirators made over \$428,000 in illicit profits.<sup>237</sup>

The jury returned a guilty verdict, following a less than two-week long trial and about five hours of deliberation.<sup>238</sup> Schulman’s motions for new trial and for acquittal are currently pending.<sup>239</sup>

### Pre-Merger Insider Trades

#### **U.S. v. DeCinces**, No. 8:12-cr-00269 (C.D. Ca. May 12, 2017)

On May 12, 2017, a California federal jury convicted former Major League Baseball player Doug DeCinces of insider trading on charges of using nonpublic information to purchase stocks in a friend’s medical device company, netting him \$1.3 million in illicit profits.<sup>240</sup> The former Baltimore Orioles third baseman was found guilty of 14 counts of insider trading, and the court declared

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229 *Id.*

230 *Id.*

231 Compl. at 16-17, *SEC v. Little*, No. 1:17-cv-03536 (S.D.N.Y. May 11, 2017), <https://www.sec.gov/litigation/complaints/2017/comp23833.pdf>.

232 *Id.* at 29.

233 *USA v. Little*, No. 1:17-mj-03408 (S.D.N.Y. May 5, 2017).

234 Minute Entry, *USA v. Klein*, No. 2:16-cr-00442 (E.D.N.Y. Mar. 15, 2017).

235 Sealed Indictment at 3-4, *USA v. Klein*, No. 2:16-cr-00442 (E.D.N.Y. Aug. 4, 2016).

236 Stewart Bishop, *Ex-Hunton Patent Atty Convicted of Insider Trading*, Law360 (Mar. 15, 2017), <https://www.law360.com/articles/902137/ex-hunton-patent-atty-convicted-of-insider-trading>.

237 Sealed Indictment at 6, *USA v. Klein*, No. 2:16-cr-00442 (E.D.N.Y. Aug. 4, 2016).

238 Bishop, *supra* note 236.

239 Motion for Acquittal, Motion for New Trial, *U.S. v. Klein*, No. 2:16-cr-00442 (E.D.N.Y. Apr. 24, 2017).

240 Jury Verdict, *U.S.A. v. DeCinces*, No. 8:12-cr-269 (C.D. Cal. May 12, 2017); *see also* Bonnie Eslinger, *Ex-MLB Player DeCinces Convicted in Insider Trading Case*, Law360 (May 12, 2017), [https://www.law360.com/securities/articles/920773/breaking-ex-mlb-player-decinces-convicted-in-insider-trading-case?nl\\_pk=7fd1d76e-eccc-42dc-a266-3e69c6707eb6&utm\\_source=newsletter&utm\\_medium=email&utm\\_campaign=securities](https://www.law360.com/securities/articles/920773/breaking-ex-mlb-player-decinces-convicted-in-insider-trading-case?nl_pk=7fd1d76e-eccc-42dc-a266-3e69c6707eb6&utm_source=newsletter&utm_medium=email&utm_campaign=securities).

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### Insider Trading Cases

a mistrial on the remaining 18 counts of insider trading on which the jury was unable to reach a unanimous decision.<sup>241</sup> David Parker, a friend of DeCinces who illegally took the insider information, was also found guilty of violating federal securities laws.<sup>242</sup> DeCinces and Parker face maximum penalties of 220 years and 60 years in federal prison, respectively.<sup>243</sup> The SEC had previously charged DeCinces and three others with insider trading in 2011, and obtained a judgment against DeCinces in the amount of \$2.5 million in penalties, disgorgement and prejudgment interest.<sup>244</sup>

### Foreign Insider Traders

#### **SEC v. Coppero del Valle**, No. 1:16-cv-7591 (S.D.N.Y. Mar. 24, 2017)

On March 24, 2017, the U.S. District Court for the Southern District of New York approved a proposed settlement agreement between the SEC and three Peruvian traders in connection with allegations that the traders traded on nonpublic information prior to the merger of two mining companies.<sup>245</sup> The traders agreed to pay a total of \$297,213.64, representing full disgorgement, interest and penalties.<sup>246</sup> The SEC remarked that “[o]verseas traders who violate U.S. insider trading laws can expect to face stiff monetary sanctions to resolve their cases.”<sup>247</sup>

According to the complaint, the SEC alleged that trader Nino Coppero del Valle tipped fellow attorney and close friend Julio Antonio Castro Roca, informing him that Canada-based HudBay Minerals, Coppero’s employer, planned to acquire Augusta Resource Corp.<sup>248</sup> Castro allegedly traded on the information, and attempted to avoid detection by using a brokerage account owned by a British Virgin Island shell company under his control.<sup>249</sup> The SEC also alleged that Coppero tipped Ricardo Carrion, who also purchased shares before the tender offer was announced.<sup>250</sup>

The SEC prosecuted the case with some assistance from Peruvian securities regulator Superintendencia del Mercado de Valores.<sup>251</sup>

#### **SEC v. Yin**, No. 17-cv-972 (S.D.N.Y. Feb. 10, 2017)

On February 10, 2017, the SEC announced that it had obtained an emergency court order freezing the assets of several brokerage accounts containing over \$29 million in illegal profits resulting from alleged insider trading.<sup>252</sup> The SEC alleged that during the course of 21 days, Shaohua (Michael)

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241 Amended Minutes, *U.S.A. v. DeCinces*, No. 8:12-cr-269 (C.D. Cal. May 12, 2017).

242 Jury Verdict, *U.S.A. v. DeCinces*, No. 8:12-cr-269 (C.D. Cal. May 12, 2017).

243 Bonnie Eslinger, *Ex-MLB Player DeCinces Convicted in Insider Trading Case*, Law360 (May 12, 2017), [https://www.law360.com/securities/articles/920773/breaking-ex-mlb-player-decinces-convicted-in-insider-trading-case?nl\\_pk=7fd1d76e-eecc-42dc-a266-3e69c6707eb6&utm\\_source=newsletter&utm\\_medium=email&utm\\_campaign=securities](https://www.law360.com/securities/articles/920773/breaking-ex-mlb-player-decinces-convicted-in-insider-trading-case?nl_pk=7fd1d76e-eecc-42dc-a266-3e69c6707eb6&utm_source=newsletter&utm_medium=email&utm_campaign=securities).

244 Judgment, *SEC v. DeCinces*, No. 8:11-cv-01168 (C.D. Cal. Aug. 9, 2011).

245 Press Release, U.S. Sec. & Exch. Comm’n, *Overseas Traders Paying Back All Profits Plus Penalties in Insider Trading Case*, Rel. No. 2017-70 (Mar. 24, 2017), <https://www.sec.gov/news/press-release/2017-70>.

246 *Id.*

247 *Id.*

248 Compl. at 2, *S.E.C. v. Coppero del Valle*, No. 1:16-cv-7591 (S.D.N.Y. Sept. 28, 2016), <https://www.sec.gov/litigation/complaints/2016/comp-pr2016-198.pdf>.

249 *Id.*

250 *Id.*

251 *Supra* note 245.

252 Press Release, U.S. Sec. & Exch. Comm’n, *SEC Charges Chinese Citizens Who Reaped Massive Profits from Insider Trading on Comcast-DreamWorks Acquisition*, Rel. No. 2017-44 (Feb. 10, 2017), <https://www.sec.gov/news/pressrelease/2017-44.html>.

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### Insider Trading Cases

Yin, a partner at Summitview Capital Management Ltd., a Hong Kong-based private equity firm, traded DreamWorks Animation SKG stock and accumulated more than \$56 million in five U.S. brokerage accounts, including an account that belonged to his elderly parents.<sup>253</sup>

Yin allegedly made the purchases days before media outlets first announced a potential DreamWorks acquisition by Comcast. After the acquisition was announced publicly, the share price immediately rose to nearly double its previous price.<sup>254</sup> The SEC used data analytic investigative tools to identify Yin and others behind the suspicious trading, despite Yin's alleged attempts to conceal his control of the brokerage accounts at issue.<sup>255</sup> The SEC warned that it "will not hesitate to freeze the assets of foreign traders when they use our markets to conduct illegal activity."<sup>256</sup>

The parties later agreed to extend the asset freeze via a preliminary injunction entered on consent. The case is currently pending in the Southern District of New York.<sup>257</sup>

### Dismissals

***U.S. v. Aggarwal***, No. 2:15-cr-00465 (C.D. Cal. Jan. 21, 2017)

On January 21, 2017, a California federal jury found former J.P. Morgan analyst Ashish Aggarwal not guilty of 26 counts relating to an alleged insider trader scheme, but the jury deadlocked on four additional counts relating to trades completed before a 2013 salesforce.com acquisition was announced.<sup>258</sup>

The prosecutors alleged that Aggarwal and two friends received over \$600,000 in profits as a result of Aggarwal's disclosure of nonpublic information about two pending deals involving publicly traded companies that were J.P. Morgan clients.<sup>259</sup> Ultimately, the defense won the case by arguing that the government did not offer proof that Aggarwal actually tipped his friends or evidence that Aggarwal profited from the trades.<sup>260</sup>

After trial, Aggarwal's attorneys moved to dismiss the four remaining counts, arguing that the jury had already addressed whether the government could prove fraudulent intent.<sup>261</sup> The court granted the motion and dismissed the case.<sup>262</sup> Trials for Shahriyar Bolandian and Kevan Sadigh, Aggarwal's friends, and the parallel SEC case brought against all three individuals, are both pending.<sup>263</sup> The U.S. Attorney's Office is considering whether it will retry Aggarwal.<sup>264</sup>

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253 Compl. at 2, 10, *S.E.C. v. Yin*, No. 17-cv-972 (S.D.N.Y. Feb. 10, 2017), <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-44.pdf>.

254 *Id.* at 2.

255 *Id.*

256 *Id.*

257 Preliminary Injunction Order on Consent, *SEC v. Yin*, No. 17-cv-972 (S.D.N.Y. Mar. 3, 2017).

258 Bonnie Eslinger, *Jury Largely Clears Ex-JP Morgan Analyst in Tipping Trial*, Law360 (Jan. 31, 2017), <https://www.law360.com/articles/885303>.

259 *Id.*

260 *Id.*

261 Notice of Motion to Dismiss, *U.S. v. Aggarwal*, No. 2:15-cr-00465 (C.D. Cal. Mar. 15, 2017).

262 Order Granting Motion to Dismiss, *U.S. v. Aggarwal*, No. 2:15-cr-00465 (C.D. Cal. Apr. 27, 2017).

263 *SEC v. Aggarwal*, No. 2:15-cv-06460 (C.D. Cal. 2017); *U.S. v. Aggarwal* No. 2:15-cr-00465 (C.D. Cal. 2017).

264 Bonnie Eslinger, *Jury Largely Clears Ex-JP Morgan Analyst in Tipping Trial*, Law360 (Jan. 31, 2017), <https://www.law360.com/articles/885303>.

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

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#### **Matter of Charles L. Hill, Jr.**, No. 3-16383 (ALJ Apr. 18, 2017)

On April 18, 2017, an SEC administrative law judge dismissed a case brought by the SEC against Charles Hill, Jr., a real estate developer accused of insider trading and of receiving \$740,000 in illicit profits.<sup>265</sup> Hill challenged the constitutionality of the SEC's in-house action before the administrative law judge, and argued that the SEC did not provide any evidence proving where he had obtained the inside information.<sup>266</sup> The SEC alleged that Hill purchased 4,500 shares of Radiant Systems, Inc. stock weeks after another company had sent Radiant a letter of interest in buying the company. He then purchased 50,000 shares in Radiant the day after due diligence began. He continued purchasing shares until he owned approximately \$2.2 million in Radiant shares, and after the merger announcement when the share value surged 30 percent, Hill sold his shares. The court acknowledged that although Hill's trading pattern "strongly suggests" that he knew something about Radiant, there were credible denials that Todd Murphy, Hill's friend, and Andrew Murphy, Radiant's chief operating officer, did not share the information.<sup>267</sup>

Hill's challenge to the administrative law judge's jurisdiction was denied in September 2016.<sup>268</sup>

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265 Martin O'Sullivan, *SEC In-House Court Challenger Beats Insider Trading Case*, Law360 (April 18, 2017), [https://www.law360.com/securities/articles/914617/sec-in-house-court-challenger-beats-insider-trading-case?nl\\_pk=c5471e4e-e918-480a-bcc0-fdecc325f28c&utm\\_source=newsletter&utm\\_medium=email&utm\\_campaign=securities&read\\_more=1](https://www.law360.com/securities/articles/914617/sec-in-house-court-challenger-beats-insider-trading-case?nl_pk=c5471e4e-e918-480a-bcc0-fdecc325f28c&utm_source=newsletter&utm_medium=email&utm_campaign=securities&read_more=1).

266 *Id.*

267 *Id.*

268 *Id.*; see also *supra* p. 27, *An Equally Divided D.C. Circuit Makes Administrative Law Judge Constitutionally Ripe For Supreme Court Review*.



## Settlements

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### Settlements

In recent years, there has been an ever-increasing number of settlements, in both volume and amount, in securities-related litigation. According to NERA Economic Consulting, the 2016 average settlement amount was \$72 million.<sup>269</sup> But as more fully discussed below, it appears that with large settlements, including Barclays's \$97 million settlement for overcharging clients and others, 2017 is likely to meet or exceed 2016's settlement numbers.

On May 17, 2017, U.S. Senators Elizabeth Warren (D-Mass.) and James Lankford (R-Okla.) introduced legislation entitled the "Truth in Settlements Act of 2017."<sup>270</sup> This legislation mirrors a prior bill introduced by the two introduced by the two, and would "require adequate information regarding the tax treatment of payments under settlement agreements entered into by Federal agencies, and for other purposes."<sup>271</sup> If passed, the legislation will likely impact future securities settlements by requiring increased reporting and disclosure from not only the settling corporation or individual, but also the SEC.

The legislation would also provide for increased government accountability and greater transparency surrounding settlements involving individuals, corporations and the SEC and/or various other governmental agencies.<sup>272</sup> According to a press release from Senator Warren, among other things, federal agencies would be required to "post basic information about major settlements and provide copies of those agreements on their websites"; and settling corporations would be "obligated to disclose in their . . . ("SEC") filings whether they have deducted any or all of the dollar amounts of their settlements from their taxes."<sup>273</sup>

The legislation, if passed by the U.S. Senate and House of Representatives, and ultimately signed by President Trump, could alter settlement strategies previously devised by counsel representing clients facing allegations of securities law violations. We will continue to monitor the progress of the legislation and provide updates accordingly.

### Civil Settlements

#### ***SEC v. Mustafa David Sayid, Kevin Jasper, Norman T. Reynolds***

On April 12, 2017, the SEC commenced a securities fraud action against Mustafa David Sayid, Kevin Jasper, and Norman T. Reynolds.<sup>274</sup> The complaint alleged that Sayid, a securities attorney, secretly controlled and operated two companies that were involved in a "pump-and-dump" scheme, with the assistance of his paralegal, Jasper, and a Texas attorney who wrote false legal opinion letters that facilitated the scheme.<sup>275</sup>

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269 Stefan Boettrich and Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2016 Full-Year Review*, 28 (Jan. 23, 2017), [http://www.nera.com/content/dam/nera/publications/2017/PUB\\_2016\\_Securities\\_Year-End\\_Trends\\_Report\\_0117.pdf](http://www.nera.com/content/dam/nera/publications/2017/PUB_2016_Securities_Year-End_Trends_Report_0117.pdf).

270 Truth in Settlements Act of 2017, S. 1145, 115th Cong. (as introduced to the S. Comm. on Homeland Sec. & Governmental Affairs on May 17, 2017), <https://www.congress.gov/115/bills/s1145/BILLS-115s1145is.pdf>.

271 *Id.*

272 Stewart Bishop, *Bipartisan Bill Again Calls for Transparency In Settlements*, Law360 (May 17, 2017), <https://www.law360.com/articles/924891/bipartisan-bill-again-calls-for-transparency-in-settlements>.

273 Press Release, U.S. Senator Elizabeth Warren, *Senators Warren and Lankford Introduce Truth in Settlements Act to Increase Transparency of Federal Agency Settlements* (May 16, 2017), [https://www.warren.senate.gov/?p=press\\_release&id=1605](https://www.warren.senate.gov/?p=press_release&id=1605).

274 Compl. at 1-12, *SEC v. Sayid*, No. 17-cv-02630 (S.D.N.Y. Apr. 12, 2017), ECF No. 1.

275 *Id.* at ¶ 22-73.

### Settlements

The SEC alleged that: (1) Sayid utilized his role as counsel for two companies involved in a securities fraud investigation to assume control over the companies; (2) facilitated stock transactions with those companies; (3) misrepresented, with Reynolds' assistance, to OTC Markets that the companies were not under investigation; and (4) installed Jasper as the nominal head of the companies to conceal Sayid's role and operation of the companies.<sup>276</sup> The scheme resulted in millions of shares of the companies being sold without restrictive legends in violation of federal securities laws.<sup>277</sup>

Pursuant to a filing made with the U.S. District Court for the Southern District of New York on June 16, 2017, the SEC and Jasper reached a settlement of the issues between them on or about February 16, 2017.<sup>278</sup> Jasper consented to payment of penalties and disgorgement, in an amount to be determined at a later date, and agreed to cooperate with the SEC's investigation efforts and enforcement action. The proposed settlement is presently awaiting approval from the court.

#### ***MagnaChip Semiconductor Corp.***

On May 1, 2017, South Korea-based semiconductor manufacturer MagnaChip Semiconductor Corp. ("MagnaChip") and its former CFO agreed to settle charges related to an accounting scheme which artificially boosted revenue and financial results reported to investors.<sup>279</sup>

According to the SEC, MagnaChip, using a variety of accounting tricks, artificially inflated its revenue figures for nearly two years so that it could meet revenue and gross margin targets that had been communicated to the public.<sup>280</sup> MagnaChip's CFO at the time, Margaret Sakai, was charged with directing or approving several fraudulent accounting practices, which included recognizing "revenue on sales of incomplete or unshipped products," the "delayed booking of obsolete or aged inventory to manipulate its unshipped products," and engaged in round-trip transactions to manipulate accounts receivable balances.<sup>281</sup> MagnaChip also hid from its auditors side agreements it made with distributors to encourage them to accept products early.<sup>282</sup>

Without admitting or denying the findings in the SEC's order, MagnaChip agreed to pay a \$3 million penalty.<sup>283</sup> In addition to paying a \$135,000 penalty, Margaret Sakai also agreed to be barred from serving as an officer or a director of a public company or practicing as an accountant before the SEC.<sup>284</sup>

#### ***Leon Cooperman***

On May 18, 2017, the SEC announced that, subject to court approval, it had reached an agreement with Leon Cooperman to settle insider trading charges against the hedge fund billionaire and the company he founded, Omega Advisors. The charges stemmed from trades

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<sup>276</sup> *Id.*

<sup>277</sup> *Id.*

<sup>278</sup> Plaintiff's Assented-To Motion for Entry of Proposed Final Judgment Against Kevin Jasper, *SEC v. Sayid*, No. 17-cv-02630 (S.D.N.Y. June 16, 2017), ECF No. 31.

<sup>279</sup> Press Release, U.S. Sec. & Exch. Comm'n, *Semiconductor Company and Former CFO Settle Accounting Fraud Charges*, Rel. No. 2017-88 (May 1, 2017), <https://www.sec.gov/news/press-release/2017-88>.

<sup>280</sup> *Id.*

<sup>281</sup> *Id.*

<sup>282</sup> *Id.*

<sup>283</sup> *Id.*

<sup>284</sup> *Id.*

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

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allegedly made by Cooperman in Atlas Pipeline Partners, L.P.<sup>285</sup> The SEC alleged that Cooperman added to his holdings in Atlas Pipeline after learning that it was going to sell an asset.<sup>286</sup> After the asset was sold, the stock price increased by 31 percent, resulting in a multimillion-dollar paper profit for Cooperman.<sup>287</sup> Additionally, the SEC accused Cooperman of violating the SEC's beneficial ownerships rules, which require disclosures of holdings by individuals or entities that own more than a 5 or 10 percent stake in public companies.<sup>288</sup>

The settlement is considered a victory for Cooperman, because the settlement does not include an industry bar or admission of wrongdoing. Instead, the settlement requires Cooperman and Omega Advisors to (1) pay \$4.9 million, consisting of fines and penalties, and (2) agree to have an independent compliance consultant at Omega Advisors until 2022.<sup>289</sup> Cooperman and Omega Advisors are also required to make monthly certifications that their trades were not based on nonpublic material information. Reportedly, the SEC had initially sought to suspend Cooperman from the securities industry for a period of time, in connection with prior settlement talks.<sup>290</sup>

According to the SEC's public statement concerning the Cooperman settlement, the independent consultant retained by Cooperman and Omega "can access, without prior notice, their electronic communications, trading records, and research"; and will (1) "review trades by Cooperman and Omega on an ongoing basis"; (2) "recommend improvements and conduct training"; and (3) "report to the SEC."<sup>291</sup> The appointment of an independent compliance consultant may likely see greater usage as would-be defendants begin to rely on *Cooperman* as a guide for settlement negotiations.

According to the SEC's Acting Enforcement Division Director, Stephanie Avakian, if approved by the court, the settlement will "protect against future violations while requiring Cooperman and Omega Advisors to pay significant fines for their misconduct."<sup>292</sup> Avakian emphasized that [b]y imposing an independent consultant to monitor their trading activity, the resolution [also] helps protect our markets from future risk of insider trading."<sup>293</sup>

### Regulatory Settlements

#### *Allergan Inc.*

On January 17, 2017, the SEC announced that Allergan Inc. ("Allergan"), a global pharmaceutical company headquartered in Dublin, Ireland, agreed to admit to securities law violations, and pay a \$15 million penalty for its disclosure failures in the wake of a hostile takeover bid by a rival Canadian

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285 Public Statement, U.S. Sec. & Exch. Comm'n, *Statement on Leon Cooperman Settling Insider Trading Charges*, (May 18, 2017), <https://www.sec.gov/news/public-statement/statement-leon-cooperman-settling-insider-trading-charges>; see also Complaint at para. 28-54, SEC v. Cooperman, No. 16-5043 (E.D.Pa. Sept. 21, 2016), <https://www.sec.gov/litigation/complaints/2016/comp-pr2016-189.pdf>.

286 Press Release, U.S. Sec. & Exch. Comm'n, *SEC Charges Hedge Fund Manager Leon Cooperman With Insider Trading*, Rel. No. 2016-189 (Sept. 21, 2016), <https://www.sec.gov/news/pressrelease/2016-189.html>.

287 *Id.*

288 *Id.*

289 *Supra* note 285.

290 Carmen Germaine, *SEC's Cooperman Deal Gives Defense Bar New Tool*, Law360 (May 19, 2017), [https://www.law360.com/securities/articles/926458/sec-s-cooperman-deal-gives-defense-bar-new-tool?nl\\_pk=7fd1d76e-eecc-42dc-a266-3e69c6707eb6&utm\\_source=newsletter&utm\\_medium=email&utm\\_campaign=securities](https://www.law360.com/securities/articles/926458/sec-s-cooperman-deal-gives-defense-bar-new-tool?nl_pk=7fd1d76e-eecc-42dc-a266-3e69c6707eb6&utm_source=newsletter&utm_medium=email&utm_campaign=securities).

291 *Supra* note 285.

292 *Id.*

293 *Id.*



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company, Valeant Pharmaceuticals International Inc. (“Valeant”).<sup>294</sup> Valeant and co-bidders made a tender offer to Allergan in June 2014.<sup>295</sup> In its Schedule 14D-9 disclosures, however, Allergan stated that the tender offer was inadequate and that it was not engaged in negotiations which could result in a merger.<sup>296</sup>

According to the SEC, however, Allergan omitted from its disclosures that it was involved in material negotiations with other merger partners in the months after Valeant’s June 2014 tender offer that would have made it more difficult for Valeant and its co-bidders to purchase Allergan because it would have resulted in a larger combined entity.<sup>297</sup> In addition, after negotiations with Valeant failed, Allergan failed to disclose that it had entered into merger negotiations with Actavis, another global pharmaceutical company, until after a merger agreement between Allergan and Actavis was executed.<sup>298</sup>

According to the SEC, Allergan violated its duty to amend its Schedule 14D-9 disclosures in the event of material changes, which included potential merger negotiations with bidders other than Valeant.<sup>299</sup> The SEC’s order, which Allergan admitted to, found that the company violated Section 14(d) of the Securities Exchange Act of 1934 and Rule 14d-9.<sup>300</sup>

### **State Street Corporation**

On January 18, 2017, Massachusetts-based financial services company State Street Corporation (“State Street”) entered into a deferred prosecution agreement with the Justice Department to settle charges that it engaged in a scheme to defraud clients by applying secret commissions to billions of dollars in securities trades.<sup>301</sup>

According to admissions made by State Street in connection with the settlement, its employees conspired to add secret commissions to fixed income and equity trades for clients of the bank’s transition management business.<sup>302</sup> The commissions were charged on top of agreed-upon fees despite written instructions to the bank’s traders that clients were not to be charged trading commissions.<sup>303</sup> After the commissions were charged, State Street employees took steps to conceal the commissions.<sup>304</sup>

In connection with the deferred prosecution agreement, State Street agreed to pay a criminal penalty of \$32.3 million to the Justice Department and also agreed to offer an equal amount as a civil penalty to the SEC.<sup>305</sup> State Street has also agreed to cooperate with the Justice Department.<sup>306</sup>

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294 Press Release, U.S. Sec. & Exch. Comm’n, *Allergan Paying \$15 Million Penalty for Disclosure Failures During Merger Talks*, Rel. No. 2017-16 (Jan. 17, 2017), <https://www.sec.gov/news/pressrelease/2017-16.html>.

295 *Id.*

296 *Id.*

297 *Id.*

298 *Id.*

299 *Id.*

300 *Id.*

301 Press Release, U.S. Dep’t of Justice, *State Street Corporation Agrees to Pay More Than \$64 Million to Resolve Fraud Charges*, Rel. No. 17-084 (Jan. 18, 2017), <https://www.justice.gov/opa/pr/state-street-corporation-agrees-pay-more-64-million-resolve-fraud-charges>.

302 *Id.*

303 *Id.*

304 *Id.*

305 *Id.*

306 *Id.*

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#### *MDC Partners Inc. and Miles S. Nadal*

On January 18, 2017, MDC Partners Inc., a publicly traded marketing company, agreed to pay to the SEC \$1.5 million for its role in failing to disclose the perks and benefits it gave to its former CEO, Miles S. Nadal.<sup>307</sup> The company did not disclose that it paid for Nadal's benefit, among other things, plastic surgery, private aircraft usage, cash for tips and gratuities, charitable donations, pet care, and vacation and personal travel expenses.<sup>308</sup> Aggregated, the benefits from MDC Partners Inc. resulted in Nadal receiving, between 2009 and 2014, an additional \$11.285 million above his disclosed benefits and salary.<sup>309</sup> The company recorded the payments to Nadal as business expenses and not compensation, and it failed to maintain internal accounting controls with respect to its assets as a result.<sup>310</sup>

In connection with the MDC Partners Inc. settlement, on May 11, 2017, the SEC announced that it had reached a separate \$5.5 million settlement with Nadal.<sup>311</sup> Nadal reimbursed to MDC Partners Inc. the full amount that he received, and agreed to the settlement with the SEC, which consisted of disgorgement, interest and penalties.<sup>312</sup> "Perks paid to corporate executives should be properly disclosed so that investors can make informed decisions," said G. Jeffrey Boujoukos, Director of the SEC's Philadelphia Regional Office.<sup>313</sup>

#### *Citigroup*

On January 26, 2017, the SEC announced that Citigroup Global Markets agreed to pay \$18.3 million to settle charges that it overbilled investment advisory clients, and that it misplaced client contracts.<sup>314</sup>

According to the SEC, at least 60,000 advisory clients were charged approximately \$18 million in unauthorized fees because Citigroup failed to properly enter negotiated billing rates into its computer systems.<sup>315</sup> In addition, Citigroup improperly collected fees during time periods when clients suspended their accounts. In total, the billing errors occurred over a 15-year period.

The SEC also found that Citigroup was unable to locate approximately 83,000 contracts for advisory accounts opened between 1992 and 2012, making it impossible for Citigroup to confirm that the fee rates negotiated by the clients when they opened their accounts were still being applied to their accounts over the years.<sup>316</sup>

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307 Press Release, U.S. Sec. & Exch. Comm'n, *Company Settles Charges Over Undisclosed Perks and Improper Use of Non-GAAP Measures*, Rel. No. 2017-21 (Jan. 18, 2017), <https://www.sec.gov/news/press-release/2017-21>.

308 *Id.*

309 *Id.*

310 *Id.*

311 Press Release, U.S. Sec. & Exch. Comm'n, *SEC Charges CEO With Failing to Disclose Perks to Shareholders*, Rel. No. 2017-99 (May 11, 2017), <https://www.sec.gov/news/press-release/2017-99>.

312 *Id.*

313 *Id.*

314 Press Release, U.S. Sec. & Exch. Comm'n, *Citigroup Paying \$18 million for Overbilling Clients*, Rel. No. 2017-35 (Jan. 26, 2017), <https://www.sec.gov/news/pressrelease/2017-35.html>.

315 *Id.*

316 *Id.*

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

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Citigroup consented to a cease-and-desist order and agreed to undertakings related to its fee-billing and books-and-records practices.<sup>317</sup> In addition to being censured, Citigroup was required to pay \$3.2 million in disgorgement of excess fees collected, \$800,000 in interest, and a \$14.3 million penalty.<sup>318</sup>

#### *Barclays*

On May 10, 2017, Barclays agreed to a settlement with the SEC of more than \$97 million. The settlement included a \$30 million penalty because Barclays improperly charged certain advisory clients in its wealth investment management business nearly \$50 million in advisory fees.<sup>319</sup> Barclays (1) charged fees to more than 2,000 clients for due diligence and monitoring services that were not being performed, and (2) received excess fees from accounts due to miscalculations and billing errors. Additionally, Barclays recommended expensive share classes to clients when less expensive ones were available, without disclosing that Barclays had a material conflict of interest.<sup>320</sup> The conflict of interest was that Barclays would receive greater compensation when its clients purchased the more expensive share classes.<sup>321</sup>

C. Dabney O’Riordan, Co-Chief of the SEC Enforcement Division’s Asset Management Unit, said that “Barclays failed to ensure that clients were receiving the services they were paying for” and “[e]ach set of clients who were harmed are being refunded through the settlement.”<sup>322</sup>

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317 *Id.*

318 *Id.*

319 Press Release, U.S. Sec. & Exch. Comm’n, *Barclays to Pay \$97 Million for Overcharging Clients*, Rel. No. 2017-98 (May 10, 2017), <https://www.sec.gov/news/press-release/2017-98>.

320 *Id.*

321 *Id.*

322 *Id.*



## Investment Advisers and Hedge Fund Cases

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### Investment Advisers and Hedge Fund Cases

On February 7, 2017, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a National Exam Program Risk Alert detailing those compliance topics most often identified in investment adviser examinations (the "Risk Alert").<sup>323</sup> The five compliance topics discussed are required regulatory findings and certain rules promulgated under the Investment Advisers Act of 1940 (the "Advisers Act"), specifically, (1) the Compliance Rule; (2) the Custody Rule; (3) the Code of Ethics Rule; and (4) the Books and Records Rule.

*The Compliance Rule* prohibits advisers from providing investment advice unless the adviser adopts and implements written policies and procedures reasonably designed to prevent a violation of the Advisers Act. An adviser must, at least annually, review these policies and procedures to gauge their effectiveness, and designate an officer responsible for administering them.

*Regulatory filings* covered in the Risk Alert are related to several filings, including Form ADV, Form PF and Form D, which apply to advisers depending on the nature of their business. The deficiencies the OCIE generally discovered resulted from inaccurate disclosures and the failure to timely file these forms. Advisers should institute policies covering regular reviews and updates and, when required, should submit their forms to the SEC in a timely manner.

*The Custody Rule* applies to advisers who are custodians of client cash and securities, whether the adviser has legal ownership or is operating under an arrangement by which it may withdraw client funds or securities. The Risk Alert provides several examples of weaknesses or deficiencies OCIE investigators often identify, including that advisers do not always recognize they have custody as a result of having authority over client accounts. Among other things, having power of attorney over an account can result in an adviser having custody for the purposes of the Custody Rule. Advisers are cautioned to review the control agreements they have over their accounts to ensure compliance with the Rule.

*The Code of Ethics Rule* requires advisers to adopt and maintain ethics codes. The rule requires the ethics code to detail conduct standards and require federal securities law compliance. The code must also require advisers' personnel to report personal securities transactions and holdings and require personnel to obtain investment preapproval. Advisers are also cautioned to ensure their codes of ethics are described in their Form ADV Part 2A, including an indication that they are available to clients (and prospective clients) upon request.

*The Books and Records Rule* requires that advisers provide information about, among other things, types of clients and assets the adviser manages, use of derivatives, and borrowings in the accounts. We would recommend that advisers regularly review their books and records to ensure the currentness and accuracy of all relevant information in those materials kept in connection with the Books and Records Rule. Advisers often find themselves with SEC trouble because a policy is not in place to conduct regular reviews.

Advisers are cautioned to review the Risk Alert and ensure their written supervisory policies and procedures are up-to-date (and being followed) to ensure they avoid these common pitfalls.

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<sup>323</sup> "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers," Office of Compliance Inspections and Examinations, Feb. 7, 2017, <https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf>.

### Investment Advisers and Hedge Fund Cases

### 2017 IA Case Update

#### *In the Matter of Citigroup Global Markets, Inc.*

On January 26, 2017, the SEC announced a settlement with Citigroup Global Markets, Inc. (“CGMI”) stemming from several alleged Advisory Act sections, including the Compliance Rule.<sup>324</sup> According to the order, CGMI overcharged tens of thousands of its advisory client accounts over 15 years.<sup>325</sup> The SEC also alleged CGMI failed to properly maintain its books and records because it was unable to locate well over 80,000 advisory contracts.<sup>326</sup>

The order detailed CGMI’s failures to adhere to the Compliance Rule. Specifically, CGMI:

1. did not have in place policies and procedures designed to ensure its advisory clients were properly billed, and failed to conduct sample testing of newly opened account to see if the correct fees were being charged;
2. lacked adequate policies and procedures to alert CGMI of overbilling so it could be corrected;
3. did not adopt procedures to identify advisory fees’ increases when an account moved from one branch to another, and failed to sample-test the transferred accounts;
4. had inadequate procedures designed to ensure investors who were due rebates received them, and did not conduct testing to ensure the rebates were issued; and
5. failed to implement policies and procedures reasonably designed to ensure all advisory account documentation was properly maintained.<sup>327</sup>

For the alleged Advisers Act violations, CGMI agreed to pay \$4 million in disgorgement and interest, plus a \$14.3 million civil penalty.<sup>328</sup>

#### *In the Matter of Barclays Capital Inc.*

On May 10, 2017, the SEC announced a settlement with dually registered investment adviser and broker-dealer, Barclays, stemming from allegations that Barclays overcharged its advisory clients for over five years, amounting to some \$50 million in overcharged fees.<sup>329</sup>

Specifically, the SEC alleged that Barclays told over 2,000 clients it was performing (and charging for) due diligence on third-party managers with whom Barclays placed their capital. Barclays, however, did not perform such services.<sup>330</sup> While it touted these services to its clients and in its

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<sup>324</sup> *In the Matter of Citigroup Global Markets, Inc.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Sec. Exch. Act Rel. No. 79882 (Jan. 26, 2017), <https://www.sec.gov/litigation/admin/2017/34-79882.pdf>.

<sup>325</sup> *Id.* at 4.

<sup>326</sup> *Id.* at 5.

<sup>327</sup> *Id.* at 6.

<sup>328</sup> *Id.* at 10.

<sup>329</sup> *In the Matter of Barclays Capital Inc.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Sec. Exch. Act Rel. No. 80639 (May 10, 2017), <https://www.sec.gov/litigation/admin/2017/33-10355.pdf>.

<sup>330</sup> *Id.* at 5.

### Investment Advisers and Hedge Fund Cases

Form ADV, Barclays allegedly understaffed the due diligence group, and senior management ignored that group's complaints that it could not handle all the work required.<sup>331</sup> Stretched thin, the group began to conduct diligence only on a few large accounts and ignored the rest.<sup>332</sup> These clients were charged \$48 million for this unperformed work.<sup>333</sup> The SEC also alleged that Barclays overcharged over 22,000 clients excess fees on their accounts and disadvantaged some retirement and charitable organization brokerage accounts by selling them more expensive mutual fund share classes than it should have.<sup>334</sup> Barclays also allegedly lacked proper supervision over its third-party account management and billing operations, which resulted in some of the overcharges, and failed to adopt written supervisory procedures to prevent these problems.<sup>335</sup>

As part of the settlement, Barclays (1) was censured; (2) must pay \$3.5 million in remediation, plus interest; (3) must pay disgorgement, plus interest, totaling \$63.2 million; and (4) incurred a \$30 million civil penalty.<sup>336</sup>

#### **SEC v. Strategic Capital Management, LLC and Michael J. Breton**

On January 25, 2017, the SEC filed a complaint against an investment advisory firm ("SCM") and its principal ("Breton"), alleging that Breton ran a cherry-picking<sup>337</sup> scheme that defrauded clients out of \$1.3 million in profits.<sup>338</sup> The Justice Department filed a parallel criminal action against Breton as well, charging him with securities fraud in violation of 15 U.S.C. §§ 78j(b) and 78ff and 17 C.F.R. § 240.10b-5.<sup>339</sup>

During market hours, Breton purchased publicly traded stocks on days when those companies were due to make earnings announcements after market close.<sup>340</sup> After the earnings announcements were made, Breton would assess whether such an announcement was likely to cause the stock to rise or fall and then allocate the trades to his own account or to the accounts of his clients.<sup>341</sup> For example, in one instance, Breton bought 5,000 Fortinet, Inc. ("Fortinet") shares, 3,000 Altera Corporation ("Altera") shares, and 4,000 MIPS Technologies ("MIPS") shares during trading hours and parked them in a master account.<sup>342</sup> The companies each reported earnings just after market close, which caused Fortinet to begin trading up and Altera and MIPS down.<sup>343</sup> Breton then allocated the Fortinet shares to his own account and the Altera and MIPS shares to clients' accounts.<sup>344</sup>

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331 *Id.* at 6-7.

332 *Id.* at 7.

333 *Id.* at 2.

334 *Id.* at 12.

335 *Id.* at 10.

336 *Id.* at 16.

337 Cherry-picking is the act of choosing investments that performed well within another portfolio in anticipation that the trend will continue.

338 *SEC v. Strategic Capital Management, LLC and Michael J. Breton*, 17-cv-10125 (ECF No. 1) (D. Mass., filed Jan. 25, 2017).

339 *United States v. Breton*, 17-cr-10017 (D. Mass., filed Jan. 25, 2017).

340 *Id.* at 5.

341 *Id.*

342 *Id.*

343 *Id.*

344 *Id.*

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### Investment Advisers and Hedge Fund Cases

For six years, this practice continued, in which Breton allocated 200 winning trades to his account and 200 losing trades to his clients' accounts.<sup>345</sup> During this time, Breton made approximately \$1.4 million in ill-gotten gains.<sup>346</sup> In addition to this improper allocation, Breton and SCM made false statements on SCM's Form ADV related to trade allocation.<sup>347</sup>

Breton and SCM settled the charges with the SEC,<sup>348</sup> and Breton pleaded guilty to the criminal charges.<sup>349</sup> The court imposed on Breton a sentence of a year and a day in prison.<sup>350</sup>

#### ***SEC v. Mark J. Varacchi and Sentinel Growth Fund Management, LLC***

On February 2, 2017, the SEC filed a complaint against Sentinel, an investment advisory firm, and its principal, Varacchi, alleging misappropriation of investor assets.<sup>351</sup> The SEC alleges that instead of allocating client money to a separately managed account or to hedge funds that Sentinel and Varrachi controlled, they made unauthorized withdrawals to cover Varacchi's personal and business expenses.<sup>352</sup> In all, the complaint alleges Varacchi took \$10 million for personal expenses, including settlement of a lawsuit brought by his former employer, repayment of loans and transfers to family members.<sup>353</sup> Varrachi covered his scheme by making misrepresentations to investors and replacing the missing funds through margin borrowing, which was not disclosed.

Varacchi and Sentinel consented to entry of judgment in May 2017, but the court has not yet determined disgorgement or civil penalties that the parties must pay.<sup>354</sup>

#### ***In the Matters of John W. Rafal, Essex Financial Services, Inc. and Peter Hershman, Esq.***

On January 9, 2009, the SEC announced settlements with (1) investment adviser John Rafal,<sup>355</sup> (2) Essex Financial Services Inc., the dually registered investment adviser and broker-dealer he heads ("Essex"),<sup>356</sup> and (3) attorney Peter Hershman,<sup>357</sup> each stemming from allegations that Rafal

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345 *Id.* at 2.

346 *Id.* at 9.

347 *Id.* at 7-9.

348 *Id.*, Order and Judgment as to Defendant Michael J. Breton (ECF No. 6) (D. Mass., filed Feb. 17, 2017); *Id.*, Order and Judgment as to Defendant Strategic Capital Management (ECF No. 7) (D. Mass., filed Feb. 17, 2017).

349 *United States v. Breton*, 17-cr-10017 (ECF No. 5) (D. Mass., filed Mar. 10, 2017).

350 *Id.* (ECF No. 19) (filed June 20, 2017).

351 *SEC v. Varacchi*, 17-cv-00155 (ECF No. 1) (D. Conn., filed Feb. 2, 2017).

352 *Id.* at 2-3.

353 *Id.* at 8.

354 *Id.* (ECF No. 13) (D. Conn., filed May 1, 2017).

355 *In the Matter of John W. Rafal*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, Sections 4C and 15(b) of the Securities Exchange Act of 1934, Section 9(b) of the Investment Company Act of 1940, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Sec. Exch. Act Rel. No. 79755 (Jan. 9, 2017), <https://www.sec.gov/litigation/admin/2017/34-79755.pdf>.

356 *In the Matter of Essex Financial Services, Inc.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Sec. Exch. Act Rel. No. 79757 (Jan. 9, 2017), <https://www.sec.gov/litigation/admin/2017/34-79757.pdf>.

357 *In the Matter of Peter Hershman, Esq.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, Sections 4C and 15(b) of the Securities Exchange Act of 1934, Section 9(b) of the Investment Company Act of 1940, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Sec. Exch. Act Rel. No. 79756 (Jan. 9, 2017), <https://www.sec.gov/litigation/admin/2017/34-79756.pdf>.



## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### Investment Advisers and Hedge Fund Cases

defrauded a client through his and Essex's improper payment to Hershman for that client's referral. Rafal also misled SEC investigators and lied to clients about the investigation.

Rafal and Hershman schemed to circumvent the SEC's rule barring payments from investment advisers to third parties for referrals, by terming (and papering) the payments as legal services Hershman supposedly provided to Rafal and Essex.<sup>358</sup> After referring his client to Essex, Hershman sent Rafal and Essex invoices over the course of several months, totaling approximately \$50,000.<sup>359</sup> While Essex paid the first two invoices, some at Essex began complaining about the bills; directed Rafal not to pay any more; and demanded back from Hershman what it had already paid, which Hershman refused to repay.<sup>360</sup> At no time did any of the parties disclose to their client the inherent conflict of interest.

As Rafal became concerned that his clients had heard bad rumors about him, including regarding an SEC investigation, he sent numerous communications to clients falsely stating, among other things, that the SEC had granted him a no-action letter.<sup>361</sup> After discovering his ruse, Essex commanded Rafal to retract the statements, which he did.<sup>362</sup> Rafal also misled investigators by telling them, among other things, that Hershman returned all payments.<sup>363</sup>

In connection with his settlement, Rafal was barred from the industry and must pay approximately \$275,000 in disgorgement, penalties and interest.<sup>364</sup> The SEC barred Hershman from the industry, adjudged that he may not appear or practice before the Commission, and pay approximately \$92,000 in disgorgement, penalties and interest.<sup>365</sup> Essex was ordered to pay approximately \$183,000 in disgorgement and interest.<sup>366</sup>

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358 *Rafal*, *supra* n.53, at 5.

359 *Id.*

360 *Id.* at 6.

361 *Id.*

362 *Id.*

363 *Id.* at 7.

364 *Id.* at 8.

365 *Hershman*, *supra* n.55, at 7.

366 *Essex*, *supra* n.54, at 7.



## SEC Cooperation and Whistleblower Programs

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### SEC Cooperation and Whistleblower Programs

As described below, the SEC Cooperation and Whistleblower Programs continued to impact its regulatory and enforcement efforts during the first half of 2017, as evidenced by the developments described below.

#### Cooperation Program

Already in 2017, the SEC has declined to prosecute at least one company that self-reported alleged securities laws violations, and has routinely continued to reward (or at least voice its approval for) companies that undertake cooperation and remedial efforts in anticipation of or in the wake of SEC investigations.

The SEC noted the cooperation or remedial measures taken by the respondents in more than a dozen settled orders issued since the first of the year. Below are illustrative examples.

#### ***Crawford & Company Declination***

On March 2, 2017, Crawford & Company, an Atlanta-based independent insurance claims management company,<sup>367</sup> announced in its annual report that the SEC had declined to take action against the company for possible violations of the Foreign Corrupt Practices Act (“FCPA”) that the company self-reported in 2015.<sup>368</sup> The annual report described that the company had uncovered the potential violations “during the course of its regular internal audit process,” and voluntarily made reports to both the SEC and the Justice Department.<sup>369</sup> The company also described its own internal investigation efforts, which involved not only an internal audit committee and the company’s board of directors, but also the hiring of outside counsel and forensic accounting professionals.<sup>370</sup> Ultimately, the company “received notice from the SEC that the SEC has concluded its investigation and did not intend to recommend an enforcement action against the company with respect to this matter.”<sup>371</sup>

#### ***In the Matter of Sociedad Quimica y Minera de Chile, S.A., Settled Order***

In January 2017, the SEC announced the settlement of a two-year-old investigation against Sociedad Quimica y Minera de Chile, S.A., (“SQM”), a Chilean mining and chemical company, accused of multiple FCPA violations.<sup>372</sup> The violations included “nearly \$15 million in improper payments to Chilean political figures and others connected to them . . . based on fake documentation submitted to SQM by individuals and entities posing as legitimate vendors.”<sup>373</sup> The payments were directed by an unnamed executive, terminated by SQM in 2015, who had “full discretion and authority” over one of SQM’s accounts; this executive arranged for the company to pay “politically exposed persons” based on “fictitious contracts and invoices for nonexistent

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367 See Crawford & Company, <http://us.crawfordandcompany.com/> (accessed July 15, 2017).

368 See Annual Report, SEC Form 10-K, Crawford & Company (Mar. 2, 2017), <http://phx.corporate-ir.net/phoenix.zhtml?c=83420&p=irol-SECText&TEXT=aHR0cDovL2FwaS50ZW5rd2l6YXJkLmNvbS9maWxpbnmcueG1sP2lwYWdlPTExNDIOMTg3JkRTRVE9MCMZTRVE9MCMZTUURFUOM9U0VDVEIPTI9FTIRJUKUmc3Vic2lkPTU3>

369 *Id.*

370 *Id.*

371 *Id.*

372 Press Release, United States Securities and Exchange Commission, “Chemical and Mining Company in Chile Paying \$30 Million to Resolve FCPA Cases,” Rel. No. 2017-13 (Jan. 13, 2017), <https://www.sec.gov/news/pressrelease/2017-13.html>.

373 Press Release, United States Securities and Exchange Commission, “Chemical and Mining Company in Chile Paying \$30 Million to Resolve FCPA Cases,” Rel. No. 2017-13 (Jan. 13, 2017), <https://www.sec.gov/news/pressrelease/2017-13.html>.

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### SEC Cooperation and Whistleblower Programs

services.”<sup>374</sup> As part of this process, SQM’s books and records were internally falsified to record these payments as legitimate expenses.<sup>375</sup>

On January 13, 2017, the SEC entered an order accepting SQM’s settlement offer. The order noted SQM’s failures in due diligence, failures in oversight, and the failure of SQM personnel responsible for implementing and maintaining SQM’s accounting controls to “take appropriate steps to prevent further payments” after becoming aware of payment-related deficiencies.<sup>376</sup> However, the settled order made note of SQM’s remedial efforts and the vigorousness of its internal investigation, the fact that SQM self-reported the potential FCPA violations to the SEC, “and fully cooperated with the Commission’s investigation.”<sup>377</sup> The SEC made note of SQM’s “extensive and thorough” cooperation, which included SQM voluntarily providing “reports of its investigative findings,” sharing “its analysis of documents and summaries of witness interviews,” and responding to the SEC’s document and information requests.<sup>378</sup>

SQM ultimately agreed to pay \$15 million to the SEC and \$15.5 million to the Department of Justice, the latter penalty as part of the deferred prosecution agreement.<sup>379</sup> As part of the settlement, SQM agreed to engage an independent compliance monitor, certify in writing its compliance with its obligations under the settlement, submit to the jurisdiction of the U.S. courts with respect to the SEC’s notices and subpoenas, and appear and be available for interviews by SEC staff upon reasonable notice.<sup>380</sup>

#### ***In the Matter of the Port Authority of New York and New Jersey***

Earlier in January, the SEC announced a settlement in which the Port Authority of New York and New Jersey “agreed to admit wrongdoing and pay a \$400,000 penalty to settle charges that it was aware of risks to a series of New Jersey roadway projects but failed to inform investors purchasing the bonds that would fund them.”<sup>381</sup> The SEC accused the Port Authority of disclosure violations, alleging that the Port Authority failed to disclose “known material risks” regarding its potential lack of legal authority to fund roadway projects for which it offered and sold approximately \$2.3 billion dollars’ worth of municipal bonds between January 2012 and June 2014.<sup>382</sup> The Port Authority’s attorneys had explicitly advised that bondholders and investors could potentially raise a successful challenge to the funding of the projects as being outside the scope of the Port Authority’s mandate, yet the Port Authority did not disclose this risk in its official statements.<sup>383</sup> The SEC found this conduct to be in violation of Sections 17(a)(2) and (3) of the Securities Act of 1993.

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374 *In the Matter of Sociedad Quimica Y Minera de Chile, S.A.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Cease-and-Desist Order, No. 3-17774 (Jan. 13, 2017), <https://www.sec.gov/litigation/admin/2017/34-79795.pdf>.

375 *Id.*

376 *Id.*

377 *Id.*

378 *Id.*

379 Press Release, United States Securities and Exchange Commission, “Chemical and Mining Company in Chile Paying \$30 Million to Resolve FCPA Cases,” Rel. No. 2017-13 (Jan. 13, 2017), <https://www.sec.gov/news/pressrelease/2017-13.html>.

380 *In the Matter of Sociedad Quimica Y Minera de Chile, S.A.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, No. 3-17774 (Jan. 13, 2017), <https://www.sec.gov/litigation/admin/2017/34-79795.pdf>.

381 Press Release, United States Securities and Exchange Commission, “SEC: Port Authority Omitted Risks to Investors in Roadway Projects,” Rel. No. 2017-4 (Jan. 10, 2017), <https://www.sec.gov/news/pressrelease/2017-4.html>.

382 *In the Matter of the Port Authority of New York and New Jersey*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, No. 3-17763 (Jan. 10, 2017), <https://www.sec.gov/litigation/admin/2017/33-10278.pdf>.

383 *Id.*

### SEC Cooperation and Whistleblower Programs

In determining to accept the Port Authority's settlement offer, the settle order specifically made note of the Port Authority's "cooperation and prompt remedial acts." Among other things, the Port Authority immediately "enhance[ed] various procedures surrounding approval of capital projects," retained and used "outside bond counsel for all bond offerings," and replaced its permanent general counsel.<sup>384</sup>

The Port Authority was ultimately permitted to pay a penalty representing less than 0.02 percent of the value of the bonds offered and sold. In addition to paying the \$400,000 penalty, the Port Authority committed to, among other things, retain an independent consultant to review the Port Authority's disclosure policies and procedures regarding municipal securities offerings (and adopt that consultant's recommendations), establish written policies and procedures regarding municipal securities offerings, and cooperate fully with any subsequent investigation by the SEC's Division of Enforcement.<sup>385</sup>

### Reduced Civil Penalties

In addition to the examples above, cooperation by alleged wrongdoers explicitly prompted the SEC to order reduced civil penalties in several matters. Such cooperation even prompted the SEC to forgo civil penalties altogether in at least two matters since the first of the year.

On January 9, 2017, after broker-dealer Essex Financial Services Inc.'s CEO was accused of "fraudulently schem[ing] to circumvent the rule regarding payments for client solicitations" by disguising payments as invoices for legal services to the client's attorney, the broker-dealer was able to settle with the SEC without admission of wrongdoing.<sup>386</sup> Although Essex Financial was ordered to pay disgorgement of \$170,000 and additional prejudgment interest, the company was not assessed any civil penalties due to its cooperation.<sup>387</sup>

On February 3, 2017, California internet testing company Ixia was assessed a reduced civil penalty of \$750,000, and did not have to admit wrongdoing, based in part on its cooperation in the SEC's investigation.<sup>388</sup> The SEC had alleged that Ixia had committee securities violations through "fraudulent misrepresentations, omissions, and certifications concerning Ixia's internal controls, namely Internal Control over Financial Reporting . . . as well as concerning Ixia's compliance with those accounting rules and principles in Ixia's filings with the Commission in 2012."<sup>389</sup>

Only a few days later, energy holding company CVR Energy, Inc. was able to settle with the SEC without paying penalties or disgorgement at all. In anticipation of the SEC instituting proceedings against it, CVR approached the SEC and cooperated regarding its alleged "failure to adequately disclose the material terms of its fee arrangements with two investment banks . . .

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384 *Id.*

385 *Id.*

386 *In the Matter of Essex Financial Services, Inc.*, Order Instituting Administrative Cease-and-Desist Proceedings, Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, No. 3-17762 (Jan. 9, 2017), <https://www.sec.gov/litigation/admin/2017/34-79757.pdf>.

387 *Id.*

388 *In the Matter of Ixia and Victor Alston*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, No. 3-17825 (Feb. 3, 2017), <https://www.sec.gov/litigation/admin/2017/33-10302.pdf>.

389 *Id.*

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### SEC Cooperation And Whistleblower Programs

in connection with financial advisory services [the banks] provided to CVR during a hostile tender offer.”<sup>390</sup> On February 14, 2017, the SEC entered a cease-and-desist order against CVR barring it from committing “any violations and any future violations of Section 14(d) of the [Securities Exchange Act of 1934 (“Exchange Act”)] and Rule 14d-9 thereunder,” but ordered no payment of civil penalties for the alleged violations that had already occurred, specifically based on CVR’s cooperation.<sup>391</sup>

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<sup>390</sup> See, e.g., *In the Matter of CVR Energy, Inc.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, No. 3-17846 (Feb. 14, 2017), <https://www.sec.gov/litigation/admin/2017/34-80039.pdf>.

<sup>391</sup> *Id.*

# 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS



## CFTC Cases and Developments

### CFTC Cases and Developments

Since the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or “Dodd-Frank Act”), the scope of the U.S. Commodity Futures Trading Commission’s (“CFTC”) regulatory authority has increased. The CFTC’s main objective is to prevent fraudulent conduct in the trading of futures contracts through safeguarding the nation’s futures, options and swaps markets, and by protecting market participants from fraud, manipulation and abusive practices. Moreover, the CFTC insulates the public and the economy from systemic risk in connection with futures derivatives.

CFTC Acting Chairman J. Christopher Giancarlo is looking to shake things up in 2017. In addition to continuing to focus on spoofing and anti-fraud enforcement, Chairman Giancarlo has stressed the need to boost the CFTC’s analytical expertise. Specifically, the CFTC is seeking an approximate 13 percent increase from its fiscal 2017 budget to account for its need to better monitor derivatives market risks, improve examinations, and upgrade financial technology resources.<sup>392</sup>

### FinTech Initiative

In May 2017, the CFTC launched a new FinTech initiative called “LabCFTC.” LabCFTC is targeted at promoting responsible financial technology innovation, with the goal of improving the quality and competitiveness of the markets the CFTC oversees.<sup>393</sup> According to Chairman Giancarlo, LabCFTC is “intended to help us bridge the gap from where we are today to where we need to be: Twenty-First century regulation for 21st century digital markets.”<sup>394</sup> The purpose of LabCFTC is “provide greater regulatory certainty that encourages market-enhancing FinTech innovation to improve the quality, resiliency, and competitiveness of our markets . . . and to identify and utilize emerging technologies that can enable the CFTC to carry out its mission more effectively and efficiently in the new digital world.”<sup>395</sup>

LabCFTC will launch two programs designed to help it fulfill its purpose. The first program is called GuidePoint, which will serve as a point of contact for firms and innovators to “engage with the CFTC, learn about the CFTC’s regulatory framework, and obtain feedback and information on the implementation of innovative technology ideas for the market.”<sup>396</sup> The second program is called CFTC 2.0, which will establish a lab intended to explore new technologies to identify potentially useful applications that will better allow the CFTC to oversee the market.<sup>397</sup> Because automated trading now accounts for 70 percent of the regulated futures markets, the CFTC believes these new initiatives are necessary in order to allow it to keep up with today’s financial firms.<sup>398</sup>

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392 Tom Zanki, *CFTC Head Seeks Bigger Budget, but Trump Wants It Flat*, Law 360 (May 23, 2017), <https://www.law360.com/articles/927470/cftc-head-seeks-bigger-budget-but-trump-wants-it-flat>.

393 Press Release, U.S. Commodities and Futures Trading Comm’n, *CFTC Launches LabCFTC as Major FinTech Initiative*, Rel. No. pr7558-17 (May 17, 2017) (“FinTech Press Release”), <http://www.cftc.gov/PressRoom/PressReleases/pr7558-17>.

394 Address of CFTC Acting Chairman J. Christopher Giancarlo before the New York FinTech Innovation Lab (May 17, 2017), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-23>.

395 Press Release, U.S. Commodities and Futures Trading Comm’n, *CFTC Launches LabCFTC as Major FinTech Initiative*, Rel. No. pr7558-17 (May 17, 2017) (“FinTech Press Release”), <http://www.cftc.gov/PressRoom/PressReleases/pr7558-17>.

396 *Id.*

397 Carmen Germaine, *Future CFTC Chair Announces New Tech Initiative*, Law360 (May 17, 2017), <https://www.law360.com/articles/924953/future-cftc-chair-announces-new-tech-initiative>.

398 *Id.*



### CFTC Cases and Developments

### Spoofting

So far in 2017, the new CFTC administration's actions are signaling a desire to bring enforcement actions targeting spoofing-related activity. Spoofing is a market-manipulating tactic wherein traders place sham orders to artificially inflate or depress the price of a security with the intent to cancel the order before execution, and therefore, profiting from a manipulated price.

In March 2017, the CFTC issued two substantially similar orders settling charges against two former Citigroup Global Markets Inc. traders for spoofing.<sup>399</sup> The settlement against Stephen Gola imposes a \$350,000 civil monetary penalty,<sup>400</sup> and the settlement against Jonathan Brims imposes a \$200,000 penalty.<sup>401</sup> The settlements also impose a six-month futures and swaps trading ban following payment of the penalty.<sup>402</sup> According to the orders, Gola and Brims "each engaged in the disruptive practice of spoofing more than 1,000 times in various Chicago Mercantile Exchange Group ("CME") U.S. Treasury futures products."<sup>403</sup> Their spoofing "strategy involved placing bids or offers of 1,000 lots or more with the intent to cancel those orders before execution. The spoofing orders were placed in the U.S. Treasury futures markets after another smaller bid or offer was placed on the opposite side of the same or a correlated futures or cash market."<sup>404</sup> The CFTC also noted that Gola and Brims coordinated with other individuals on the U.S. Treasury desk in order to carry out their spoofing strategy.

Further, in June 2017, the CFTC issued an order filing and settling charges against futures trader David Liew for "engaging in numerous acts of spoofing, attempted manipulation, and, at times, manipulation of the gold and silver futures markets."<sup>405</sup> Liew's fraudulent conduct took place over a period of two years while he was employed as a junior trader for an unnamed financial institution.<sup>406</sup> Liew acted both individually and in coordination with traders working for this institution and others. For example, Liew would communicate with a trader at a different financial institution via instant message in order to coordinate their manipulation of the silver futures market.<sup>407</sup>

Liew pleaded guilty to spoofing charges, receiving a lifetime ban from trading commodity interests. He also agreed to cooperate with government officials in connection with his settlement in exchange for the CFTC agreeing not to impose a civil monetary penalty against him.<sup>408</sup> According to the CFTC's

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399 Press Release, U.S. Commodities and Futures Trading Comm'n, *CFTC Orders Former Citigroup Global Markets Inc. Traders Stephen Gola and Jonathan Brims to Pay \$350,000 and \$200,000, Respectively, and Bans Them From Trading for 6 Months for Spoofing in U.S. Treasury Futures Markets*, Rel. No. 7542-17 (March 30, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7542-17>.

400 *In the Matter of Stephen Gola*, U.S. Commodities and Futures Trading Comm'n, CFTC Docket No. 17-12 (Mar. 30, 2017)

401 *In the Matter of Jonathan Brims*, U.S. Commodities and Futures Trading Comm'n, CFTC Docket No. 17-13 (Mar. 30, 2017)

402 Brims Order at 6; Gola Order at 6.

403 See Gola and Brims Press Release.

404 *Id.*

405 *In the Matter of David Liew*, CFTC Docket No. 17-14 (June 2, 2017) ("Liew Order"), <http://www.cftc.gov/idc/groups/public/@enforcementactions/documents/legalpleading/enfdavidlieworder060217.pdf>; Press Release, U.S. Commodities and Futures Trading Comm'n, *CFTC Finds Former Trader David Liew Engaged in Spoofing and Manipulation of the Gold and Silver Futures Markets and Permanently Bans Him From Trading and Other Activities in CFTC-Regulated Markets*, Rel. No. pr7567-17 (June 2, 2017) ("Liew Press Release"), <http://www.cftc.gov/PressRoom/PressReleases/pr7567-17>.

406 See Liew Press Release.

407 *In the Matter of David Liew*, 3-4.

408 *Id.* at 7-8.

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### CFTC Cases and Developments

Director of Enforcement, James McDonald, the resolution of this enforcement action “demonstrates that the [CFTC] will aggressively pursue individuals who manipulate and spoof in our markets. [The] action also shows that while holding individuals accountable for their conduct, the [CFTC] will give meaningful cooperation credit to those who acknowledge their own wrongdoing, enter into a Cooperation Agreement and provide substantial assistance to the Division in its investigations and enforcement actions against others who have engaged in illegal conduct.”<sup>409</sup>

Accordingly, so far in 2017, the CFTC has not shown any sign of curbing its focus on prosecuting spoofers who jeopardize the integrity of the futures market. The enforcement actions discussed above indicate that both firms and individuals will be held accountable for market manipulation. Therefore, it is imperative that firms review their policies, procedures, and training programs to ensure that they reflect the enhanced attention the CFTC has given to spoofing-related activities.

### Anti-Fraud Enforcement

In the first half of 2017, Chairman Giancarlo explained that he would implement an organizational restructuring in order to strengthen the CFTC’s mission to identify and prosecute violations of law and regulation such as fraud.<sup>410</sup> The CFTC’s anti-fraud enforcement actions have thus far led to three notable judgments.

#### ***CFTC v. EJS Capital Management, LLC***

The CFTC started the year by obtaining a favorable result in order to combat a fraudulent, off-exchange foreign currency (“Forex”) scheme involving the misappropriation of over \$2.3 million of customer funds.<sup>411</sup> Through their Brooklyn, New York Forex trading firm, defendants EJS Capital Management (“EJS”), former CEO of Paramount Management, Alex Vladimir Ekdeshman, and Ekdeshman’s co-conspirator, Edward J. Servider were found to have solicited and accepted over \$2 million from approximately 112 people by falsely claiming high annual rates of return.<sup>412</sup> Defendants provided false account statements to customers that listed purported profits from Forex trading.<sup>413</sup> The reality is that there were no customer funds traded in Forex and no profits were generated.<sup>414</sup> The historical trading performance on the company website was completely fictitious.<sup>415</sup> Ekdeshman and Servider whittled away their clients’ funds on personal expenses such as travel, a diamond ring, and a BMW.<sup>416</sup> A portion of the customer funds were used to pay fictitious “profits” to five EJS customers.<sup>417</sup>

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409 See Liew Press Release.

410 Acting CFTC Chairman J. Christopher Giancarlo made this statement during his March 15, 2017, speech, “CFTC: A New Direction Forward,” before the 42nd Annual International Futures Industry Conference in Boca Raton, Florida. A transcript of the speech can be found at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-20>.

411 Press Release, *Commodity Futures Trading Comm’n, Federal Court Orders Defendants EJS Capital Management, LLC, Alex Vladimir Ekdeshman, and Edward J. Servider to Pay \$11.6 Million in Sanctions for Forex Fraud Scheme*, Rel No. PR7509-17 (Jan. 9, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7509-17>; Cara Mannion, *Forex Fraudsters Shell Out Nearly \$12M in CFTC Case*, Law360 (January 10, 2017), <https://www.law360.com/articles/879326/forex-fraudsters-shell-out-nearly-12m-in-cftc-case>.

412 Order at 9; *CFTC v. EJS Capital Management, LLC*, 14-CV-3107 (S.D.N.Y. Dec. 18, 2015), ECF No. 110, <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfekdeshmanorder121815.pdf>.

413 *Id.* at 9-10.

414 *Id.* at 10.

415 *Id.* at 12.

416 Jack Newsham, *NYC Man Pinched in \$2.4M Forex Fraud Pleads Guilty*, Law360 (Mar. 30, 2017), <https://www.law360.com/articles/908180?scroll=1>.

417 Order at 9, *CFTC v. EJS Capital Management, LLC*, 14-CV-3107 (S.D.N.Y. Dec. 18, 2015), ECF No. 110, <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfekdeshmanorder121815.pdf>.

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

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The final judgment against the fraudsters and relief defendants, who were recipients of the ill-gotten funds, resulted in a judgment for \$2.3 million in restitution, \$2.3 million in disgorgement, and \$7 million in civil monetary penalties.<sup>418</sup> The amount recovered from the defendants will be used to repay victims of the fraud.<sup>419</sup>

The defendants are also facing related criminal charges. Due to a near-identical fraud that permeated Paramount Management, on June 29, 2016, Ekdesman was sentenced to 87 months in prison and ordered to pay restitution to the victims of his fraud. Ekdesman pleaded guilty to commodities, mail and wire fraud.<sup>420</sup> Servider is awaiting sentencing for conspiracy to commit commodities fraud.<sup>421</sup>

#### **CFTC v. Vision Financial Partners, LLC**

On March 9, 2017, the U.S. District Court for the Southern District of Florida entered a consent order against defendants Neil Pecker and Vision Financial Partners, LLC, who were charged with fraudulent solicitation and misappropriation in connection with off-exchange binary options.<sup>422</sup> Binary options permit clients to predict whether a particular asset will go up or down in value.<sup>423</sup> Defendants initially argued in their motion to dismiss that the CFTC's powers are limited to illegal trading of options and do not apply to this matter.<sup>424</sup> The court disagreed, ruling that the CFTC's powers did regulate the conduct at issue since binary options are "commonly known to the trade" as an option even though it may lack a traditional option's essential character.<sup>425</sup>

Defendants made a wide assortment of misrepresentations to prospective clients and existing clients regarding their registration status and trading experience.<sup>426</sup> Defendants failed to mention to investors that they would be unable to withdraw funds from their accounts unless a minimum number of trades had occurred, that the trading accounts were with offshore entities, or that client funds would be controlled for defendants' personal use.<sup>427</sup> As a result of the misrepresentations and material omissions, 120 clients sent approximately \$3 million to defendants to trade binary options.<sup>428</sup> Defendants misappropriated almost \$2 million of the customer funds intended for trading for their own personal use.<sup>429</sup>

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418 *Id.* at 16-25.

419 Press Release, Commodity Futures Trading Comm'n, "Federal Court Orders Defendants EJS Capital Management, LLC, Alex Vladimir Ekdesman, and Edward J. Servider to Pay \$11.6 Million in Sanctions for Forex Fraud Scheme," Rel. No. PR7509-17 (Jan. 9, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7509-17>.

420 Judgment, *United States of America v. Alex Ekdesman*, No. 1:14-cr-00427 (S.D.N.Y. July 1, 2015), ECF No. 31.

421 Press Release, U.S. Dept. of Justice, *Staten Island Man Pleads Guilty in Manhattan Federal Court to Defrauding Investors of Over \$2 Million*, Rel. No. 17-091 (March 30, 2017), <https://www.justice.gov/usao-sdny/pr/staten-island-man-pleads-guilty-manhattan-federal-court-defrauding-investors-over-2>.

422 Press Release, U.S. Commodities and Futures Trading Comm'n, *Federal Court in Florida Orders Neil Pecker and His Company, Vision Financial Partners, LLC, to Pay More Than \$6.5 Million in Restitution and a Civil Monetary Penalty in CFTC Binary Options Fraud Action*, Rel. No. PR7536-17 (Mar. 21, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7536-17>.

423 Carmen Germaine, *Court Orders \$1.7M Disgorgement for Binary Options Scheme*, Law360 (Apr. 7, 2017), <https://www.law360.com/articles/911198/court-orders-1-7m-disgorgement-for-binary-options-scheme>.

424 *Id.*

425 *Id.*

426 Consent Order at 8, *CFTC v. Vision Financial Partners, LLC*, No. 1:16-CV-60297-CIV (S.D.Fla. Mar. 9, 2017), ECF No. 139, <http://www.cftc.gov/idc/groups/public/@renforcementactions/documents/legalpleading/enfpeckerorder030917.pdf>.

427 *Id.*

428 *Id.* at 9.

429 *Id.*

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

### CFTC Cases and Developments

The Consent Order resulted in a permanent injunction precluding defendants from engaging in fraud or trading in commodity interests in violation of CFTC regulations.<sup>430</sup> The defendants and relief defendants, the recipients of the ill-gotten gains, were also ordered to pay more than \$6.5 million in restitution, civil penalties, and disgorgement.<sup>431</sup>

#### ***In the Matter of McVean Trading & Investments, LLC***

On June 21, 2017, the CFTC entered an order filing and simultaneously settling charges against McVean Trading & Investments, LLC (“MTI”), a futures commissions merchant; its chairman and CEO, Charles Dow McVean Sr.; President Michael J. Wharton; and MTI’s consultant Samuel C. Gilmore (“Gilmore”) (collectively, “Respondents”), for allegedly feeding false information into the market.<sup>432</sup> Specifically, the Respondents are alleged to have secretly used straw buyers to bypass position limits on how many cattle futures MTI could hold, and therefore “they created a false appearance of wider interest, participation, and fragmentation on the long side of the live cattle futures market during the delivery period than actually existed.”<sup>433</sup>

The order required MTI to pay a civil monetary penalty of \$1.5 million; McVean to pay a civil monetary penalty of \$2 million; Wharton to pay a civil monetary penalty of \$1 million; and Gilmore, who was charged as an aider and abettor of McVean’s position limits violations, to pay a civil monetary penalty of \$500,000.<sup>434</sup>

Although the CFTC could not assess the exact impact of the alleged behavior on the market, it needed only to demonstrate that there was an “intentional or reckless employment of a manipulative device, scheme, or artifice to defraud” in connection with a swap or commodity sale or futures contract.<sup>435</sup> As such, this order is yet another example of how the CFTC is paying close attention to prosecuting all forms of fraud that may manipulate the market.

### **Ponzi Schemes**

The second half of 2017 may see the resolution of charges brought by the CFTC as a result of at least two Ponzi schemes.

#### ***CFTC v. Gold Chasers***

Charges are pending against Javier Ramirez and his companies, Gold Chasers, Inc. and Royal Leisure International, Inc., who are alleged to have obtained \$4.1 million by promising to invest in gold or sell customers gold at a discounted rate due to Ramirez’s connections to mines in Central and South America.<sup>436</sup> Defendants promised customers they would obtain physical possession of

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430 *Id.* at 11-13.

431 *Id.* at 13-18.

432 Order, *In the Matter of McVean Trading & Investments, LLC*, CFTC Docket No. 17-15 (June 21, 2017), <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfmcveanorder062117.pdf>.

433 *Id.* at 14-15.

434 *Id.* at 20.

435 *Id.* at 13.

436 Press Release, U.S. Commodities and Futures Trading Comm’n, *CFTC Charges Carlos Javier Ramirez and His Companies, Gold Chasers, Inc. and Royal Leisure International, Inc., with Misappropriation, Fraudulent Sales Solicitation, and Issuing False Statements in Fraud Schemes Involving Gold*, Rel. No. PR7532-17 (Feb. 14, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7532-17>; Sophia Morris, *Gold Scammer Stole \$4.1M From Customers, CFTC Says*, Law360 (Feb. 15, 2017), <https://www.law360.com/articles/892186/gold-scammer-stole-4-1m-from-customers-cftc-says>.

## 2017 MID-YEAR SECURITIES LITIGATION AND ENFORCEMENT HIGHLIGHTS

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gold bars if they purchased gold.<sup>437</sup> On the other hand, if they invested in gold, the customers were promised they would receive a 10, 15 or 20 percent profit on their investment every 10 days.<sup>438</sup> The CFTC has alleged that in violation of the Commodity Exchange Act and CFTC regulations, Ramirez would then use new customer money to pay false profits to old customers or use the remaining funds for defendant's personal use.<sup>439</sup>

#### **CFTC v. Cory Williams**

The CFTC also initiated a civil enforcement action against defendants as a result of a Ponzi scheme in connection with a commodity pool.<sup>440</sup> Defendants Cory Williams and his company, Williams Advisory Group, are alleged to have duped 40 fellow Mormon churchgoers in and around the area of Phoenix, Arizona, out of at least \$13 million. Defendants represented to investors via weekly text messages that they were receiving profits as high as \$30,000 per week on their investments.<sup>441</sup> In actuality, Williams traded significant volumes of E-Mini S&P 500 futures contracts in his personal trading accounts and lost more than \$8.3 million of the pool participants' funds.<sup>442</sup> Williams used the remaining funds for his personal expenses and to pay false profits to select customers.<sup>443</sup>

The CFTC has stated that it is committed to protecting customers from harm, and in order to do so there must be repercussions against defendants who fail to provide "full and truthful" disclosures to their customers.<sup>444</sup>

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437 Compl. at 7, *CFTC v. Gold Chasers* No. 6:17-cv-00256 (M.D. Fla. Feb. 13, 2017), ECF No. 1, <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfchaserscomplaint021317.pdf>.

438 *Id.* at 7.

439 *Id.* at 8.

440 Press Release, U.S. Commodities and Futures Trading Comm'n, *CFTC Charges Arizona Resident Cory Williams and His Company, Williams Advisory Group, LLC, with Fraudulently Soliciting and Receiving At Least \$13 Million in Commodity Pool Scheme*, Rel. No. PR7556-17 (May 3, 2017), <http://www.cftc.gov/PressRoom/PressReleases/pr7556-17>; Cara Mannion, *Churchgoers Duped In \$13M Trading Scheme, CFTC Says*, Law360 (May 3, 2017), <https://www.law360.com/securities/articles/920232/churchgoers-duped-in-13m-trading-scheme-cftc-says>.

441 Compl. at 9, *CFTC v. Cory Williams*, No. 2:17-cv-01325 (D. Ariz. May 3, 2017), ECF No. 1, <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcorywilliamscomplaint050317.pdf>.

442 *Id.* at 2.

443 *Id.* at 7.

444 Dorothy Atkins, *FXCM to Pay \$7M for Hiding Deal With Market Maker*, Law 360 (Feb. 6, 2017), <https://www.law360.com/articles/889101>.



## Securities Policy and Regulatory Developments

### Securities Policy and Regulatory Developments

Shortly before his confirmation as the new Chairman of the SEC, Jay Clayton spoke on his commitment to remain neutral and nonpartisan.<sup>445</sup> Chairman Clayton's previous experience as a law partner representing banks and corporations suggests to some that he will cause the SEC to prioritize economic growth and ease regulatory barriers,<sup>446</sup> most of which resulted from the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "Dodd-Frank Act"), which the GOP seeks to dismantle. The new chairman has also articulated his aim to coordinate efforts between agencies, as he has sought public comment about the SEC's fiduciary rules in order to align with the Department of Labor's rule to require investment advisers to suggest products in the best interest of retirement fund clients rather than suitable instruments.<sup>447</sup> These efforts would likely promote consistent coordination across agencies, but may also slow down progress and prompt responsiveness in agencies' activities.

Although the SEC has not yet officially released its enforcement results for the first half of fiscal year 2017, we can expect continued robust activity to complement the SEC's renewed emphasis on protecting retail investors and senior investors, strengthening the technological infrastructure of securities markets, and ensuring compliance with anti-money laundering regulations.<sup>448</sup> The recently named Co-Director of the SEC's Enforcement Division, Steve Peikin, and the Office of Compliance Inspections and Examinations ("OCIE") have indicated enhanced evaluation of electronic mechanisms used by firms to conduct investment activities, while also implementing SEC technology to improve access to information to investors,<sup>449</sup> demonstrating the SEC's commitment to combat cybercrime and encourage overall transparency.

### The U.S. House of Representatives Votes to Repeal Dodd-Frank Regulations

On June 8, 2017, the House of Representatives passed the Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs ("CHOICE") Act,<sup>450</sup> which would unravel most of the Dodd-Frank Act. Notable provisions of the CHOICE Act include the following:<sup>451</sup>

1. Repealing Title II of the Dodd-Frank Act, which currently allows the Federal Deposit Insurance Corporation ("FDIC") to bail out creditors and counterparties of a failing non-bank institution;
2. Re-establishing and reforming the Consumer Financial Protection Bureau ("CFPB") as an independent agency, funded through congressional appropriations;

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445 Jay Clayton, Nominee of Chairman, U.S. Sec. & Exch. Comm'n, Opening Statement at the Senate Committee on Banking, Housing and Urban Affairs (March 23, 2017), [https://www.banking.senate.gov/public/\\_cache/files/640c2f54-9c7d-47c2-8dc7-7d4debd6a13d/559D4F50EF7D195B8291094DA7490CA4.clayton-testimony-3-23-17.pdf](https://www.banking.senate.gov/public/_cache/files/640c2f54-9c7d-47c2-8dc7-7d4debd6a13d/559D4F50EF7D195B8291094DA7490CA4.clayton-testimony-3-23-17.pdf).

446 Renae Merle, *Senate Confirms Wall Street Lawyer Jay Clayton to Lead SEC*, The Washington Post (May 2, 2017), [https://www.washingtonpost.com/news/wonk/wp/2017/05/02/senate-confirms-wall-street-lawyer-jay-clayton-to-lead-sec/?utm\\_term=.2420ab06b808](https://www.washingtonpost.com/news/wonk/wp/2017/05/02/senate-confirms-wall-street-lawyer-jay-clayton-to-lead-sec/?utm_term=.2420ab06b808).

447 Robert Weible, Suzanne Hanselman and Margaret Hirce, *Trump and the SEC: A New Agenda for Corporate Governance and Enforcement*, PowerPoint, BakerHostetler (June 22, 2017), <https://www.bakerlaw.com/webfiles/Litigation/2017/Events/06-22-2017-Trump-SEC-Presentation.pdf>.

448 Press Release, U.S. Sec. & Exch. Comm'n, *SEC Announces 2017 Examination Priorities*, Rel. No. 2017-7 (Jan. 12, 2017), <https://www.sec.gov/news/pressrelease/2017-7.html>.

449 See Press Release, U.S. Sec. & Exch. Comm'n, *SEC Approves Rules to Ease Investor Access to Exhibits in Company Filings*, Rel. No. 2017-55 (March 1, 2017), <https://www.sec.gov/news/pressrelease/2017-55.html>.

450 Memorandum from the Financial Services Committee Majority Staff to the Members of the Committee on Financial Services (April 27, 2017), [https://financialservices.house.gov/uploadedfiles/050217\\_fc\\_memo.pdf](https://financialservices.house.gov/uploadedfiles/050217_fc_memo.pdf).

451 House Committee on Financial Services, *Summary of Key Provisions of the Financial Choice Act*, The Wall Street Journal (June 21, 2017), <http://online.wsj.com/public/resources/documents/FinancialChoiceActSummary06-15-2016.pdf>.

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3. Providing defendants in administrative actions the right to remove cases to federal court, and clarifying that Dodd-Frank's three-year statute of limitations applies;
4. Repealing the CFPB's authority to prohibit arbitration clauses in financial services contracts;
5. Repealing the Durbin Amendment, which currently limits fees imposed on retailers for processing debit cards;
6. Allowing certain defendants to appear before SEC officers after receiving a Wells Notice to argue their case, and limiting the duration of subpoenas issued by the SEC;
7. Repealing the Volcker Rule, which currently prohibits banks from conducting investment activities with their own accounts; and
8. Repealing judicial reference to agency interpretations by amending the standard of judicial review in the Administrative Procedure Act as it relates to financial regulatory agencies.

The Financial CHOICE Act would also modify Dodd-Frank's "Say-on-Pay" frequency rule for public companies, requiring companies to conduct the advisory vote on executive compensation only in years when "there has been a material change to the compensation of executives of an issuer from the previous year."<sup>452</sup> However, the Financial CHOICE Act also proposes to raise the eligibility of shareholders who can bring a shareholder proposal, fixing it at a minimum threshold of one percent of outstanding shares, and to increase the holding period to three years. Currently, a shareholder with one percent outstanding shares or shares with \$2,000 in market value who has held the shares for one year is entitled to submit a proposal.<sup>453</sup> These modifications seek to inhibit shareholders' ability to vocalize disapproval, which is why the bill in its current form is unlikely to pass the Senate.

Additionally, the bill significantly narrows the SEC's ability to conduct investigations and bring enforcement proceedings.<sup>454</sup> As mentioned above, the Financial CHOICE Act would require the SEC to allow those who were served with a Wells Notice to appear before the SEC to argue their case, and would limit the duration of subpoenas issued by it.<sup>455</sup> This move is likely in response to the widespread criticism the SEC has received regarding use of its administrative courts instead of the federal district courts. Additionally, the bill would also allow the president to terminate the head of the CFPB as well as the Federal Housing Finance Agency, which regulates Fannie Mae and Freddie Mac, without cause.<sup>456</sup> If enacted into law, this bill would substantially deregulate the financial services industry, which may promote economic growth, but without higher oversight, it could also lead to riskier activities that undermine the integrity of the financial system.

Given that no House Democrats voted for the Financial CHOICE Act,<sup>457</sup> it is unlikely that the Senate will approve the bill in its current form. Whichever form this bill eventually manifests into, any new regulation will have to respond to the criticism of Dodd-Frank, which some believe stunted U.S. economic growth.

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452 See fn. 146.

453 *Id.*

454 Carmen Germaine, *Congress Tells SEC to Rein Itself In With CHOICE Act 2.0*, Law360 (April 24, 2017), <https://www.law360.com/articles/916657/congress-tells-sec-to-rein-itself-in-with-choice-act-2-0>.

455 *Id.*

456 Donna Borak, *House Votes to Kill Dodd-Frank. Now What?*, CNN (June 8, 2017), <http://money.cnn.com/2017/06/08/news/economy/house-dodd-frank-repeal/index.html>.

457 Jeremy Venook, *The House Takes Another Step Toward Repealing Dodd-Frank*, The Atlantic (June 9, 2017), <https://www.theatlantic.com/business/archive/2017/06/financial-choice-act-house/529851/>.



### Securities Policy and Regulatory Developments

#### SEC Adopts New Two-Day Settlement Period for Securities Transactions

On March 22, 2017, the SEC unanimously voted to cut the time period requirement for brokers to settle stock and bond trades, from three to two business days.<sup>458</sup> The new rule requires a broker-dealer who is “effecting or entering into a contract” of buying or selling a security to settle the transaction no later than two days after the trade date.<sup>459</sup> The current cycle based on a three-day settlement period has not been updated since 1993.<sup>460</sup> Broker-dealers should note that the new settlement time will take effect on September 5, 2017.<sup>461</sup> SEC Commissioner Michael Piwowar stated that the abbreviated time frame would decrease risk and credit exposures while promoting capital efficiency.<sup>462</sup> Doing so will allow the SEC to evaluate whether the shortened cycle indeed encourages these priorities.

#### SEC Proposes Amendments to Rule of Municipal Securities Disclosures

On March 1, 2017, the SEC proposed two amendments to Exchange Act Rule 15c2-12 to “to include two additional disclosure events.”<sup>463</sup> The proposed rule amendments seek to include two new event notices:<sup>464</sup>

1. The incurrence of a financial obligation of the issuer or obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material; and
2. Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of the financial obligation of the issuer or obligated person, any of which reflect financial difficulties.

The SEC seeks to implement these amendments in order to provide investors with more information about the financial condition of those who issue municipal securities, or “munis,”<sup>465</sup> and any obligated persons. The amendments should assist in shedding light on the risks involved in investing in the municipal bond market, despite attractive tax advantages.

#### Amendments to Investment Advisers Act Rules to Consider Small Business Companies as Venture Capital Funds

On May 3, 2017, the SEC issued a proposed rule to revise the definition of a venture capital fund and the private fund adviser exemption under the Investment Advisers Act of 1940.<sup>466</sup> The amendments were proposed to reflect similar revisions in the Fixing America’s Surface

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458 Press Release, U.S. Sec. & Exch. Comm’n, *SEC Adopts T+2 Settlement Cycle for Securities Transactions*, Rel. No. 2017-68 (March 22, 2017), <https://www.sec.gov/news/press-release/2017-68-0>.

459 *Id.*

460 Sarah N. Lynch, *SEC poised to shorten settlement cycle for securities trades*, Reuters (March 16, 2017), <http://www.reuters.com/article/us-usa-sec-meeting-idUSKBN16N25L>.

461 Sarah N. Lynch, *SEC poised to shorten settlement cycle for securities trades*, Reuters (March 22, 2017), <http://www.reuters.com/article/us-usa-sec-settlement-idUSKBN16T1SW>.

462 Press Release, U.S. Sec. & Exch. Comm’n, *SEC Adopts T+2 Settlement Cycle for Securities Transactions*, Rel. No. 2017-68 (March 22, 2017), <https://www.sec.gov/news/press-release/2017-68-0>.

463 *Proposed Amendments to Municipal Securities Disclosure*, Exchange Act Release No. 34-80130; File No. S7-01-17 (Mar. 1, 2017), <https://www.sec.gov/rules/proposed/2017/34-80130.pdf>.

464 Proposed Amendments to Municipal Securities Disclosure, 82 Fed. Reg. 13928 (proposed March 1, 2017) (to be codified at 17 C.F.R. pt. 240).

465 FINRA, Municipal Securities, <http://www.finra.org/industry/municipal-securities>.

466 Amendments to Investment Advisers Act Rules to Reflect Changes Made by the FAST Act, 82 Fed. Reg. 21487 (proposed May 3, 2017) (to be codified at 17 C.F.R. 275).

### Securities Policy and Regulatory Developments

Transportation (“FAST”) Act of 2015.<sup>467</sup> Prior to the FAST Act, only advisers to venture capital funds could be exempted from investment adviser registration required by Section 203(l) of the Advisers Act.<sup>468</sup> The FAST Act then extended the exemption to small-business investment companies by including them in the definition of “venture capital funds.” The currently proposed rule seeks to amend similar definitions to align with the FAST Act by also proposing to amend the term “assets under management” to exclude assets held by small business investment companies.<sup>469</sup> Comments were due June 8, 2017.<sup>470</sup> By offering a registration exemption, this proposed categorization indicates the SEC’s promotion of smaller companies, acknowledging the proliferation of the small-business industry and promoting economic growth.

### FINRA Introduces Measures to Prevent Financial Exploitation of Senior Citizens

The SEC approved a FINRA rule to protect senior investors from financial exploitation by requiring firms to make reasonable efforts to collect the contact information for a trusted person for an account.<sup>471</sup> Firms will also be allowed to place a temporary hold on fund or securities disbursement if they have a reasonable belief that there may be an incident of financial exploitation.<sup>472</sup> In doing so, firms are permitted to conduct an investigation to determine whether a customer is operating under undue influence. This initiative marks yet another step FINRA is taking to protect older investors; in 2015, FINRA launched a devoted helpline for seniors to call and inquire about information related to brokerage accounts and investments.<sup>473</sup> As the baby-boomer generation ages, these types of protections are critical to ensure senior investors are empowered to make sound financial decisions for retirement and feel secure in their finances and savings.

### FINRA Sought Comments on Capital Formation Rules

On April 12, 2017, FINRA requested comments on its current rules related to the capital-raising activities of its member firms as part of a comprehensive evaluation of all its processes and programs, titled FINRA360.<sup>474</sup> FINRA’s capital-raising rules include the creation of the Funding Portal Rules, which govern crowdfunding platforms and require their registration with the SEC and membership with FINRA. FINRA also seeks to collect comments on its rules governing underwriting and the capital acquisition brokers,<sup>475</sup> which are firms that engage in advising companies and private equity funds on capital raising and corporate restructuring, as well as serving as placement agents for the sale of unregistered securities to institutional investors. Comments were due May 30, 2017. This interactive process evidences FINRA’s mandate to serve as a platform made for investors, while engaging with members to be as efficient and user-friendly as possible.

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467 *Id.*

468 Guidance Update, Division of Investment Management, U.S. Sec. & Exch. Comm’n, *FAST Act Changes Affecting Investment Advisers to Small Business Investment Companies*, Rel. No. 2016-03 (March, 2016), <https://www.sec.gov/investment/im-guidance-2016-03.pdf>.

469 Amendments to Investment Advisers Act Rules to Reflect Changes Made by the FAST Act, 82 Fed. Reg. 21487 (proposed May 3, 2017) (to be codified at 17 C.F.R. 275).

470 *Id.*

471 News Release, Financial Industry Regulatory Authority, *FINRA Receives SEC Approval on Rule Proposal Addressing Financial Exploitation of Seniors* (March 30, 2017), <http://www.finra.org/newsroom/2017/finra-receives-sec-approval-rule-proposal-addressing-financial-exploitation-seniors>.

472 *Id.*

473 News Release, Financial Industry Regulatory Authority, *FINRA Senior Helpline Marks Second Anniversary with \$4.3 Million in Voluntary Reimbursements to Callers* (April 20, 2017), <http://www.finra.org/newsroom/2017/finra-senior-helpline-marks-second-anniversary-43-million-voluntary-reimbursements>.

474 FINRA Regulatory Notice 17-14, April 12, 2017, [http://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Regulatory-Notice-17-14.pdf](http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-14.pdf).

475 *Id.*

### Securities Policy and Regulatory Developments

### New Sanction Guidelines in Effect to Address Undue Influence, Supervisory Failures

In April 2017, FINRA's National Adjudicatory Council, the committee that is empowered to review initial decisions from FINRA disciplinary and membership proceedings, revised the Authority's Sanction Guidelines to be used by adjudicators to impose an appropriate sanction. The revised sanctions address the following: (1) vulnerable customers; (2) systemic supervisory failures; (3) short interest reporting; (4) borrowing from or lending to customers; and (5) consideration of regulator or firm-imposed sanctions.<sup>476</sup>

The consideration of vulnerable customers and any potential exercise of undue influence over those customers should be evaluated when sanctions are imposed. This is consistent with FINRA's new initiatives to address the financial exploitation of seniors (see above).

The guideline on systemic supervisory failures expands the previous guidance, which addressed only limited supervisory failures.<sup>477</sup> The new guideline refers to any violations that arise from systemic and/or firmwide supervisory failures, pressuring firms to ensure thorough flows of management and control throughout their operations.

The guideline on short interest reporting lists the following considerations when lists the following points to consider when a sanction is being imposed<sup>478</sup>:

1. The number of short interest reporting cycles that the respondent did not report short interest or reported short interest incorrectly;
2. The number and size of the positions the respondent did not report or reported incorrectly;
3. If a firm failed to exercise reasonable supervision of its short interest reporting process;
4. Whether the respondent diligently chose, installed and tested a system; the frequency and thoroughness with which the respondent ensured the system was compliant with the relevant rules; and whether the respondent took sufficient care in undertaking any and all necessary steps to ensure any systems-related malfunctions were fixed (considerations include respondent's reliance on a third-party vendor); and
5. The extent to which the respondent's violations affected public disclosure of short interest information.

The new guideline on borrowing and lending addresses transaction arrangements between registered representatives and customers, since there had not been any previous guidance on these often-litigated cases.<sup>479</sup>

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476 FINRA Regulatory Notice 17-13, April 2017, <http://www.finra.org/sites/default/files/Regulatory-Notice-17-13.pdf>.

477 *Id.*

478 FINRA Sanction Guidelines, April 2017, [http://www.finra.org/sites/default/files/Sanctions\\_Guidelines.pdf](http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf).

479 *Id.*

### Securities Policy and Regulatory Developments

Finally, there is a new guideline for adjudicators to consider any sanctions previously imposed by other regulators or any corrective action imposed by a firm on the respondent dealing with the same conduct at issue.<sup>480</sup> Adjudicators could essentially consider any previous sanctions or corrective action as mitigating factors when deciding its sanction.

The modified guidelines indicate FINRA's acknowledgment of individuals exerting improper influence over others for their own financial advantage, demonstrating the authority's commitment toward investor protection. The inclusion of evaluating systemic supervisory failures also indicates a more thorough approach to determine where and how wrongdoing originates. These considerations should prompt firms to implement comprehensive and holistic checks to ensure compliance with FINRA rules and regulations, in order to safeguard themselves against a situation deserving sanctions.

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<sup>480</sup> *Id.*

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