2015 Year-End Securities Litigation and Enforcement Highlights

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BakerHostetler

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by
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Welcome to the 2015 Year-End Report from the BakerHostetler Securities Litigation and Regulatory Enforcement Practice Team.

The purpose is to provide a periodic survey, apart from our 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 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:

- ***Supreme Court Cases***, including granting certiorari to determine the meaning of "personal gain" in the insider trading context, denying the petition for certiorari in *United States v. Newman*, and hearing oral argument regarding the extent to which Section 27 of the Securities Exchange Act of 1934 ("Exchange Act") confers federal jurisdiction over state law claims;
- ***Securities Law Cases***, including continuing Halliburton litigation, and the continuing focus on the conduct of, and individual responsibility and accountability for, individuals at the executive level;
- ***United States Securities and Exchange Commission ("SEC") Cooperation and Whistleblower Programs***, including emphasizing the benefits of cooperation, several settled orders resulting in lower civil penalties, reporting a record number of whistleblower tips, and announcing four whistleblower awards;
- ***Insider Trading Cases***, including the impact of the Supreme Court's denial of certiorari in *United States v. Newman*, and other recent, noteworthy insider trading cases;
- ***Settlements***, including historic settlements with financial institutions stemming from litigation derived from the financial crisis;
- ***Investment Adviser and Hedge Fund Cases***, including enforcement actions by the SEC relating to failures to disclose conflicts of interest, misleading and fraudulent representations to investors, and failure to establish policies and procedures in advance of a breach of personally identifiable information ("PII");
- ***Commodities and Futures Regulation and Cases***, including settlement of its first insider trading case and Bitcoin litigation; and

- ***Securities Policy and Regulatory Developments***, including adoption of rules by the SEC relating to clawback policies and the Pay Ratio Disclosure Rule as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), use of derivatives by registered investment companies, and offering and selling of securities via crowdfunding.

Finally, we would like to dedicate this Report to our late Partner Michael Oxley, given his tremendous career and contributions to the securities industry. He has left a rich legacy serving as a longtime congressman, former Chairman of the House Financial Services Committee, and BakerHostetler attorney. He spent 25 years serving his constituents from Ohio's Fourth Congressional District. Throughout his remarkable career, Mike left an indelible mark on U.S. history for his co-authorship of the landmark Sarbanes-Oxley Act of 2002, which restored Americans' confidence in capital markets and created a new accounting oversight board for publicly traded companies.

At BakerHostetler, Mike was a highly respected member of the firm's Government Policy team, where he focused on helping clients resolve or avert problems related to federal or state policy through legislative or administrative solutions. He also assisted private and public companies establish governance policies and compliance programs. Mike recently served as Senior Advisor to the Board of Directors of NASDAQ OMX Group, Inc. He personified excellence, and will be remembered as an avid advocate for both investors and companies.

Supreme Court Cases Review

The Supreme Court issued three notable securities and regulatory enforcement-related decisions in the first half of 2015—including the landmark decision in *Omnicare Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*[1] (as discussed in our 2015 Mid-Year Report)—yet issued none in the second half of 2015. It did, however, consider a petition for a writ of certiorari regarding what personal gain an insider must obtain to be charged under the insider trading laws.[2] The Supreme Court also heard oral argument in a case regarding the proper interpretation of Section 27 of the Exchange Act as it relates to federal jurisdiction over certain securities actions.

The Supreme Court Grants Certiorari to Determine the Meaning of "Personal Gain" in the Insider Trading Context and Denial of Certiorari in *United States v. Newman*

On November 10, 2015, the defendant in *Salman v. United States* filed a petition for writ of certiorari so that the Supreme Court may determine whether an insider violates Section 10(b) of the Exchange Act and SEC Rule 10b-5 if it provides a family relative or friend with confidential information without any proof that he received any "personal gain" in return.[3] This issue arises from the Supreme Court's 1983 decision in *Dirks v. SEC*, where it held that "absent some personal gain," an insider cannot be said to have violated the insider trading laws.[4]

In 2015, the Supreme Court had considered a similar petition by the U.S. Government in the *United States v. Newman* litigation. There, just as in *Salman*, the U.S. Government brought insider trading charges against an individual whom it accused of providing a family relative or friend with material, nonpublic information. Importantly, there was no proof in either case that the accused individual received a monetary reward or any other pecuniary benefit in return for his insider tip.[5] In *Newman*, the Second Circuit interpreted the *Dirks* decision narrowly and held that, for "personal gain" to exist, there must be a *quid pro quo* agreement whereby the tipper receives some pecuniary benefit in exchange for the tip. In so doing, it rejected the U.S. Government's theory that mere friendship and association, alone, is enough to satisfy the "personal gain" requirement under *Dirks*. On October 5, 2015, the Supreme Court denied the U.S. Government's petition for a writ of certiorari and refused to revisit the *Newman* decision.[6]

In *Salman*, the Ninth Circuit Court of Appeals disagreed with the Second Circuit Court of Appeals and adopted the U.S. Government's broad interpretation of "personal gain."[7] Judge Jed S. Rakoff, who was visiting from the Southern District of New York, wrote on behalf of a unanimous Ninth Circuit Court of Appeals panel that limiting "personal gain" to a *quid pro quo* exchange—as the Second Circuit held in *Newman*—effectively provided a glitch whereby friends and family of insiders could trade and profit on confidential information without any legal consequences. *See also* our 2015 Mid-Year Report.

In his petition papers to the Supreme Court, the defendant noted that the Ninth Circuit Court of Appeals decision signals that there is a split between the circuit courts on the issue of personal gain/benefit, which only the Supreme Court can resolve.[8] On January 19, 2016, the Supreme Court granted certiorari.[9] The parties are expected to brief and argue the merits of this issue in the coming months and the Supreme Court may issue a decision as soon as this year. Its decision on this controversial issue will have a significant impact on how prosecutors and regulators enforce insider trading laws.

1 135 S.Ct. 1318 (2015).

2 *See* our 2015 Mid-Year Report.

3 *See* Petition for a Writ of Certiorari, *Salman v. United States*, No. 15-628, (Nov. 10, 2015).

4 *Dirks v. SEC*, 463 U.S. 646, 659 (1983).

5 *United States v. Newman*, 773 F.3d 438, 452-53 (2d Cir. 2014).

6 *United States v. Newman*, 136 S.Ct. 242 (2015).

7 *United States v. Salman*, 792 F.3d 1087, 1092-94 (9th Cir. 2015).

8 *See* Petition for a Writ of Certiorari, *Salman v. United States*, No. 15-628, (Nov. 10, 2015).

9 *United States v. Salman*, No. 15-628, 2016 WL 2077256 (Jan. 19, 2016).

The Supreme Court Hears Oral Argument to Determine Extent to Which Section 27 of the Exchange Act Confers Federal Jurisdiction Over State Law Claims

On December 1, 2015, the Supreme Court heard oral argument in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Manning* on the issue of whether Section 27 of the Exchange Act confers federal jurisdiction over state law claims that overlap with federal securities claims. In our 2015 Mid-Year Report, we discussed how the Supreme Court had granted certiorari in this matter. The plaintiffs in *Manning* brought New Jersey RICO and common law claims to remedy alleged manipulative, "naked" short selling of stock shares by Merrill Lynch and other financial institutions. The defendants moved to withdraw the claims to federal court on the ground that Section 27 of the Exchange Act conferred exclusive jurisdiction to the federal courts on claims, such as these, which seek to remedy alleged violations of the federal securities laws.

The District Court adopted the defendants' position and removed the claims from state court.[10] The plaintiffs appealed that decision to the Third Circuit Court of Appeals, which ultimately reversed the District Court order and held that Section 27 of the Exchange Act did not apply in this instance.[11] On June 30, 2015, the Supreme Court granted certiorari on this issue.[12]

Section 27 of the Exchange Act provides in relevant part that federal courts "have exclusive jurisdiction of violations of [the Exchange Act or its regulations] … and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act or its regulations]."[13] The defendants argued to the Supreme Court that this plain language clearly and unambiguously confers federal courts with jurisdiction over state law claims that seek to remedy violations that are proscribed by the federal securities laws. According to the defendants, the alleged conduct in this action is already covered under the Exchange Act and, specifically, SEC's Regulation SHO, which specifies the circumstances under which naked short sales are permissible.[14] The defendants contended that this overlap triggers the exclusive jurisdiction provision under Section 27 of the Exchange Act and requires the removal of this action from state court.

The plaintiffs countered that Section 27 of the Exchange Act is not applicable in this case because the claims seek *only* to enforce liabilities and duties created under New Jersey state and common law. They conceded that their complaint includes references to Regulation SHO, but argued that those references were not elemental to their claims and, without more, do not trigger the exclusive jurisdiction provision under Section 27 of the Exchange Act.

During oral argument, Justice Antonin Scalia suggested that it would be "quite an onerous task" for federal judges to ensure in each case that state law claims do not mirror a claim that happens to exist under the federal law. Justice Ruth Bader Ginsburg echoed these concerns and added that there is always some overlap between state and federal laws, making it impossible to separate the two bodies of law. Another concern shared by the Justices was that the SEC was conspicuously absent from this dispute, even though its opinion might well resolve the issue of whether these claims overlapped with the private rights of action under Regulation SHO to such an extent as to merit federal court review.

The tone from this argument indicated that the Supreme Court is likely to affirm the Third Circuit Court of Appeals and adopt a narrower interpretation of Section 27 of the Exchange Act. If so, this would be an uncharacteristic departure by the Supreme Court from recent decisions in which it has sided with the defense bar in the securities and regulatory enforcement arena. And such an outcome would make financial institutions more vulnerable to state law claims and force them to litigate in venues where they are typically less comfortable. The Supreme Court will announce its decision on this matter sometime in 2016.

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10 *Manning v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 12-4466 (JLL), 2013 WL 2285955, at *4 (D.N.J. May 23, 2013).

11 *Manning v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 772 F.3d 158, 166-68 (3d Cir. 2014).

12 *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Manning*, 135 S.Ct. 2938 (2015).

13 15 U.S.C. §78aa.

14 *See* 17 C.F.R. §§ 242.200-242.204.

Securities Law Cases

The latter half of 2015 has seen notable securities law decisions in the lower courts as well. Since July, courts in the Second, Fifth, and Ninth Circuits have issued decisions with potentially wide-ranging implications for securities litigation.

Continuing Halliburton Litigation

The second half of 2015 also saw continued–and complex–litigation of the investor class action against Halliburton Co., which is now amid its *third* interlocutory appeal at the class certification stage.[15] At the center of the putative class action are investors' allegations that "Halliburton made a series of misrepresentations regarding its potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the anticipated benefits of its merger with another company—all in an attempt to inflate the price of its stock" and "subsequently made a number of corrective disclosures, which … caused the company's stock price to drop and investors to lose money."[16]

Remand of *Halliburton II*,[17] Predominance, and Price Impact

On July 25, 2015, the U.S. District Court for the Northern District of Texas issued an opinion on remand[18] from the U.S. Supreme Court's decision in *Halliburton Co. v. Erica P. John Fund ("Halliburton II")*, which may help chart the course that a court's "price impact" inquiry will take in future investor class actions. *See* our previous Executive Alert.[19] However, as will be discussed further below, *Halliburton III* may further adjust this inquiry.

After an initial interlocutory appeal and remand centering on the issue of loss causation (*Halliburton I*), Halliburton argued on remand that it had already presented sufficient evidence "demonstrat[ing] that none of the alleged misrepresentations actually impacted Halliburton's stock price, i.e., there was a lack of 'price impact.'" If so, then Halliburton had already rebutted the presumption that the "members of the class relied on the misrepresentations when they bought and sold Halliburton's stock at the market price."[20] Halliburton's new price impact arguments invoked an issue central to class action litigation. Under Federal Rule of Civil Procedure Rule 23(b)(3), a class action may not be maintained unless "the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members … ." Thus, in allegedly having rebutted the presumption of class reliance, the "putative class members would have to prove reliance on an individual basis, thereby causing individual issues to predominate over common issues."[21]

The District Court and the Fifth Circuit Court of Appeals both rejected Halliburton's argument, "holding that evidence of the absence of price impact to rebut the *Basic* presumption is not relevant to predominance under Rule 23(b)(3), but can be admitted at trial."[22] However, in *Halliburton II*, the Supreme Court reversed and remanded, holding that Halliburton "could introduce evidence of a lack of price impact at the class certification stage to show the absence of predominance."[23]

On remand, the District Court thoroughly examined Halliburton's price impact evidence from dueling experts.[24] The Court required the parties to submit certain "event studies" as evidence that "Halliburton's stock price was, or was not, affected on days when an alleged misrepresentation or corrective disclosure reached

15 *See* Order on Motion for Leave to Appeal under Fed. R. Civ. P. 23(f), *Halliburton Co. v. Erica P. John Fund*, No. 15-90038 (5th Cir. Nov. 4, 2015) ("Halliburton III").

16 *Halliburton Co. v. Erica P. John Fund*, 134 S. Ct. 2398 (2014) ("Halliburton II"). *See also* our 2014 Mid-Year Report; "Basic is Dying a Slow Death: The Supreme Court Upholds the Fraud-on-the-Market Presumption in *Halliburton* But Allows Rebuttal," BakerHostetler Client Alert, Marc Powers, Mark Kornfeld, Deborah Renner, and Jessie Gabriel (June 26, 2014).

17 *Id.* at 2405-06.

18 *Erica P. John Fund v. Halliburton*, No. 3:02-CV-1152-M, 2015 WL 4522863 (N.D. Tex. July 25, 2015) ("*Halliburton II Remand*").

19 "District Court Follows Supreme Court's Lead in *Halliburton*, Allows Class Action to Proceed with Narrowed Factual Scope, BakerHostetler Client Alert, Deborah Renner, Jessie Gabriel, and David McMillan (July 31, 2015).

20 *Halliburton II Remand*, at 2-3; *see also Basic v. Levinson*, 485 U.S. 224, 243 (1988).

21 *Halliburton II Remand*, at 3.

22 *Id.*

23 *Id.*

24 *See* Jessie Gabriel, *Price Impact: The Battle of Experts and Burden of Proof after Halliburton II*, American Bar Association Section of Litigation (Sept. 2015) http://apps.americanbar.org/litigation/committees/securities/articles/summer2015-0815-price-impact-experts-and-burden-of-proof-after-halliburton-ii.html.

the market."[25] After a thorough examination of both parties' event studies, the Court concluded that Halliburton had successfully shown a lack of price impact for five of six alleged "corrective disclosures," i.e., events that disclose a company's fraud.[26]

In addition, before it even examined the event studies, the District Court decided two threshold issues: "(1) who has the burden of production and persuasion; and (2) whether the Court should, as part of the price impact inquiry, rule as a matter of law that particular disclosures are corrective."[27] The District Court concluded that the defendant (Halliburton) bore both the burden of production and persuasion, meaning that a defendant "must ultimately persuade the Court that its expert's event studies are more probative of price impact than the [plaintiff's] expert's event studies."[28] The Court further held that at the class certification stage, the Court was required to "conclude[] that the asserted misrepresentations were, in fact, misrepresentations, and assume[] that the asserted corrective disclosures were corrective of the alleged misrepresentations."[29] To do otherwise, the Court reasoned, would require Courts to examine the merits of allegations regarding corrective disclosures after the motion to dismiss stage and before summary judgment. This finding ultimately set the stage for *Halliburton III*.

A Third Interlocutory Appeal – *Halliburton III* and the Presumption of "Corrective" Disclosures

Just a few months after the opinion following the *Halliburton II* remand, the case was once again teed up for an interlocutory appeal on the issue of price impact. Halliburton moved for leave to appeal to the Fifth Circuit Court of Appeals, arguing that a court should not assume at the class certification stage that so-called "corrective disclosures" are actually corrective.[30]

The Fifth Circuit agreed to consider the issue. However, Judge James L. Dennis specially noted his reluctance to agree to a third interlocutory appeal in a case that had already been pending at the class certification stage for a decade.[31] Judge Dennis reasoned that the District Court had correctly decided the issue in view of Fifth Circuit and Supreme Court precedent, but thought it best for the Fifth Circuit to address the issue directly and settle any doubt.[32] Judge Dennis applied the Supreme Court's reasoning in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*,[33] which holds that "any question as to the materiality of an alleged misrepresentation should be left to the merits stage because it does not bear on the predominance requirement" of Fed. R. Civ. P. 23(b)(3).[34] Thus, determination of the issue of whether a disclosure was corrective was not necessary to determine the preliminary issue of class certification. Likewise, in the recent case of *Ludlow v. BP P.L.C.*, the Fifth Circuit applied *Amgen* and found that the similar question of "whether certain corrective disclosures are linked to the alleged misrepresentations in question is common to the class, and is 'susceptible of a class-wide answer.'"[35]

Judge Dennis also noted that Halliburton was urging a broader review similar to what the Fifth Circuit had urged, and ultimately been reversed for, in *Halliburton I*.[36] Regardless, Judge Dennis concurred in the decision to permit the appeal, and the case is now back on its way to the Fifth Circuit. The Fifth Circuit's ultimate decision, potentially leading to a third foray before the United States Supreme Court, will undoubtedly shape future litigation on price impact and corrective disclosures.

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25 *Id.*

26 *Id.* at 16-53.

27 *Id.* at 7.

28 *Id.* at 12.

29 *Id.* at 15.

30 According to Halliburton, a "defendant in a federal securities fraud class action may rebut the presumption of reliance at the class certification stage by producing evidence that a disclosure preceding a stock-price decline did not correct any alleged misrepresentation." *Halliburton III*, at 2-3 (Dennis, J., concurring).

31 *Id.* at 2.

32 *Id.* at 3.

33 133 S.Ct. 1184, 1194 (2013).

34 *Halliburton III*, at 3.

35 800 F.3d 674, 688 (5th Cir. 2015) (quoting *Amgen*, 133 S.Ct. at 1196).

36 *See Halliburton III*, at 4 ("[T]he Supreme Court subsequently rejected th[e Fifth Circuit's] analysis and held that plaintiffs need not prove loss causation at the class certification stage.") (citing *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2184 (2011)(*Halliburton I*)).

Increasing Use of Experts at the Class Certification Stage

Notably, *Halliburton II* is also setting the stage for the increased use of, and extensive court reliance on, testifying experts at the class certification stage in securities litigation. *Halliburton II*'s "battle of the experts," specifically with regard to price impact, has demonstrated that courts will engage in extensive evidentiary hearings to evaluate the competing experts' opinions and methodologies. To meet and/or rebut the burden of production and persuasion, parties will need to retain experts much earlier in the litigation process and master the corresponding Federal Rules of Civil Procedure and Evidence regarding, *inter alia*, expert qualifications, reliable principles and methodologies applied to the facts of the case, and admissible expert testimony.

Three cases in the latter half of 2015 have not only demonstrated the heightened burden placed on defendants to prove a "complete lack of price impact" through expert testimony,[37] but also the level to which courts will analyze the connection between the proffered expert testimony and the parties' claims, as well as the reliability of the expert opinions.[38] *In Carpenters Pension Trust Fund of St. Louis v. Barclays PLC*, 310 F.R.D. 69 (S.D.N.Y. 2015), the defendants turned to the *Daubert* test and Federal Rule of Evidence 702 to argue that the plaintiffs could not establish class-wide reliance in accordance with the *Basic* presumption. The Court rejected the defendants' *Daubert* challenge vis-à-vis the plaintiffs' expert's event studies by concluding that the expert's testimony was relevant, reliable, relied on sufficient data, and employed sufficiently objective methods. Overall, the defendants' objections focused on the weight of the evidence, as opposed to the sufficiency, and did not suffice to exclude the plaintiffs' expert.[39]

Corporate Imputation and the Threat of Rogue Corporate Executives

In re ChinaCast Education Corp. Securities

On October 23, 2015, the Ninth Circuit Court of Appeals entered its opinion in *In re ChinaCast Education Corp. Securities*,[40] a decision that may expose many otherwise-blameless corporations to liability for the improper actions of their executives. In *ChinaCast*, the founder and CEO of a company was alleged to have embezzled more than $120 million, while simultaneously making false and misleading statements regarding the company's financial condition to investors and regulators.[41] The SEC successfully obtained a judgment against the company's founder in 2013 for the disgorgement of more than $40 million. The company's investors then turned their attention to the company, suing the company for alleged SEC Rule 10b-5[42] violations and requesting that the founder's scienter, or knowledge of the criminality of one's conduct, be imputed to the company for the purposes of liability.

The District Court for the Central District of California dismissed the investors' claims for failure to plead scienter on the part of the corporation. The lower court noted that while corporate agents' actions can ordinarily be imputed to the corporation, under the "'adverse interest exception,' courts 'refus[e] to impute scienter from the fraud of a rogue agent.'"[43] Because the corporation's founder was alleged to have been acting for his own interests, rather than those of the corporation, the District Court believed imputation to be improper.

The Ninth Circuit disagreed. As the corporation's founder was a key person at the corporation, his conduct resulted in red flags that should have prompted further attention from the company, the company did not deny its founders

37 *See In re Goldman Sachs Grp., Inc. Sec. Litig.*, No. 10 Civ. 3461, 2015 U.S. Dist. LEXIS 110382 (S.D.N.Y. Sept. 24, 2015).

38 *See City of Sterling Heights Gen. Employees' Ret. Sys. v. Prudential Fin., Inc.*, No. 12-5275, 2015 U.S. Dist. LEXIS 115287 (D.N.J. Aug. 31, 2015) (denying defendants' motion to exclude lead plaintiffs' expert report via a *Daubert* analysis evaluating the expert's qualifications, reliability, and fit).

39 *Carpenters Pension Trust Fund of St. Louis v. Barclays PLC*, 310 F.R.D. 69, 86-91 (S.D.N.Y. 2015).

40 *In re ChinaCast Education Corp. Securities*, No. 12-57232, 2015 U.S. App. LEXIS 18462 (9th Cir. Oct. 23, 2015).

41 *Id.* at 5.

42 *See* 17 C.F.R. 240.10b-5.

43 *Id.* at 6; *see also id.* at 11 ("Under that exception, a rogue agent's actions or knowledge are 'not imputed to the principal if the agent acts adversely to the principal in a transaction or matter, intending to act solely for the agent's own purposes or those of another person.'") (quoting Restatement (Third) of Agency § 5.04 (2006)).

wrongdoing, and the founder had made "material misrepresentation or omissions … within the scope of [his] apparent authority," the Ninth Circuit found that "the shareholders pled sufficient allegations to support imputation and survive the pleading requirements of the PSLRA."[44] As summarized by the *ChinaCast* court, "[t]his approach, which takes an appropriately narrow view of the adverse interest exception, is consistent with the purpose of the securities laws to deter fraud and promote confidence in the securities markets."[45]

Several key takeaways from this Ninth Circuit opinion are that companies and other management personnel are responsible for their agents, cannot turn a blind eye to misconduct or malfeasance even at the highest levels of executives within a company, and cannot rely on the legal system to give them a pass even when an executive damages a company solely for personal reasons. Companies must be vigilant at all times, as well as proactive in their compliance, oversight, and responsiveness to individuals who act badly. *ChinaCast* is a direct warning shot, for example, to Boards of Directors of public and private companies that they need to engage in "high alert" monitoring of individuals running the show at the helm of companies.

44 *Id.* at 16.

45 *Id.* at 17.

First Circuit Hands the SEC a Loss in the Controversial Flannery Enforcement Action

On December 8, 2015, the U.S. Court of Appeals for the First Circuit vacated an SEC order imposing sanctions against two former employees of State Street Bank and Trust Company, James D. Hopkins ("Hopkins"), a former vice president and head of North American Product Engineering, and John P. Flannery ("Flannery"), a former chief investment officer.[46]

The SEC brought charges against Hopkins and Flannery in 2010, alleging that they made material misrepresentations and omissions that misled investors about two substantially identical State Street-managed funds during the 2007 subprime mortgage crisis. The SEC's Chief Administrative Law Judge ("ALJ") dismissed the proceeding, finding that neither Hopkins nor Flannery was responsible for, nor had ultimate authority over, the documents at issue, and that the documents did not contain materially false or misleading statements or omissions.

At the outset, the decision represented that in-house SEC administrative proceedings were fair and balanced. This was short-lived, however, as the SEC's Division of Enforcement appealed to the SEC itself. In 2014, the SEC reversed the ALJ in a 3-2 decision. The SEC imposed cease-and-desist orders on Hopkins and Flannery, suspended them from association with any investment adviser or company for one year, and imposed respective monetary penalties of $65,000 and $6,500.

46 *Flannery v. Sec. Exch. Comm'n.*, No. 15-1080, 2015 WL 8121647, at *7 (1st Cir. Dec. 8, 2015).

On appeal, the First Circuit reversed the SEC's findings by concluding that they were not supported by "substantial evidence," meaning "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion," and vacated the SEC's order. The court noted that where the SEC reaches the opposite conclusion from that of its ALJ, the court's review is "slightly less deferential than it would be otherwise." It ultimately found, however, that the SEC's case failed the "substantial evidence" test for upholding SEC factual findings of liability and that the SEC had abused its discretion. The court held that the evidence underlying the SEC's decision was "thin" and "marginal" as to Hopkins and could not support a finding of scienter. The First Circuit highlighted that only one witness was identified who stated that the information omitted in Hopkins' slide show would have "significantly altered the total mix of information that was available to them," and that a slide at issue was labeled as "typical."

Flannery demonstrates the critical role federal courts play as a check and balance on the extent of the SEC's broad use of power, especially regarding the liability of individuals. Federal courts are a critical avenue not to be ignored for appealing SEC decisions and/or confronting the constitutionality of SEC in-house proceedings and the interplay with SEC administrative judges.

The SEC Cooperation and Whistleblower Programs

The Cooperation and Whistleblower Programs continued to be important initiatives in the SEC's enforcement program in the last half of 2015. In particular:

- The SEC continued to emphasize the benefits of cooperation—especially in the context of Foreign Corrupt Practices Act ("FCPA") violations—and the consequences of not self-reporting misconduct in light of the increasing number of whistleblower tips that often guide the SEC in opening investigations and bringing enforcement actions;
- Although the SEC did not enter into any deferred prosecution agreements ("DPAs") or non-prosecution agreements ("NPAs") during the past half year, cooperation credit was provided to entity and individual defendants alike responding to various types of allegations—mainly in the form of decreased civil penalties;
- The orders and releases now appear to be more transparent regarding how cooperation credit is tied to reduced sanctions, as well as how the Division of Enforcement uses ongoing cooperation in its investigatory and enforcement activities;[47] and
- The SEC reported a record number of whistleblower tips for Fiscal Year 2015, and during the second half of the year, announced four whistleblower awards and took steps to protect whistleblowers from adverse employment consequences for internally reporting potential misconduct.

Given that the SEC views these programs as very successful tools in the enforcement arsenal for Chairman Mary Jo White, the creation of internal cultures of incentivized compliance and internal reporting is crucial for 2016.[48] More specifically, all these developments reinforce the importance of effective compliance programs that encourage internal reporting of potential misconduct to provide a company with the opportunity to investigate, remediate, and cooperate with any government investigation, including by self-reporting. As the SEC has repeatedly pointed out, these are all factors the SEC considers when determining whether, and to what extent, credit should be extended in a settlement.

47 *See, e.g., In the Matter of Trinity Capital Corporation*, 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 a Cease-and-Desist Order and Penalties, Securities Act of 1933 Rel. No. 9930 (Sept. 28, 2015) (listing as an undertaking Trinity Capital Corporation's commitment to provide ongoing cooperation, including the production of information and witnesses), https://www.sec.gov/litigation/admin/2015/33-9930.pdf; *In the Matter of UBS Financial Services Incorporated of Puerto Rico*, Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions, Securities Exchange Act of 1934 Rel. No. 76013 (Sept. 29, 2015) (disclosing UBS's cooperation agreement, including using best efforts to make principals, partners, officers, and employees available to be interviewed by the Staff, accepting service by mail through counsel, waiving territorial limits on service of third-party subpoenas, and consenting to personal jurisdiction in federal court for the purposes of subpoena enforcement), http://www.sec.gov/litigation/admin/2015/34-76013.pdf.

48 *See* BakerHostetler Brief, Hedge Funds: A Look Toward 2016 (January 2016).

The SEC Continues to Encourage Cooperation and Self-Reporting

On November 17, 2015, the Director of the SEC's Division of Enforcement, Andrew Ceresney, echoed his remarks from earlier this year about the importance of cooperation and self-reporting FCPA violations.[49] As evidence of the "significant and tangible" benefits for cooperating, Director Ceresney cited the more than half a dozen FCPA cases over the past year in which the SEC gave cooperation credit, including: (i) the Layne Christensen Company settlement where the civil penalty was 10 percent of the disgorgement amount; (ii) the PBSJ Corporation DPA where the civil penalty was a "small fraction" of the disgorgement amount; and (iii) the Goodyear Tire & Rubber Company settlement where there was no civil penalty. Director Ceresney stated that these settlements "send the message loud and clear that the SEC will reward self-reporting and cooperation with significant benefits."

49 Speech, SEC Director of Division of Enforcement Andrew Ceresney, "ACI's 32nd FCPA Conference Keynote Address" (Nov. 17, 2015), http://www.sec.gov/news/speech/ceresney-fcpa-keynote-11-17-15.html.

Director Ceresney also warned that companies are "gambling" if they fail to self-report FCPA violations. He explained that if the Division of Enforcement learns of misconduct through other means, like its Whistleblower Program, "the consequences to the company will likely be worse and the opportunity to earn additional cooperation credit may well be lost."

To encourage self-reporting FCPA violations, Director Ceresney announced that "going forward, a company must self-report misconduct in order to be eligible for the Division to recommend a DPA or NPA to the SEC in an FCPA case." He noted, however, that "self-reporting alone is not enough" to obtain a DPA or NPA and that it is one of the many factors set forth in the Seaboard report that the Division of Enforcement takes into consideration when determining cooperation credit.

FCPA misconduct is not the only context in which the Division of Enforcement openly encourages cooperation and self-reporting. One month prior to Director Ceresney's speech, the SEC noted in its release accompanying its settlement with The Blackstone Group that the Division of Enforcement's Asset Management Unit "encourages private equity fund advisers that have identified [fee and expense] issues to self-report them to the staff."[50] Although Blackstone did not self-report, it still was able to receive cooperation credit in settling the SEC's disclosure and compliance failure allegations based on voluntarily stopping the alleged violative conduct, making certain disclosures to its investors, and voluntarily providing the staff with documents and detailed summaries of relevant information both through production and in meetings.[51] Without admitting or denying the order's findings, Blackstone agreed to: (i) cease and desist from future violations, (ii) pay disgorgement and prejudgment interest in the amount of approximately $29 million, and (iii) pay a civil penalty in the amount of $10 million–around one-third of the disgorgement amount. (*See also infra Investment Adviser and Hedge Fund Cases*).

Over the next year, we anticipate that the SEC will continue to emphasize the benefits of cooperation and self-reporting as part of both its regulatory and enforcement programs and their various initiatives.

Cooperation Resulting in Lower Civil Penalties for All Types of Defendants

The second half of 2015 witnessed many settlements in which entities and individual defendants alike received cooperation credit in the form of reduced civil penalties. In fact, in certain cases, the defendants were able to avoid a civil penalty based on their cooperation.[52] Some of the more notable settlements involving cooperation credit are discussed below.

On August 18, 2015, the SEC announced a settled order with The Bank of New York Mellon Corporation ("BNY Mellon") for alleged FCPA violations in connection with BNY Mellon's providing student internships to family members of foreign government officials affiliated with a Middle Eastern sovereign wealth fund.[53] Without admitting or denying the order's findings, BNY

50 Press Release, United States Securities and Exchange Commission, "Blackstone Charged With Disclosure Failures," Rel. No. 2015-235 (Oct. 7, 2015), http://www.sec.gov/news/press-release/2015-235.html.

51 *In the Matter of Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C., and Blackstone Management Partners IV L.L.C.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order, Investment Advisers Act of 1940 Rel. No. 4219 (Oct. 7, 2015), https://www.sec.gov/litigation/admin/2015/ia-4219.pdf.

52 *See*, *e.g.*, Press Release, United States Securities and Exchange Commission, "SEC Announces Settlement With Cooperator in Grand Central Post-It Notes Insider Trading Case," Rel. No. 2015-143 (July 13, 2015), http://www.sec.gov/news/pressrelease/2015-143.html; *In the Matter of Brian David Hall*, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Securities Exchange Act of 1934 Rel. No. 75939 (Sept. 17, 2015), https://www.sec.gov/litigation/admin/2015/34-75939.pdf; *In the Matter of Toney Anaya*, Order Concerning Civil Penalty and Terminating Administrative and Cease-and-Desist Proceedings, Securities Act of 1933 Rel. No. 9970 (Oct. 29, 2015), https://www.sec.gov/litigation/admin/2015/33-9970.pdf; *In the Matter of Michael C. McKenna, CPA*, Order Instituting Cease-and-Desist Proceedings, Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, Securities Exchange Act of 1934 Rel. No. 76634 (Dec. 14, 2015), https://www.sec.gov/litigation/admin/2015/34-76634.pdf.

53 Press Release, United States Securities and Exchange Commission, "SEC Charges BNY Mellon With FCPA Violations," Rel. No. 2015-170 (Aug. 18, 2015), http://www.sec.gov/news/pressrelease/2015-170.html.

Mellon agreed to: (i) cease and desist from committing future FCPA violations, (ii) pay disgorgement and prejudgment interest in the amount of $9.8 million, and (iii) pay a civil penalty in the amount of $5 million—or just over half the disgorgement amount.[54] BNY Mellon expressly acknowledged in the order that the SEC did not impose a civil penalty in excess of $5 million based upon BNY Mellon's cooperation during the SEC's investigation. According to the order, prior to the investigation, BNY Mellon began enhancing its anti-corruption compliance program to address the hiring process of government officials' relatives, including, among other things, requiring a centralized hiring process overseen by BNY Mellon's anti-corruption office under which applicants must identify whether they have close personal connections to a government official.

On September 21, 2015, the SEC announced a settled order with the investment adviser First Eagle Investment Management, LLC ("First Eagle") and its wholly-owned broker-dealer subsidiary FEF Distributors, LLC ("FEF") for allegedly using approximately $25 million in mutual fund assets to pay for the marketing and distribution of fund shares outside of a written, approved Rule 12b-1 plan, thereby rendering their disclosures inaccurate.[55] Without admitting or denying the order's findings, First Eagle agreed to: (i) cease and desist from committing future violations of Section 12(b) of the Investment Company Act of 1940 and Rule 12b-1 thereunder, (ii) pay disgorgement and prejudgment interest in the amount of approximately $27 million, (iii) pay a civil penalty in the amount of $12.5 million—or nearly half the disgorgement amount, and (iv) FEF's retention of a compliance consultant for two years.[56] The compliance consultant will conduct a top-down review of all policies and procedures related to distribution-related services and payments and will be required to submit a comprehensive report to the SEC addressing these issues. The SEC will then make recommendations in its own report, which FEF must fully adopt. The order indicates that the SEC considered First Eagle and FEF's cooperation and remedial actions, including their voluntary production of documents and First Eagle's immediate payment of such costs and their offer to return the amounts improperly paid from the funds' assets.

On September 30, 2015, the SEC announced settled orders against 22 municipal underwriting firms in connection with its Municipalities Continuing Disclosure Cooperation Initiative. Like the previous settlements with other underwriters pursuant to this continuing initiative (as discussed in our 2015 Mid-Year Report), each underwriter agreed to: (i) cease and desist from such future violations, (ii) retain an independent consultant to review its policies and procedures on due diligence for municipal securities underwriting, and (iii) pay civil penalties ranging from $40,000 to $500,000 based on the number and size of the fraudulent offerings, up to a cap based on the size of the underwriter. None of the underwriters were required to admit or deny the findings in the orders.

On October 13, 2015, in a "first-of-its-kind case," the SEC announced a settled order with UBS AG ("UBS") for allegedly making false or misleading statements and omissions in offering materials for $190 million worth of structured notes linked to a proprietary foreign exchange trading strategy that resulted in approximately $5.5 million in investor losses.[57] Without admitting or denying the order's findings, UBS agreed to: (i) cease and desist from committing future violations of Section 17(a)(2) of the Securities Act of 1933, (ii) pay disgorgement and prejudgment interest in the amount of $11.5

54 *In the Matter of The Bank of New York Mellon Corporation*, 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, Securities Exchange Act of 1934 Rel. No. 75720 (Aug. 18, 2015), http://www.sec.gov/litigation/admin/2015/34-75720.pdf.

55 Press Release, United States Securities and Exchange Commission, "SEC Charges Investment Adviser With Improperly Using Mutual Fund Assets to Pay Distribution Fees," Rel. No. 2015-198 (Sept. 21, 2015), http://www.sec.gov/news/pressrelease/2015-198.html.

56 *In the Matter of First Eagle Investment Management, LLC and FEF Distributors LLC*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Investment Advisers Act of 1940 Rel. No. 4199 (Sept. 21, 2015), http://www.sec.gov/litigation/admin/2015/ia-4199.pdf.

57 Press Release, United States Securities and Exchange Commission, "UBS to Pay $19.5 Million Settlement Involving Notes Linked to Currency Index," Rel. No. 2015-238 (Oct. 13, 2015), http://www.sec.gov/news/pressrelease/2015-238.html.

million, and (iii) pay a civil penalty in the amount of $8 million—or over two-thirds the disgorgement amount.[58] The order indicates that the SEC considered UBS's cooperation and remedial measures, including conducting an internal investigation, providing the SEC with information and analyses and access to witnesses located in Europe, and voluntarily centralizing and enhancing the systems and controls relating to the operation, calculation, and administration of its proprietary indices.

While the SEC has continued to emphasize the benefits of cooperation, it has also pointed out where the failure to cooperate has yielded harsher sanctions. For example, on October 14, 2015, the SEC announced settled orders against six investment advisers for alleged violations of Rule 105 of Regulation M, which generally prohibits short selling a stock within five business days of participating in an offering for that same stock.[59] To emphasize the Cooperation Program, the SEC singled out one of the advisers, War Chest Capital Partners LLC ("War Chest"), for previously refusing to review its past trading during the SEC's first Rule 105 sweep in 2013 to determine whether additional violations occurred. Unlike the other advisers that generally were ordered to pay civil penalties that were half the disgorgement amounts (subject to the statutory minimum for civil penalties), War Chest was censured and ordered to pay a civil penalty that nearly matched the disgorgement amount. More significantly, pursuant to the order, War Chest is prohibited from participating directly or indirectly in any secondary or follow-on offering for one year.

Whistleblower Developments

As evidenced by the 2015 Whistleblower Report, the SEC received an increasing amount of tips during its Fiscal Year 2015—nearly 4,000 through its Tips, Complaints, and Referrals Intake System—which continued to inform its enforcement activities.[60] During the second half of 2015, the SEC announced the following four awards further incentivizing whistleblowers to report potential misconduct either internally to their company or to the SEC.

- On July 17, 2015, the SEC announced a whistleblower award in excess of $3 million, which is the third-largest award to a company insider whose specific, detailed, and comprehensive information assisted the SEC in successfully pursuing enforcement actions against a complex fraudulent scheme.[61]
- On September 28, 2015, the SEC announced a whistleblower award of 20% to two foreign nationals—one for 11% and the other for 9%—who jointly reported information causing the Division of Enforcement to initiate the investigation that resulted in the underlying enforcement proceeding.[62]
- On September 29, 2015, the SEC issued a final order authorizing a whistleblower award of 28%.[63]
- On November 4, 2015, the SEC issued a final order authorizing a whistleblower award payment of over $325,000 factoring in the whistleblower's delay in reporting either internally or to the SEC, which was found to be "unreasonable" under the circumstances where the whistleblower waited until after leaving the employer to report the misconduct.[64]

The SEC also took steps during the second half of the year to clarify whistleblower protections instituted by the Dodd-Frank Act. In particular,

58 *In the Matter of UBS AG*, Order Instituting Cease and Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings and Imposing Remedial Sanctions and a Cease and Desist Order, Securities Act of 1933 Rel. No. 9961 (Oct. 13, 2015), http://www.sec.gov/litigation/admin/2015/33-9961.pdf.

59 Press Release, United States Securities and Exchange Commission, "SEC Charges Six Firms for Short Selling Violations in Advance of Stock Offerings," Rel. No. 2015-239 (Oct. 14, 2015), http://www.sec.gov/news/pressrelease/2015-239.html.

60 2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program (Nov. 16, 2015) (hereinafter "2015 Whistleblower Report"), https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2015.pdf.

61 Order Determining Award Claim, Securities Exchange Act of 1934 Rel. No. 75477 (July 17, 2015), https://www.sec.gov/rules/other/2015/34-75477.pdf.

62 Order Determining Award Claim, Securities Exchange Act of 1934 Rel. No. 76000 (Sept. 28, 2015), https://www.sec.gov/rules/other/2015/34-76000.pdf.

63 Order Determining Award Claim, Securities Exchange Act of 1934 Rel. No. 76025 (Sept. 29, 2015), https://www.sec.gov/rules/other/2015/34-76025.pdf.

64 Order Determining Award Claim, Securities Exchange Act of 1934 Rel. No. 76338 (Nov. 4, 2015), https://www.sec.gov/rules/other/2015/34-76338.pdf.

on August 4, 2015, the SEC released interpretive guidance clarifying that individuals are protected against adverse employment consequences where they internally report potential securities law violations even if they have not yet reported the potential misconduct to the SEC in a manner to qualify for a whistleblower award.[65]

The SEC also filed *amicus curiae* briefs in private retaliation cases urging the federal courts to defer to the SEC's rule by holding that individuals are entitled to protection against employment retaliation where they report internally potential misconduct at a publicly-traded company, regardless of whether they have separately reported the information to the SEC.[66]

Whistleblower Protection Under the Dodd-Frank Act

Berman v. Neo@Ogilvy LLC, No. 14-4626 (2d Cir. Sept. 10, 2015)

On September 10, 2015, the United States Court of Appeals for the Second Circuit entered its opinion in *Berman v. Neo@Ogilvy LLC*, a case with implications for corporations and whistleblowers alike. In this particular case, a whistleblower sued his former employer claiming that he had been improperly discharged in violation of the Dodd-Frank Act.[67] The district court previously had dismissed the whistleblower's claim, finding that the Dodd-Frank Act whistleblower provisions "protect only employees discharged for reporting violations to the SEC and not those reporting violations only internally."[68] The Second Circuit disagreed.

The issue was one of statutory interpretation. Rule 21F-2 of the Exchange Act defines a "whistleblower" as someone who "provide[s] the *Commission*" (i.e., the SEC) with information.[69] Simultaneously, however, a subsection of the same rule concerning "Protection against retaliation" specifies that a whistleblower is someone who "'provide[s]' specified information 'in a manner described in'" certain provisions of the Dodd-Frank Act and the Sarbanes-Oxley Act, which also "protect an employee who reports internally *without* reporting to the Commission."[70] The Second Circuit, therefore, sought to interpret the ambiguity of the pertinent rule to determine whether the Dodd-Frank Act also protected internal whistleblowers from retaliation.

Previously, on August 4, 2015, the SEC issued interpretive guidance on this very issue, concluding that internal whistleblowers are in fact protected under the relevant provisions of the Dodd-Frank Act.[71] After analyzing the legislative history of the statute extensively, the Second Circuit found that there was sufficient ambiguity in the statute for courts to "defer to the reasonable interpretive rule adopted by the appropriate agency."[72] In view of the SEC's guidance, the Second Circuit "conclude[d] that the pertinent provisions of the Dodd-Frank Act create a sufficient ambiguity to warrant our deference to the SEC's interpretive rule," and found that the Dodd-Frank Act also protects whistleblowers who report internally rather than directly to the SEC.[73]

The Second Circuit recognized that its decision in Berman created a circuit split "against a landscape of existing disagreement among a large number of district courts."[74] Already, in *Asadi v. G.E. Energy (USA), LLC* 720 F.3d 620 (5th Cir. 2013), the U.S. Court of Appeals for the Fifth Circuit had held that a "plain language" interpretation of the applicable rule protected only whistleblowers who reported directly to the SEC.[75] As Judge Jacobs's dissent in *Berman* makes clear, this issue is now ripe for interpretation by the U.S. Supreme Court,[76] and corporations will have to prepare to face retaliation claims that, until now, may have been considered meritless.

65 Interpretation of the SEC's Whistleblower Rules under Section 21F of the Securities Exchange Act of 1934, Rel. No. 34-75592, 17 C.F.R. Part 241 (Aug. 4, 2015), https://www.sec.gov/rules/interp/2015/34-75592.pdf.

66 2015 Whistleblower Report.

67 *Berman v. Neo@Ogilvy LLC*, No. 14-4626, 2015 WL 5254916 (2d Cir. Sept. 10, 2015), at 1.

68 *Id.*

69 *Id.* at 9 (emphasis added); *see also* 17 C.F.R. § 240.21F-2(a)(1).

70 *Berman* at 9 (emphasis added); *see also* 17 C.F.R. § 240.21F-2(b)(ii).

71 *See* Release No. 34-75592 (Aug. 4, 2015) available at https://www.sec.gov/rules/interp/2015/34-75592.pdf.

72 *Berman* at 28-29.

73 *Id.* at 4.

74 *Id.* at 24.

75 720 F.3d 620 (5th Cir. 2013).

76 *See Berman* at 30 (Jacobs, J.) (dissenting) ("But our obligation is to apply congressional statutes as written. In this instance, the alteration creates a circuit split, and places us firmly on the wrong side of it.").

Insider Trading Cases

The SEC further intensified its commitment to insider trading enforcement actions by charging 87 parties with trading on the basis of inside information during Fiscal Year 2015.[77] These actions covered various types of illicit activity, including receiving nonpublic information via hacking, sharing of non-public information among family member-employees, and private equity information-sharing relationships between general and limited partners. What is telling is the rising link between cybercrimes and insider trading. Using illegal electronic means to obtain and share inside information has the SEC working tirelessly to quell the tide of increased computer hacking to the extent that the SEC has made cybersecurity a 2016 priority.[78]

A continuing effort in 2015 was the SEC's use of data analytics to spot suspicious trading, which is also a priority for the commission in 2016.[79] These enforcement efforts, along with the increasing number of cases levied in 2015, show the government has not pulled away from its prioritizing of insider trading cases. Many of these cases were also referred to the Department of Justice ("DOJ"), which pursued parallel criminal charges. The DOJ's Securities and Financial Fraud Unit within the Fraud Section maintains insider trading enforcement as a priority, and along with the U.S. Attorney's Office for the Southern District of New York, the DOJ has investigated and charged the majority of the cases brought by the SEC.

The latter half of 2015 involved insider trading cases across a variety of industries and relationships. From targeting big-market entities down to smaller father-son relationships, the government is showing no affinity toward any market or industry. Interestingly, the suit filed against the Marwood Group, a political intelligence firm, indicates that the SEC is not only focusing on the traditional violators of the insider trading laws. Not a broker-dealer, an investment advisor, or a traditional public corporation, the Marwood Group analyzes policy issues, which at times include material non-public information. The dissemination of this information without going through proper compliance channels led the government to charge the firm with violating insider trading rules. Even the Commodity Futures Trading Commission filed, and settled, its first insider trading case.

Below is a summary of the key insider trading enforcement actions brought by the government in the second half of 2015.

Wake of Supreme Court's Denial of Certiorari in *United States v. Newman*

On October 5, 2015, the U.S. Supreme Court denied certiorari in *United States v. Newman*.[80] As discussed more fully in our 2014 Year-End Report and 2015 Mid-Year Report, the Second Circuit Court of Appeals' decision in *Newman* effectively makes it more difficult for federal prosecutors to prosecute alleged "downstream" or "remote" tippees of insider information, who did not receive the information directly from the tipper. Under *Newman*, for a remote tippee to be guilty of insider trading, the tippee must have direct knowledge of the tipper who leaked the insider information and know that the tipper breached his or her fiduciary duty in doing so, and the insider must have received a pecuniary benefit in exchange for the leak.[81] Under this stricter standard, pending – and some prior – prosecutions of tippees without a direct link to their tippers may no longer be viable.

Less than a month after the U.S. Supreme Court's refusal to grant review in *Newman*, the U.S. Attorney for the Southern District of New York, Preet Bharara, dropped similar insider trading charges against Michael Steinberg and several other defendants who were accused of insider trading with respect to hedge fund manager

77 Release, United States Securities and Exchange Commission, SEC Announces Enforcement Results for FY 2015, Rel. No. 2015-245 (Oct. 22, 2015), https://www.sec.gov/news/pressrelease/2015-245.html.

78 Release, United States Securities and Exchange Commission, SEC Announces 2016 Examination Priorities, Rel. No. 2016-4 (Jan. 11, 2016), https://www.sec.gov/news/pressrelease/2016-4.html.

79 *Id.*

80 *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), *reh'g denied*, Nos. 13-1837(L), 13-1917(Con), 2015 WL 1954058 (2d Cir. April 3, 2015); *United States v. Newman*, 136 S.Ct. 242 (2015).

81 *Id.* at 443-44.

SAC Capital Advisors LP.[82] One of SAC Capital's managers, Mathew Martoma, previously convicted of insider trading,[83] is also challenging his conviction based on *Newman*. Mr. Martoma was convicted after it emerged that he obtained a confidential PowerPoint presentation indicating the negative results of certain drug trials, prior to selling shares in the parent pharmaceutical companies.[84]

However, even in the wake of *Newman*, courts have continued to find liability where a "meaningfully close personal relationship" exists between the tipper and the tippee, even if no other benefit to the tipper was alleged.[85] On July 6, 2015, the Ninth Circuit Court of Appeals, in an opinion written by Judge Rakoff sitting by designation, held in *United States v. Salman* that the "element of breach of fiduciary duty" sufficient for insider trading liability "is met where an 'insider makes a gift of confidential information to a trading relative or friend.'"[86] In this case, the remote tippee and tipper were brothers-in-law, and there were no other allegations of personal benefit to the tipper. The *Salman* court found, even in light of *Newman*, "'personal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia*, … the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.'"[87]

The Supreme Court's denial of certiorari in *Newman* is expected to have continued impact on the scope of insider trading prosecutions in the months to come throughout 2016.

Insider Trading Cases in Advance of Mergers and Acquisitions

SEC v. Spallina, et al., No. 15-cv-07118 (Sept. 28, 2015)

The SEC charged, on September 28, 2015, two Florida lawyers and an accountant with insider trading pertaining to the acquisition of Pharmasset Inc.[88] Specifically, they are alleged to have violated Sections 10(b) and 14(e) of the Exchange Act and Rules 10b-5 and 14e-3 thereunder.[89] The complaint alleges that they used confidential information obtained from a mutual client to purchase securities for themselves and also disseminated the information to others.[90] The SEC seeks to permanently restrain and enjoin them from violating the rules and to order disgorgement and a penalty.

Going as far back as 2011, the client worked with his lawyers and accountant and disclosed that the company was negotiating a sale, after which the lawyers and accountant purchased Pharmasset securities. The complaint also alleged that the tipping chain continued with other investment advisors whom the accountant and attorneys knew. Upon announcement of the sale, the defendants collected over $234,000 in profits.

They have agreed to settle with the SEC for $489,000.

SEC v. Aggarwal, et al., No. 15-cv-06460 (Aug. 25, 2015)

On August 25, 2015, the SEC charged a former JPMorgan investment bank analyst, Ashish Aggarwal ("Aggarwal"), with illegally tipping his close friend confidential information about clients involved in impending mergers and acquisitions of technology companies. The SEC also charged his friend, Shahriyar Bolandian ("Bolandian"), and another individual, Kevin Sadigh ("Sadigh"), with trading on the inside information.[91]

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82 *See* Statement of U.S. Attorney Preet Bharara on Dismissal of Charges Against Michael Steinberg and Six Other Insider Trading Defendants, Dep't of Justice (Oct. 22, 2015) available at http://www.justice.gov/usao-sdny/pr/statement-us-attorney-preet-bharara-dismissal-charges-against-michael-steinberg-and-six.

83 Release, United States Department of Justice, SAC Capital Portfolio Manager Mathew Martoma Sentenced in Manhattan Federal Court to Nine Years for Insider Trading (Sept. 8, 2014), http://www.justice.gov/usao/nys/pressreleases/September14/MathewMartomaSentencingPR.php.

84 *Id.*

85 *United States v. Salman*, No. 14-10204 (9th Cir. July 6, 2015), at 13 (quoting *Newman*, 773 F.3d at 443).

86 *Id.* at 14 (citing *Dirks v. SEC*, 463 U.S. 646, 664 (1983).

87 *Id.* (quoting *Newman*, 773 F.3d at 452).

88 Release, SEC Charges Five With Insider Trading, Including Two Attorneys and an Accountant, Rel. No. 2015-213 (Sept. 28, 2015), http://www.sec.gov/news/pressrelease/2015-213.html.

89 Complaint, *SEC v. Spallina, et al.*, No. 15-cv-07118 (Sept. 28, 2015).

90 *Id.*

91 Release, SEC Charges Former Investment Bank Analyst and Two Others With Insider Trading in Advance of Client Deals, Rel. No. 2015-174 (Aug. 25, 2015), http://www.sec.gov/news/pressrelease/2015-174.html.

The SEC's complaint charged Aggarwal, Bolandian, and Sadigh with violating Sections 10(b) and 14(e) of the Exchange Act and Rules 10b-5 and 14e-3. Notably, the complaint alleged that Aggarwal misappropriated confidential information and communicated the information to his friends, who in turn traded on this information.[92] It also sought disgorgement, interest, penalties, and permanent injunctions from future violations of these provisions.

Parallel to this investigation, the Department of Justice announced criminal charges against the defendants for netting over $600,000 in profits. The charges included conspiracy to commit securities and tender offer fraud, substantive tender offer and securities fraud, and wire fraud. Bolandian was also charged with money laundering.[93]

SEC v. Condon et al., No. 15-cv-07443 (C.D. Cal. Sept. 23, 2015)

On September 23, 2015, the SEC charged a consultant and his friend with insider trading based on material, nonpublic information related to an acquisition by P.F. Chang's China Bistro.[94]

The SEC alleges that Richard G. Condon, a consultant, tipped Jonathan Ross ("Ross") with confidential details about the bidding process for P.F. Chang's merger in 2011 titled Project Potsticker. Although that particular deal did not materialize, in 2012, another offer emerged to revitalize Project Potsticker.[95] In turn, Ross purchased options and informed additional friends about the nonpublic information. Upon the public announcement of an offer for ownership of P.F. Chang's, the defendants sold their options and made $300,000.[96] The case continues in Los Angeles.

SEC v. Sudfeld, No. 5-cv-3930 (E.D. PA. July 16, 2015)

The SEC, on July 16, 2015, charged a Pennsylvania attorney with insider trading of the stock of Harleysville Group, Inc., in advance of the 2011 announcement of a $760 million merger of Harleysville and Nationwide Mutual Insurance Company.[97]

According to the SEC's complaint, the attorney, Herbert Sudfeld ("Sudfeld"), illegally traded on information he learned while a real estate partner at a law firm. In overhearing the details from another conversation within the firm, Sudfeld purchased stock and realized $79,000 upon the sale.[98] The complaint charged Sudfeld with violating antifraud provisions of the federal securities laws and an SEC antifraud rule.[99] The SEC sought a permanent injunction and financial penalties against Sudfeld and return of the money along with interest.

Additionally, the U.S. Attorney's office for the Eastern District of Pennsylvania filed charges against Sudfeld. The DOJ charged him with insider trading and making false statements. Similar to the SEC allegations, the DOJ alleged that Sudfeld knew about the imminent merger and purchased stock in Harleysville Group, Inc.[100] Further to the illicit trading, the DOJ indicated that Sudfeld made false statements to the FBI. If convicted, he faces up to 25 years in prison and a $5 million fine.

SEC v. McEnery III, et al., No. 15-cv-04091 (Sept. 9, 2015)

The SEC further demonstrated its commitment to insider trading enforcement regarding the sharing of information in advance of mergers, regardless of the profits at issue and/or the nature of the actors, by charging a father-son-friend trio on September 9, 2015.[101] Indeed, the household names at issue here were the merging healthcare companies – Clarient and GE Healthcare.[102] The father, John McEnery III ("McEnery III"), worked

92 Complaint, *SEC v. Aggarwal*, et al., 15-cv-06460 (Aug 25, 2015).

93 Indictment, *U.S. v. Aggarwal*, et al., CR 15-00465 (Aug. 20, 2015).

94 Release, SEC Charges Consultant and Friend With Insider Trading in Advance of P.F. Chang's Merger, Rel. No. 2015-205 (Sept. 23, 2015), http://www.sec.gov/news/pressrelease/2015-205.html.

95 Complaint, *SEC v. Condon et al.*, No. 15-cv-07443 (C.D. Cal. Sept. 23, 2015).

96 *Id.*

97 Release, SEC Charges Pennsylvania Attorney With Insider Trading in Advance of Merger Announcement, Rel. No 2015-149 (July 16, 2015), http://www.sec.gov/news/pressrelease/2015-149.html.

98 Complaint, *SEC v. Sudfeld*, No. 15-cv-3930 (E.D. PA. July 16, 2015).

99 *Id.*

100 Indictment, *U.S. v Sudfeld*, (July 16, 2015), http://www.justice.gov/usao-edpa/file/631026/download.

101 Release, SEC Charges Father and Son and Friend With Insider Trading, Rel. No. 2015-185 (Sept. 9, 2015), http://www.sec.gov/news/pressrelease/2015-185.html.

102 *Id.*

at Clarient and dated (on and off) a Clarient employee, the "Clarient Insider."[103] The SEC alleged that McEnery III and the Clarient Insider engaged in a practice of sharing confidences with each other whereby the Clarient Insider believed that McEnery III would maintain her confidence.[104]

McEnery III tipped his son John McEnery IV ("McEnery IV") about the Clarient stock upon learning of its upcoming acquisition. McEnery III also tipped his friend, Michael Rawitser ("Rawitser"). In 2010, as a result of the tips, the three defendants purchased Clarient stock three weeks before the announcement of the deal and earned over $50,000 in profits from the sale following announcement of the acquisition.[105]

All three have agreed to settle the charges and pay $170,000. Without admitting or denying the allegations in the SEC's complaint filed in federal court in San Jose, McEnery III agreed to pay disgorgement of $32,482, prejudgment interest of $4,919.25, and a penalty of $64,156; McEnery IV agreed to pay disgorgement of $3,288, prejudgment interest of $497.92, and a penalty of $3,288; and Rawitser agreed to pay disgorgement of $28,386, prejudgment interest of $4,081.87, and a penalty of $28,386.[106] The settlement is subject to court approval.

Insider Trading Resulting From Inadequate Compliance Procedures

***In the Matter of Marwood Group Research, LLC,* No. 3-16970 (Nov. 24, 2015)**

On November 24, 2015, the SEC announced that Marwood Group Research, LLC, a political intelligence firm, agreed to a $375,000 penalty for failing to maintain adequate compliance procedures.[107] The SEC's investigation revealed that the firm failed to inform compliance officers about instances when analysts obtained potential material, nonpublic information from government employees. The order instituting a settled administrative proceeding found that the Marwood Group violated Section 15(g) of the Exchange Act and Section 204A of the Investment Advisers Act of 1940.[108]

One of the Marwood Group's functions is to take information it receives about major policy issues or pending regulatory approvals and disseminate updates and analyses to its clients. In doing so, Marwood employees maintain relationships with government employees and usually obtain nonpublic information.[109] Per the company's policies and procedures, employees are to funnel all material, nonpublic information through the compliance department. The SEC alleged that though the employees received red flags as to some of the information, they continued to draft research analyses and pass the information along to their clients. Overall, the SEC believed that the policies at Marwood were not reasonably designed to address the risks of confidential information being shared.

As a part of the settlement, in addition to the monetary penalty and cease and desist order, Marwood is required to hire an independent compliance consultant to conduct a review of the enforcement of Marwood's supervisory, compliance, and other policies and procedures as they relate to the obtaining or use of material, nonpublic information. Additionally, the company must adhere to strict recordkeeping and self-certifying procedures and present to the SEC.[110]

CFTC's First Insider Trading Case

In 2015, the CFTC filed and settled its first insider trading case. In an enforcement action brought against an oil and gasoline trader named Arya Motazedi ("Motazedi"), the CFTC alleged that Motazedi stole and illegally traded on confidential information that belonged to his

103 Complaint, *SEC v. McEnery III, et al.*, No. 15-cv-04091 (Sept. 9, 2015).

104 *Id.*

105 *SEC charges father, son, friend with insider trading in GE deal*, REUTERS, http://www.reuters.com/article/sec-insidertrading-general-electric-clar-idUSL1N11F25F20150909.

106 *See* Rel. No. 2015-185.

107 Release, SEC Charges Political Intelligence Firm, Rel. No. 2015-266 (Nov. 24, 2015), http://www.sec.gov/news/pressrelease/2015-266.html.

108 Order, In the Matter of Marwood Group Research, LLC, 3-16970 (Nov. 24, 2015).

109 *See* Rel. No. 2015-266.

110 *See* Order.

now-former employer.[111] According to the CFTC, Motazedi had access to confidential, proprietary information concerning his employer's proprietary trading in energy commodities, and Motazedi owed a duty to his employer not to misuse the information based on his employer's personal trading and conflict of interest policies, as well as his relationship of trust and confidence with his employer. Nevertheless, Motazedi used this information to enter 34 sham "opposite side" orders in oil and gas futures contracts that matched his employer's orders at prices that disadvantaged his employer. Motazedi also placed 12 orders for his personal account ahead of orders he placed for the company's account (an illegal practice known as "front running"), which generated additional profits for himself at the expense of his former employer. As part of the settlement, Motazedi agreed to: (1) a cease and desist order, (2) restitution to his employer in the amount of $216,955.80, (3) a $100,000 penalty from the CFTC, and (4) a permanent trading ban.

This is the first instance in which the agency has charged an individual with trading on material, nonpublic information in breach of the anti-manipulation and fraud rules established under the Dodd-Frank Act. In its settlement, the CFTC stated an intent to interpret CEA Section 6(c)(1), which prohibits manipulative and deceptive devices and contrivances in connection with any swap or contract of sale of any commodity, as a broad catch-all provision reaching fraud in all its forms. Specifically, Rule § 180.1, implements the provisions under Section 6(c)(1) by prohibiting, among other things, manipulative and deceptive devices and contrivances employed intentionally or recklessly, regardless of whether the conduct in question resulted in actual price manipulation. With its enforcement action against Motazedi, the CFTC has established a precedent for pursuing insider trading actions, and this development should be examined closely by all private fund managers that trade or engage in transactions that include commodity interests, regardless of whether they are registered with the CFTC.

111 Commodity Futures Trading Commission, "CFTC Orders Arya Motazedi to Pay a Civil Monetary Penalty and Restitution and Bans Him from Trading and Registration for Engaging in Gas and Crude Oil Futures Transactions that Defrauded His Employer," Rel. No. PR7286-15 (Dec. 2, 2015).

Settlements

According to analysis conducted by NERA Economic Consulting, 2015 saw a pronounced growth in federal class action lawsuits with 234, a height not seen since 2008.[112] Indeed, a record number of cases were filed faster than previously with the median time between the end of the alleged class period and the filing date reduced to 11 days, indicating a decrease of approximately 40% since 2014.[113] Even though 108 cases settled in 2015, representing a larger number than in any year since 2011, the settlement amounts continued to hover in low ranges by historical standards.[114] The median settlement amounts did not vary much from 2014 at $7.3 million.[115] However, due to 14 settlements valuing more than $100 million, the 2015 average settlement amount was $52 million, nearing the all-time high of $54 million.[116] As for specific types of defendants, six of the 10 largest settlements featured financial sector defendants and derived from litigation related to the financial crisis.[117]

The SEC continued its strong trend of first-of-their-kind cases covering a wide range of participants in the securities industry. On October 22, 2015, the SEC reported that it brought a record 807 enforcement actions yielding approximately $4.2 billion in penalties and disgorgements during the fiscal year ending on September 30, 2015.[118] As highlighted in our 2015 Mid-Year Report, some of the ground-breaking, first-of-their-kind cases included: (1) an enforcement action against a private equity advisor for misallocating broken deal expenses[119] and (2) an enforcement action for violating the whistleblower protection rule enacted under the Dodd-Frank Act through the use of improperly restrictive language in confidentiality agreements, possibly to stifle the whistleblowing process.[120] This year also saw an enforcement action against BNY Mellon for violations of the Foreign Corrupt Practices Act,[121] and an admission settlement with national audit firm BDO USA for dismissing red flags and submitting false and misleading unqualified audit opinions about the financial statements of General Employment Enterprises.[122]

We highlight some noteworthy settlements for the last half of 2015 regarding misconduct by financial institutions and their import below.

Misconduct Involving Complex Financial Instruments

Residential Mortgage-Backed Securities – RMBS

On November 6, 2015, U.S. Bank NA, along with certain units of Deutsche Bank AG and HSBC Holdings PLC, sought approval of a $1.1 billion residential mortgage-backed securities ("RMBS") settlement with Citigroup, Inc. This proposed settlement came on the heels of various similar agreements between major financial institutions and investors regarding purportedly misleading mortgage-backed securities issues and other practices related to home loans. The case is *In the Matter of the Application of U.S. Bank National Association et al.*, No. 653902/2014 (N.Y. Sup. Ct.).

Credit Suisse, on November 4, 2015, reached a settlement to resolve a certified class action in New York federal court involving claims that it duped a class of more than 300 investors into buying $1.6 billion in faulty mortgage-backed securities. The plaintiffs alleged that the bonds' registration statements and offering documents did not reveal that many of the pooled certificates

112 Svetlana Starykh and Stefan Boettrich, Recent Trends in Securities Class Action Litigation: 2015 Full-Year Review, (Jan. 25, 2016).

113 *See id.* at 15.

114 *See id.* at 21.

115 *See id.* at 25.

116 *See id.* at 26.

117 *See id.* at 30.

118 Release, United States Securities and Exchange Commission, SEC Announces Enforcement Results for Fiscal Year 2015, Results Include Significant Number of High-Impact and First-of-Their-Kind Actions, Rel. No. 2015-245 (Oct. 22, 2015), http://www.sec.gov/news/pressrelease/2015-245.html.

119 *In the Matter of Kohlberg Kravis Roberts & Co.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order, Investment Advisers Act of 1940, Release No. 4131 (June 29, 2015), http://www.sec.gov/litigation/admin/2015/ia-4131.pdf.

120 Press Release, United States Securities and Exchange Commission, "SEC: Companies Cannot Stifle Whistleblowers in Confidentiality Agreements," Rel. No. 2015-54 (April 1, 2015), http://www.sec.gov/news/pressrelease/2015-54.html.

121 *See supra* Section III for discussion of *In the Matter of the Bank of New York Mellon Corp.*, No. 3-16762.

122 Release, United Stated Securities and Exchange Commission, SEC Charges BDO and Five Partners in Connection with False and Misleading Audit Opinions, Rel. No. 2015-184 (Sept. 9, 2015).

were tied to inferior New Century Mortgage Corporation loans issued in contravention of underwriting standards. The case is *New Jersey Carpenters Health Fund v. DLJ Mortgage Capital Inc. et al.*, 1:08-cv-05653 (S.D.N.Y.).

On December 10, 2015, the National Credit Union Administration ("NCUA") announced that Morgan Stanley agreed to a settlement payment of $225 million resulting from the NCUA's claims derived from losses in connection with corporate credit unions' purchases of toxic RMBS. As a result of the settlement of the NCUA's 2013 claims that the faulty RMBS led to the collapse of certain credit unions, the NCUA will dismiss pending suits against Morgan Stanley in federal district courts in New York and Kansas.[123]

In August 2015, a $235 million settlement agreed to by Citigroup Global Markets Inc., Goldman Sachs Co., and UBS Securities was approved by a New York federal judge to resolve a class action led by a pension fund against these defendants as underwriters of mortgage-backed securities issued with purportedly false prospectuses. As the underlying loans went into default and suffered foreclosures, the certificates plummeted in value. The pension fund claimed that the sale of mortgage-backed securities involved prospectuses with material misstatements and omissions. Specifically, the pension fund alleged that the offering statements lied about the strict nature of the lending protocols of the mortgage originations.[124]

London Interbank Offered Rate – LIBOR

Early November 2015, Barclays agreed to a $120 million settlement to resolve charges by private investors in 2011 arising from manipulation of the London Interbank Offered Rate ("LIBOR"). The class plaintiffs, "over-the-counter" investors, argued that Barclays, and several banks, reported artificially low borrowing costs to inflate earnings and represent a financially sound front. The case is *In re: Libor-Based Financial Instruments Antitrust Litigation*, 1:11-mad-02262 (S.D.N.Y.). Notably, this settlement was only one part of extensive multidistrict litigation against several other banks alleged to have been involved in fixing LIBOR rates.

Additionally, 11 days later, Barclays reached a settlement of $14 million in connection with litigation brought by U.S. investors holding depositary shares, who claimed Barclays conspired with rivals to manipulate LIBOR and benefit from an inflated share price. They further contended that Barclays did not pay attention to misconduct before and after the financial crisis and senior management permitted the manipulation to elevate Barclays' reputation in the global marketplace. The case is *Gusinsky et al. v. Barclays PLC et al.*, No. 12-05329 (S.D.N.Y.).

Collateralized Debt Obligations – CDOs

In the Matter of Taberna Capital Management, LLC, Michael Fralin, and Raphael Licht

On September 2, 2015, the SEC announced a settlement with an investment advisory firm ("Taberna"), a former managing director ("Fralin"), and a former chief operating officer ("Licht") in connection with charges that Taberna fraudulently retained fees belonging to its collateralized debt obligations ("CDOs") clients.[125]

The SEC alleged that Taberna undertook, for a fee, certain restructuring transactions between its CDO clients and the underlying CDO's issuers. Taberna retained over $15 million of these fees, which was prohibited by the CDO governing documents. Retaining the fees created actual and potential conflicts of interest that Taberna failed to disclose to its clients, itself a violation of its fiduciary duty as an investment adviser. Fralin and Licht played key roles in the misconduct. Fralin was responsible for negotiating the fees and incorporating the false information in Taberna's Form ADVs. Licht approved the fees' collection,

123 Release, National Credit Union Administration, Morgan Stanley Agrees to Pay $225 Million to Settle NCUA's Claims (Dec. 10, 2015).

124 *New Jersey Carpenters Health Fund et al. v. Residual Capital LLC* et al., No. 1:08-cv-08781 (S.D.N.Y.).

125 *In the Matter of Taberna Capital Management, LLC, Michael Fralin, and Raphael Licht*, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 4C, 15(b) and 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, Section 9(b) of the Investment Company Act of 1940, and Rule 102(e) of the Commission's Rules on Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and Desist Order, Sec. Exch. Act Rel. No. 75814 (Sept. 2, 2015). http://www.sec.gov/litigation/admin/2015/34-75814.pdf.

oversaw Fralin's efforts to generate the fees, and failed to ensure the fees were disclosed in the ADVs.

The SEC suspended Taberna from acting as an investment adviser for three years and ordered it to pay disgorgement of $13 million, interest of $2 million, and a $6.5 million civil penalty. Fralin was barred from the industry, with the right to apply for reentry in five years, and must pay a $100,000 penalty. Licht was barred from the industry, with the right to apply for re-entry in two years, and must pay a $75,000 penalty.

The overall theme arising from these settlements involving complex financial instruments such as RMBS, LIBOR, and CDOs is that the far-reaching effects of the financial crisis are still impacting the financial institution participants in the global marketplace even more than seven years later. Litigation often responds to the economic landscape, and companies should bear this in mind with an eye toward how their potential liabilities can be shaped by the expansiveness and strength of financial meltdown.

Investment Adviser and Hedge Fund Cases

In the second half of 2015, the SEC announced several enforcement actions and related settlements with registered investment advisers, broker-dealers, their executives, and third-party vendors. These actions stemmed from various misdeeds, including conflicts of interest violations, inflating assets' values to reap higher fees, improper use of investors' assets, and misrepresenting risks to investors. The actors often made these problems worse by failing to disclose these actions, a further violation of the operative act. For violations large and small, the SEC continues to press this sector.

Failures to Disclose Conflicts of Interest

In the Matter of JPMorgan Chase Bank, N.A., and J.P. Morgan Securities, LLC

On December 18, 2015, the SEC announced a settlement with a nationally-chartered bank and its investment advisory sister entity (together, "JPMorgan") for failure to tell clients they were steering them to proprietary products to receive higher fees.[126] JPMorgan agreed to settle the SEC charges against it for $267 million. In a parallel proceeding, JPMorgan agreed to settle charges brought by the CFTC for $40 million.[127]

The SEC alleged that JPMorgan failed to disclose conflicts of interest over several years, arising from JPMorgan-managed mutual funds, private hedge funds, and third-party private hedge funds that shared fees with JPMorgan.

For example, JPMorgan created, for its clients, a risk-weighted portfolio comprised of registered funds managed by the investment advisory company, which selected the components of the portfolio. Up to 60% of the portfolio's components were proprietary JPMorgan mutual funds. The SEC alleged that JPMorgan never disclosed this conflict of interest. The order also alleged that JPMorgan did not advise its clients that lower-cost share classes were available for certain products. The CFTC order made allegations substantially similar to those made by the SEC.

JPMorgan must disgorge $127.5 million in profits, plus $11.8 million in interest, in addition to paying a $127.5 million penalty. The CFTC ordered JPMorgan to pay a civil monetary penalty of $40 million.

In the Matter of Guggenheim Partners Investment Management, LLC

On August 10, 2015, the SEC announced a settlement with an investment advisory firm ("Guggenheim") for failing to disclose a $50 million loan made by an advisory client to a Guggenheim senior executive.[128]

The SEC alleged that the executive approached the advisory client and received $50 million, which the executive used to personally participate in an acquisition made by Guggenheim's parent company. This loan created a conflict of interest, the concern being Guggenheim might place the lender's interests ahead of other clients.

According to the settlement, Guggenheim failed to disclose the loan when two other clients invested alongside the lender. Senior Guggenheim officials knew of the loan but did not inform the compliance department.

The SEC also alleged various other compliance policy and code of ethics violations, including: (i) Guggenheim employees taking unreported flights on Guggenheim private planes, a violation of the gifts and entertainment policies; (ii) failing to properly book trades, leading to Guggenheim charging asset management fees for assets it did not manage; and (iii) failing to maintain books and records.

The SEC censured Guggenheim, which was forced to pay a $20 million civil penalty.

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126 *In the Matter of JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC*, Order Instituting Administrative 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 Finding, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Sec. Act Rel. No. 9992 (Dec. 18, 2015) http://www.sec.gov/litigation/admin/2015/33-9992.pdf.

127 Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 16-05 (Dec. 18, 2015). http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfjpmorganorder121815.pdf.

128 *In the Matter of Guggenheim Partners Investment Management, LLC*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to 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, Inv. Adv. Act. Rel. No. 4163 (Aug. 10, 2015). http://www.sec.gov/litigation/admin/2015/ia-4163.pdf.

In the Matter of Fenway Partners, LLC, Peter Lamm, William Gregory Smart, Timothy Mayhew, Jr., and Walter Wiacek, CPA

On November 3, 2015, the SEC announced a settlement with a private equity firm ("Fenway") and four of its executives for failure to disclose conflicts of interest when investor assets were used to pay former firm employees and a related entity.[129]

Fenway was the investment adviser to a private equity fund ("Fund III"), which was primarily invested in various portfolio companies. The portfolio companies paid Fenway fees for providing portfolio management services (the "Monitoring Fees") and Fund III paid Fenway fees in its role as investment adviser (the "IA Fees"). The IA Fees were offset by payment of the Monitoring Fees.

In 2011, the executives caused the portfolio companies to stop paying the Advisory Fees and instead pay them to a new entity ("Consultant Co."), of which they were the principal owners. Because the offset was no longer in effect, the portfolio companies paid larger fees to Fenway.

Fenway and the executives made material omissions to Fund III investors regarding this new arrangement. In one instance, Fenway and certain of the executives asked Fund III investors to provide $4 million for a potential investment in a portfolio company's equity securities, but did not disclose that Consultant Co. would receive $1 million of these funds. In another situation, Fund III sold its interest in another portfolio company. It was not disclosed that one of the executives and two other Consultant Co. employees were part of the company's cash incentive plan; they received $15 million as a result of the sale, which reduced Fund III's returns.

The SEC censured Fenway, and the company and three executives had to pay $8.7 million in disgorgement and interest. The respondents must also pay $1.525 million in civil penalties, the majority of which is to be paid by Fenway. Fenway and two executives must also oversee a distribution fund, about $10 million, to be paid to Fund III's investors.

Misleading and Fraudulent Representations to Investors and Omissions

In the Matter of Citigroup Alternative Investments LLC and Citigroup Global Markets Inc.

On August 17, 2015, the SEC announced a settlement with two Citigroup entities (respectively, "CAI" and "CGMI") stemming from charges they defrauded investors by claiming the hedge funds in which they invested were safe and low-risk. Indeed, the funds collapsed during the financial crisis.[130]

CAI managed the hedge funds, and CGMI financial advisers sold interests in those funds to investors. Respondents raised $3 billion for the funds from 4,000 investors. From 2002 to 2008, when the funds collapsed, CGMI's financial advisers and CAI misrepresented the funds' risks, telling advisory clients that the investments were "safe," "low-risk," "bond substitutes," and suitable for traditional bond investors. The Respondents made these representations notwithstanding the funds' marketing documents, which stated they should not be viewed as bond substitutes. The SEC alleged that the Respondents encouraged clients to sell bonds and invest the proceeds in the funds.

As the financial crisis deepened, the funds began to experience margin calls and liquidity problems, but Respondents continued to represent the funds as a safe, low-risk investment. By January 2008, one of the funds' managers had already drawn up liquidation plans. As the other fund ran into trouble, its manager continued to tell investors the biggest risk to the fund was the adoption of a flat tax by the federal government.

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129 *In the Matter of Fenway Partners, LLC, Peter Lamm, William Gregory Smart, Timothy Mayhew, Jr., and Walter Wiacek, CPA*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and Desist Order, Inv. Adv. Act Rel. No. 4253 (Nov. 3, 2015). http://www.sec.gov/litigation/admin/2015/ia-4253.pdf.

130 *In the Matter of Citigroup Alternative Investments LLC* and Citigroup Global Markets Inc., Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 15(b)(4) 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. Act Rel. No. 9893 (Aug. 17, 2015). http://www.sec.gov/litigation/admin/2015/33-9893.pdf.

The SEC alleged that CAI failed to adopt and implement policies and procedures to prevent misrepresentations about the funds. In practice, the funds' managers educated the wholesalers, who educated the financial advisers. At each turn, misrepresentations about the funds were made, and those misrepresentations were relayed to the investors; CAI failed to exercise reasonable oversight here.

The SEC censured CAI and CGMI and ordered them to disgorge $140 million and pay $40 million in interest.

In the Matter of Blackstone Management Partners, L.L.C., Blackstone Management Partners III, L.L.C., and Blackstone Management Partners IV, L.L.C.

On October 7, 2015, the SEC announced a settlement with three related private equity fund advisers (together, "Blackstone") stemming from their failure to inform investors about benefits they received from accelerating monitoring fees and discounts on legal fees.[131]

Blackstone provided portfolio company monitoring services and received monitoring fees. From 2010 through March 2015, when a Blackstone portfolio company was sold (privately or through an IPO), Blackstone terminated the related services agreement and accelerated the payment of future fees. Blackstone did not disclose this to their funds and the funds' limited partners. Blackstone also received discounts for legal services, a discount the funds did not receive; Blackstone also did not disclose this information. These omissions were violations of the Advisers Act.

Under the settlement, Blackstone was required to disgorge $26.2 million and pay $2.7 million in interest to a disgorgement fund for distribution to the funds and their limited investors. Blackstone must also pay a $10 million civil penalty.

In the Matter of UBS Willow Management L.L.C. and UBS Fund Advisor L.L.C.

On October 19, 2015, the SEC announced a settlement with two UBS advisory firms for failure to disclose a change in investment strategy in a UBS closed-end fund ("Willow Fund").[132]

UBS Fund Advisor had contractual control and supervisory authority over Willow Management. Willow Management marketed Willow Fund as investing primarily in distressed debt through the purchase of credit default swaps, a strategy it pursued until 2008. By that fall, Willow Fund had transitioned from being long the positions to become a net short credit and remained short. By 2012, Willow Fund's losses in these short positions caused it to be liquidated.

During this four-year period, the SEC alleged Willow Management misrepresented to investors its actual strategy, including in its offering memoranda and offering brochures. UBS Fund Advisor was obligated to ensure Willow Management followed Willow Fund's stated investment strategy. The SEC alleged that UBS Fund Advisor was aware of the change in investment strategy but failed to ensure adequate disclosure of the change.

The SEC censured the Respondents, who were required to compensate Willow Fund investors for losses and disgorgement of $8.2 million, pay $1.4 million in interest, and pay $4.4 million in civil penalties.

Failure to Establish Policies and Procedures Preventing Dissemination or Breach of Non-Public Information

In the Matter of Wolverine Trading, LLC and Wolverine Asset Management, LLC

On October 8, 2015, the SEC announced a cease-and-desist order against related entities, a broker-dealer ("WT"), and an investment adviser ("WAM") for failure to maintain and enforce policies and procedures preventing misuse of material, nonpublic

131 *In the Matter of Blackstone Management Partners, L.L.C., Blackstone Management Partners III, L.L.C., and Blackstone Management Partners IV, L.L.C.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing a Cease-and Desist Order, Inv. Adv. Act Rel. No. 4219 (Oct. 7, 2015). http://www.sec.gov/litigation/admin/2015/ia-4219.pdf.

132 *In the Matter of UBS Willow Management L.L.C. and UBS Fund Advisor L.L.C.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Sec. Act Rel. No. 9964 (Oct. 16, 2015). http://www.sec.gov/litigation/admin/2015/33-9964.pdf.

information.[133] The SEC found that WT and WAM wrongly shared information regarding a certain exchange-traded note, TVIX.

Trading in TVIX had been suspended. During the suspension, WT shared with WAM information regarding WT's trading positions, activities, and strategies, and WAM shared with WT its intent to enter into a swap agreement and create TVIX notes. This information sharing violated existing policies and procedures. WT and WAM employees also met to discuss TVIX, which breached information barriers between them. The SEC also found that the policies and procedures were insufficient, including the lack of adequate monitoring and surveillance of potential information sharing.

The SEC censured WT and WAM. WAM was ordered to pay disgorgement and interest of approximately $400,000, and WT was ordered to pay $375,000 in civil penalties.

In the Matter of R.T. Jones Capital Equities Management, Inc.

On September 22, 2015, the SEC announced a settlement with an investment adviser ("Jones") stemming from charges that Jones failed to establish proper cybersecurity policies and procedures ahead of a breach of personally identifiable information ("PII") of 100,000 individuals, including thousands of firm clients.[134]

For several years, Jones stored its clients' and others' PII on a third-party web server without adopting policies and procedures to protect that information. In July 2013, the web server was attacked by an unknown intruder, who gained access to the data on the server, leaving the PII vulnerable to theft.

The failure to adopt the policies and procedures was in violation of the Safeguard Rule, adopted in 2000.[135] The Safeguard Rule requires all registered investment advisers to implement policies and procedures that: (i) ensure the security and confidentiality of customer records and information, (ii) protect against anticipated hazards or threats to those records, and (iii) protect against unauthorized access to the information that could lead to harm or inconvenience to the customer.

Jones has appointed an information security manager and now stores PII on its own, encrypted internal network. The SEC censured Jones and ordered it to pay a $75,000 civil penalty.

This case further reinforces the SEC's focus on cybersecurity as a priority for 2016, which in turn, requires companies to intensify their cybersecurity and Information Governance policies. Further, cybersecurity is a huge exposure item regarding class action litigations and enforcement actions for all companies, not just retail ones, because data is the lifeblood for companies – termed the new oil. It is critical for companies to recognize that the manner in which their Big Data is collected, stored, secured, sold, and used will be a constant pressure point of class actions, especially for publicly traded companies, and hence will have long-term effects on their reputation and valuation.[136]

133 *In the Matter of Wolverine Trading, LLC and Wolverine Asset Management, LLC*, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b) and 21C 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. 76109 (Oct. 8, 2015). http://www.sec.gov/litigation/admin/2015/34-76109.pdf.

134 *In the Matter of R.T. Jones Capital Equities Management, Inc.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to 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, Inv. Adv. Act Rel. No. 4204 (Sep. 22, 2015). http://www.sec.gov/litigation/admin/2015/ia-4204.pdf.

135 Rule 30(a) of Reg. S-P (17 C.F.R. § 248.30(a)).

136 *See* "Like It" or Not, Big Data Decisions Affect Business Valuations, Judy Selby and Melissa Kosack, BakerHostetler Data Privacy Monitor, (March 23, 2015).

CFTC Cases and Developments

This past fiscal year, the U.S. Commodity Futures Trading Commission ("CFTC") filed 69 enforcement actions focusing on manipulation, spoofing and fraud, compliance with regulatory requirements, and even Bitcoins. Notably, the CFTC filed and settled its first insider trading case.[137] The CFTC took a number of significant actions enforcing new authorities granted by Congress in the Dodd-Frank Act. This included enforcement of the Commodity Exchange Act's ("CEA") anti-spoofing clause, use of the CEA's anti-manipulation authority, and enforcement actions against swaps markets intermediaries. The CFTC also continued its prosecution of benchmark rate manipulation cases, imposing the largest monetary penalty in CFTC history against Deutsche Bank AG ("Deutsche Bank") for manipulation of LIBOR, and the CFTC brought and settled the first cases charging attempted manipulation of foreign exchange benchmark rates.[138] The CFTC's monetary sanctions in Fiscal Year 2015 totaled over $3.2 billion, including civil monetary penalties and restitution and disgorgement orders.[139]

The Enforcement Division of the CFTC continues to place a high priority on cooperative enforcement efforts with federal and state civil and criminal law enforcement authorities, as well as international civil and criminal authorities. In 2015, the Enforcement Division handled nearly 300 matters involving joint cooperation with federal and state authorities, and the division issued 200 requests for assistance to foreign regulators.[140] Approximately 90 percent of the CFTC's major fraud and manipulation cases involved parallel criminal proceedings.[141]

Bitcoin Litigation

In another first-of-its kind, the CFTC brought an enforcement action against an unregistered Bitcoin options trading platform operator, Coinflip, Inc., for failing to comply with the CEA and CFTC regulations.[142] The CFTC found that Coinflip, Inc. operated a facility for the trading or processing of commodity options without complying with CFTC regulations applicable to swaps. Specifically, the CFTC found that Coinflip, Inc. failed to register as a swap execution facility or as a designated contract market. In so doing, the CFTC found for the first time that Bitcoin and other virtual currencies are in fact commodities under Section 5h of the CEA. Aitan Goelman, the CFTC's Director of Enforcement, commented, "While there is a lot of excitement surrounding Bitcoin and other virtual currencies, innovation does not excuse those acting in this space from following the same rules applicable to all participants in the commodity derivatives markets."[143]

This enforcement action by the CFTC reinforces the increasing trend at the federal and even state levels regarding the regulation of Bitcoin, which we have identified in previous alerts.[144]

Spoofing, Manipulation, and Attempted Manipulation

As part of the Dodd-Frank Act, Congress provided the CFTC with new authorities to fight "spoofing," the manipulation and market-disrupting tactic defined as entering an order with the intent to cancel it before it is consummated in a complete transaction. Specifically, Section 747 of the Dodd-Frank Act amended the CEA to prohibit disruptive trading practices in futures, options, or swaps trading. Congress added Section 4c(a)(5) to the CEA, which makes it unlawful for any person to engage in any trading practice or conduct on any exchange that constitutes spoofing. Congress also amended Section 6(c) of the CEA to prohibit the employment or attempted employment of any manipulative device or contrivance with any swap or commodity trade.

In our 2015 Mid-Year Report, we highlighted that the CFTC charged Navinder Singh Sarao and his company Nav Sarao Futures Limited PLC with manipulation, attempted manipulation, and spoofing with regard to S&P 500 futures contracts over a five-year period. The CFTC argued that defendants' alleged misconduct contributed to market

137 *See supra* Section IV.

138 *See* our 2015 Mid-Year Report.

139 Commodity Futures Trading Commission, "CFTC Releases Annual Enforcement Results for Fiscal Year 2015," Rel. No. PR7274-15 (Nov. 6, 2015).

140 *Id.*

141 *Id.*

142 Commodity Futures Trading Commission, "CFTC Orders Bitcoin Options Trading Platform Operator and Its CEO to Cease Illegally Offering Bitcoin Options and to Cease Operating a Facility for Trading or Processing of Swaps without Registering," Rel. No. PR7231-15 (Sept. 17, 2015).

143 *Id.*

144 *See* "Bitcoin Investment Vehicles Beware – The SEC Is Watching," A. Mackenna Mosier and Madiha Zuberi, June 2014; "The Empire State Strikes Back – New York Proposes Rules for Virtual Currency," Aaron O'Brien and Madiha Zuberi (August 2014).

conditions that led to the "Flash Crash" on May 6, 2010.[145] Mr. Sarao was arrested in his home in London and is currently fighting extradition to the United States. According to the CFTC's complaint, Mr. Sarao netted over $40 million from his scheme.

Reporting and Trade Practice Violations

In 2015, the CFTC brought several actions charging reporting violations, including its first enforcement actions of the new Dodd-Frank Act reporting requirements for physical commodity swap positions and for real-time public reporting of swap provisions. For example, the CFTC fined Australia and New Zealand Banking Group Ltd. $150,000 for failing to submit daily large trader reports for positions in physical commodity swaps.[146] The CFTC also fined Deutsche Bank $2.5 million for failing to properly report its swap transactions, failing to diligently address and correct reporting errors, and failing to have an adequate swaps supervisory system governing its swaps reporting requirements.[147]

145 Commodity Futures Trading Commission, "CFTC Charges U.K. Resident Navinger Singh Sarao and His Company Nav Sarao Futures Limited PLC with Price Manipulation and Spoofing," Rel. No. PR7156-15 (April 21, 2015).

146 Commodity Futures Trading Commission, "CFTC Orders Australia and New Zealand Banking Group Ltd. to Pay a $150,000 Penalty for Inaccurate Large Trader Reports for Physical Commodity Swap Positions," Rel. No. PR7233-15 (Sept. 17, 2015).

147 Commodity Futures Trading Commission, "CFTC Orders Deutsche Bank AG to Pay a $2.5 Million Civil Monetary Penalty for Swaps Reporting Violations and Related Supervision Failures," Rel. No. PR7255-15 (Sept. 30, 2015).

Conflicts of Interest and Protection of Customer Funds

In 2015, the CFTC ordered JPMorgan to pay a $100 million civil monetary penalty for failure to disclose certain conflicts of interest to clients of its U.S.-based wealth management business, J.P. Morgan Private Bank.[148] Specifically, JPMorgan failed to fully disclose its preference for placing client funds in certain commodity pools or exempt pools, namely hedge funds and mutual funds managed by affiliates in exchange for undisclosed "retrocession" fees. According to the CFTC's Director of Enforcement, "Investors are entitled to know if a bank managing their money favors placing investments in its own proprietary funds or other vehicles that generate fees for the bank."[149] *(See also supra Investment Adviser and Hedge Fund Cases.)*

The CFTC also continued to bring enforcement actions aimed at the protection of customer funds. Morgan Stanley & Co. LLC, a registered FCM and a provisionally registered swaps dealer, paid a $300,000 civil monetary fine for failing to hold sufficient U.S. dollars in segregated accounts in order to meet its obligations to swaps customers.[150]

148 Commodity Futures Trading Commission, "CFTC Orders JPMorgan Chase Bank, N.A. to Pay $100 Million for Failure to Disclose Conflicts of Interest," Rel. No. PR7297-15 (Dec. 18, 2015).

149 *Id.*

150 Commodity Futures Trading Commission, "CFTC Orders Morgan Stanley & Co. LLC to Pay a $300,000 Civil Monetary Penalty for Violations of Customer Protection Rule for Cleared Swaps and Related Supervision Failures," Rel. No. PR7209-15 (Aug. 6, 2015).

Anti-Fraud Enforcement

During 2015, the CFTC filed 17 enforcement actions against persons who sought to defraud retail customers, commodity pool participants, and others.[151] For example, the CFTC ordered Mark Evan Bloom and his company North Hills Management, LLC to pay a $26 million civil monetary fine for operating a fraudulent commodity pool and misappropriating customer funds.[152] As another example, the CFTC ordered Scott M. Ross and his companies, Maize Capital Management, LLC and Maize Asset Management, LLC to pay $5.4 million in restitution and a $1.3 million civil monetary fine for fraudulent solicitation, issuing false customer account statements, and mishandling customer funds.[153]

Based on this year's developments, anti-fraud enforcement is expected to remain a core commitment of the CFTC's enforcement program.

151 Commodity Futures Trading Commission, "CFTC Releases Annual Enforcement Results for Fiscal Year 2015," Rel. No. PR7274-15 (Nov. 6, 2015).

152 Commodity Futures Trading Commission, "Federal Court in New York Imposes a $26 Million Civil Monetary Penalty against Mark Evan Bloom and his Company, North Hills Management, LLC, for Commodity Pool Fraud," Rel. No. PR7130-15 (March 3, 2015).

153 Commodity Futures Trading Commission, "Federal Court Orders Scott M. Ross and his Companies to Pay More than $6.7 Million in Restitution and a Civil Monetary Penalty for Defrauding Investors in His Commodity Pools, Mishandling Customer Funds, and Failing to Properly Register as a Commodity Pool Operator," Rel. No. PR7122-15 (Feb. 13, 2015).

Securities Policy and Regulatory Developments

In the second half of 2015, the SEC continued to work toward completing its required rulemaking under the Dodd-Frank Act. In an interview with the *Wall Street Journal*, Chairman Mary Jo White stated that she felt that the SEC was "essentially finished" with its mandated rulemaking under the Dodd-Frank Act.[154] As detailed below, during the period the SEC issued two long-awaited rulemaking developments related to executive compensation under the Dodd-Frank Act: (i) proposing rules on "clawing back" erroneously awarded incentive-based compensation from executive officers and (ii) finalizing the "Pay Ratio Disclosure Rule," which requires public companies to disclose the ratio of the compensation of its chief executive officer to the median compensation of its employees.

The SEC's other notable rulemaking focused on modernizing current regulations. This can be seen in the SEC's proposed rules updating and providing a more comprehensive approach to the regulation of investment companies' use of derivatives and its adoption of a rule that permits companies to offer and sell securities through "crowdfunding" for the first time.

SEC Proposes Clawback Rules As Required Under the Dodd-Frank Act

On July 1, 2015, the SEC, by a 3-2 vote, proposed rules requiring national securities exchanges and associations to adopt, disclose, and comply with "clawback" policies to recover from "any current and former executive officers" any incentive-based compensation the executive officers received based on financial information that was later corrected in an accounting restatement (the "Proposed Clawback Rules").[155] The SEC was directed to draft the Proposed Clawback Rules by Section 954 of the Dodd-Frank Act, which added Section 10(D) to the Exchange Act. The Proposed Clawback Rules were the SEC's final executive compensation proposal that was required under the Dodd-Frank Act.

Under the Proposed Clawback Rules, the responsibility to "claw back" excess incentive-based compensation from current and former employees is ultimately placed on the companies themselves. The Proposed Clawback Rules would apply to "all issuers" and would include emerging growth companies, smaller reporting companies, and foreign private issuers, as the SEC reads the language of Section 954 of the Dodd-Frank Act as "generally calling for a broad application of the mandated listing standards." Incentive-based compensation potentially subject to recovery includes compensation that is granted, earned, or vested based wholly, or in part, on the attainment of a "financial reporting measure," with the Proposed Clawback Rules providing a nonexclusive list of financial metrics that would qualify.

Section 954 of the Dodd-Frank Act does not define "executive officer." The Proposed Clawback Rules, however, take an expansive view in defining executive officers, as they apply to "all executive officers of the issuer," as long as the executive officer served in his or her position at any time during the performance period related to the incentive-based compensation. The definition of "executive officer" in the Proposed Clawback Rules is modeled on the definition of "executive officer" under Section 16 of the Exchange Act and would include, in addition to the president, principal financial officer, and principal accounting officer, any vice president in charge of an official business unit or any officer "who performs a policy-making function" for the issuer. Further, the Proposed Clawback Rules are essentially a "no-fault" policy, as they are to be applied "without regard to an executive officer's responsibility for preparing the issuer's financial statements."

The Proposed Clawback Rules provide that an issuer's recovery policy must apply to any incentive-based compensation received by current or former executive officers during the three completed fiscal years immediately preceding the date on which the issuer is "required" to prepare a restatement to correct a "material" error. An

154 Dennis K. Berman, *Mary Jo White Explains the New SEC Rules*, *Wall Street Journal* (Nov. 24, 2015), http://www.wsj.com/articles/mary-jo-white-explains-the-new-sec-rules-1448302777.

155 Proposed Rule, *Listing Standards for Recovery of Erroneously Awarded Compensation*, Release Nos. 33-9861, 34-75342, File No. S7-12-15 (July 1, 2015), http://www.sec.gov/rules/proposed/2015/33-9861.pdf; Press Release, United States Securities and Exchange Commission, "SEC Proposes Rules Requiring Companies to Adopt Clawback Policies on Executive Compensation," Rel. No. 2015-136 (July 1, 2015), http://www.sec.gov/news/pressrelease/2015-136.html.

issuer is to pursue recovery of improperly awarded incentive-based compensation "reasonably promptly." Issuers would have very little discretion in deciding whether to pursue recovery of erroneously awarded compensation, as they can only decline to pursue a recovery to the extent it would be "impracticable," essentially meaning the direct costs of enforcing recovery would exceed the recoverable amounts or would violate a foreign company's home country laws. In order to determine impracticability, the issuer must still follow the mandated recovery process to conclude it is impracticable. Further, an issuer would not be permitted to indemnify or reimburse executives for recovered compensation.

As discussed in a previous Executive Alert on December 16, 2015, in the months since the SEC approved the Proposed Clawback Rules, various parties have raised a number of issues related to the Proposed Clawback Rules. These issues include the expansive definition of executive officer, the "no-fault" aspect of the Rules, what would be considered a "material" error in an issuer's financial statements warranting an accounting restatement, and what "reasonably promptly" means in connection with an issuer bringing a clawback action. Chairman Mary Jo White indicated that she was "very interested" in receiving public comment on the Proposed Clawback Rules and that there may be complexities with respect to putting the Rules into practice.[156] Accordingly in their final form, the Proposed Clawback Rules may ultimately address some of these issues.

SEC Adopts Pay Ratio Disclosure Rule Required by the Dodd-Frank Act

On August 5, 2015, the SEC adopted a final rule that requires public companies to disclose the ratio of the "annual total compensation" of its chief executive officer to the median of the "annual total compensation" of its employees (the "Pay Ratio Disclosure Rule").[157] The Pay Ratio Rule was mandated by Section 953(a) of the Dodd-Frank Act. The Rule will require disclosure of the CEO pay ratio in registration statements, proxy and information statements, and annual reports that call for executive compensation disclosure. Companies will be required to provide disclosure of their pay ratios for their fiscal year beginning on or after January 1, 2017. The Pay Ratio Rule does not apply to smaller reporting companies, emerging growth companies, foreign private issuers, or registered investment companies.

The Pay Ratio Rule provides flexibility to companies in selecting a methodology to identify their median employee and that employee's compensation, allowing each company to select a methodology based on its "own facts and circumstances." For instance, a company could use its total employee population or a statistical sampling of that population and/or other reasonable methods. A company is required to calculate the annual total compensation for its median employee using the same rules that apply to the CEO's compensation, with "total annual compensation" meaning total compensation for the last completed fiscal year, calculated using the definition of "total compensation" in existing compensation rules, namely Item 402(c)(2)(x) of Regulation S-K. A company is required to describe the methodology used to identify the median employee and any material assumptions, adjustments, or estimates used to identify the median employee or to determine annual total compensation. A company is permitted to identify its median employee once every three years, unless there has been a change in its employee population or employee compensation arrangements that it reasonably believes would result in significant changes to its pay ratio disclosure.

SEC Proposes Rule Regarding Use of Derivatives by Registered Investment Companies

On December 11, 2015, the SEC voted to propose a new rule, Rule 18f-4, under the Investment

156 Chairman Mary Jo White, Statement at an Open Meeting on Dodd-Frank Act "Clawback" Provision (July 1, 2015), available at http://www.sec.gov/news/statement/listing-standards-for-clawing-back-erroneously-awarded-executive.html.

157 *Final Rule, Pay Ratio Disclosure*, Securities Act Release 33-9877, Release No. 34-75610, File No. S7-07-13 (July 1, 2015), http://www.sec.gov/rules/final/2015/33-9877.pdf; Press Release, United States Securities and Exchange Commission, "SEC Adopts Rule for Pay Ratio Disclosure," Rel. No. 2015-160 (Aug. 5, 2015), http://www.sec.gov/news/pressrelease/2015-160.html.

Company Act of 1940 (the "Proposed Derivative Rules"), which changes the way it regulates the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and business development companies.[158] The SEC stated that the Proposed Derivative Rules were designed to "provide a modernized, more comprehensive approach to the regulation of funds' use of derivatives." The Proposed Derivative Rules place restrictions on investment companies' use of derivatives and require the investment companies to implement risk management measures in order to provide better protection for investors.

Specifically, the Proposed Derivative Rules would require a fund that engages in derivatives transactions to comply with one of two alternative portfolio limitations, which would limit the amount of leverage the fund may obtain through derivatives. Under the "Exposure-Based Portfolio Limit," a fund would be required to limit its aggregate exposure to 150 percent of the fund's net assets. A fund's "exposure" would generally be calculated as the aggregate notional amount of its derivatives transactions, together with its obligations under financial commitment transactions and certain other transactions. Under the "Risk-Based Portfolio Limit," a fund would be permitted to obtain exposure up to 300 percent of the fund's net assets, provided the fund satisfies a risk-based test. This test is designed to determine whether the fund's derivatives transactions, in aggregate, result in a fund portfolio that is subject to less market risk than if the fund did not use derivatives.

The Proposed Derivatives Rules would also require a fund to segregate assets in connection with derivative transactions in an amount designed to enable the fund to meet its obligations, including under stressed conditions. The Rules would require segregated assets to be "qualifying coverage assets," which would be limited to cash and cash equivalents or, with respect to any derivatives transaction under which the fund may satisfy its obligations by delivering a particular asset, that particular asset. The amount a fund would be required to segregate would be required to meet both the "mark-to-market coverage amount," meaning the amount the fund would pay if it exited the derivatives transaction at the time of the determination, and the "risk-based coverage amount," which is a reasonable estimate of the potential amount the fund would pay if the fund exited the derivatives transaction under stressed conditions.

Additionally, any fund that engages in more than a limited number of derivatives transactions or uses complex derivatives would be required to establish a formalized derivatives risk management program consisting of certain components administered by a designated derivatives risk manager approved by the fund's board of the directors. The fund's Board of Directors would be required to review and approve the derivatives risk management program.

SEC Adopts a Rule to Permit Offering and Selling Securities via Crowdfunding

On October 30, 2015, the SEC adopted final rules under the Jumpstart Our Business Startups Act (the "JOBS Act") permitting companies to offer and sell securities through "crowdfunding" ("Regulation Crowdfunding").[159] The SEC noted that crowdfunding is a "new and evolving method of using the Internet to raise capital," defining it as when an individual or entity "seeks small individual contributions from a large number of people." Crowdfunding has not been used previously to offer and sell securities because offering a share of the financial returns or profits from business activities would trigger the applicable federal securities laws. These laws would require registration with the SEC unless an exemption is available. Title III of the JOBS Act created a federal exemption under the securities laws so that crowdfunding could be used to offer and sell securities.

158 *Proposed Rule, Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release 33-9877, File No. S7-24-15 (Dec. 11, 2015), http://www.sec.gov/rules/proposed/2015/ic-31933.pdf; Press Release, United States Securities and Exchange Commission, "SEC Proposes New Derivatives Rules for Registered Funds and Business Development Companies," Rel. No. 2015-276 (Dec. 11, 2015), http://www.sec.gov/news/pressrelease/2015-276.html.

159 *Final Rule, Crowdfunding*, Release 33-9877, File Nos. 33-9974, 34-76324, File No. S7-09-13 (Oct. 30, 2015), http://www.sec.gov/rules/final/2015/33-9974.pdf; Press Release, United States Securities and Exchange Commission, "SEC Adopts Rules to Permit Crowdfunding," Rel. No. 2015-249 (Oct. 30, 2015), http://www.sec.gov/news/pressrelease/2015-249.html.

Under Regulation Crowdfunding, individuals are permitted to invest in securities-based crowdfunding transactions subject to certain investment limits. The Rules also limit the amount of money an issuer can raise using the crowdfunding exemption, impose disclosure requirements on issuers for certain information about their business and securities offering, and create a regulatory framework for the broker-dealers and funding portals that facilitate the crowdfunding transactions.

Specifically, Regulation Crowdfunding permits a company to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period. Individual investors, over a 12-month period, would be able to invest in the aggregate across all crowdfunding offerings either: the greater of up to $2,000 or 5 percent of the lesser of their annual income or net worth if their annual income or net worth is less than $100,000, or 10% of the lesser of their annual income or net worth if their annual income or net worth are more than $100,000. During a 12-month period, the aggregate amount of securities sold to an investor through crowdfunding offerings may not exceed $100,000. Securities purchased in a crowdfunding transaction generally cannot be resold for one year.

A company conducting a crowdfunding offering under Regulation Crowdfunding must file certain information with the SEC, along with providing this information to investors and the intermediary facilitating the offering. The company is required to disclose, among other things, the company's financial condition, a description of the business and use of the proceeds from the offering, and details related to the pricing of the securities.

Under Regulation Crowdfunding, a funding portal is required to register with the SEC on a new Form Funding Portal and become a member of a national securities association. There are numerous other requirements for intermediaries under the Rule, including that they provide investors with educational materials explaining the process for investing on the platform and take measures to reduce the risk of fraud.

What to Watch in 2016

Reflecting on 2015 and looking toward the upcoming months of 2016, we will be watching closely to see how high-profile cases such as *Halliburton* and *Newman* continue to impact the landscape of securities litigation. We will also be analyzing the import of the SEC's focus on internal cultures of incentivized compliance and internal reporting, as well as the significant systemic risk of cybersecurity. Finally, U.S. Supreme Court Justice Antonin Scalia's sudden passing will have ripple effects on pending cases, issues, and the types of cases for which the Supreme Court will grant certiorari, throughout 2016 and for many years to come.

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