2015 Mid-Year Securities Litigation and Enforcement Highlights

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Welcome to the 2015 Mid-Year 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 of interest to sophisticated general counsel, chief compliance officers, compliance departments, legal departments, and members of the securities and commodities industries at financial institutions, private investment funds, and public companies.

We issue this Securities Litigation and Enforcement Highlights report at mid-year and shortly after year-end. We hope you find the information and commentary useful, and we welcome your comments and suggestions. We also encourage you to contact any of our 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 the United States Supreme Court review of the scope of Section 11 of the Securities Act of 1933 ("Securities Act"), the duty of 401(k) trustees to monitor plan investments, and federal agency discretion to significantly modify interpretive rules without a notice and comment period (the Supreme Court also granted certiorari to resolve a circuit split on whether Section 27 of the Securities Exchange Act of 1934 ["Exchange Act"] confers independent federal jurisdiction);

- ***Securities law cases***, including the United States Court of Appeals for the First and Second Circuits' examination of scienter and materiality under Sections 10(b) and 20(a) of the Exchange Act, proof of loss causation and forward-looking statements under Rule 10b-5, litigation under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), and challenges to the SEC's use of administrative proceedings under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act");

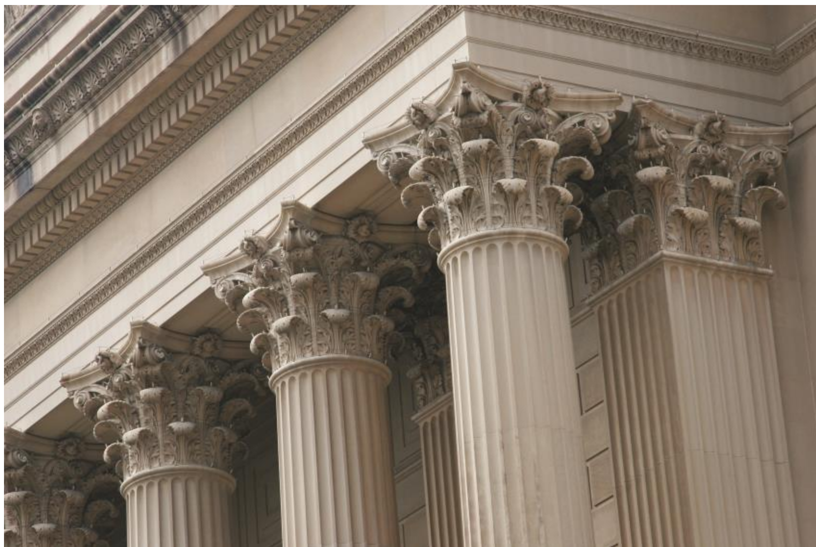
- ***Insider trading cases***, including the impact of the United States Court of Appeals for the Second Circuit's decision in *United States v. Newman* and other recent, noteworthy insider trading cases;

- ***Investment adviser and hedge fund cases***, including enforcement actions by the United States Securities and Exchange Commission ("SEC") relating to misappropriation of client assets, improper valuations, and conflicts of interest;

- ***Commodities and futures regulation and cases***, including continued efforts to curtail spoofing and interest rate manipulation;

- ***Securities policy and regulatory developments***, including the adoption of rules by the SEC relating to modernization of data reporting, the implementation of diversity standards, and cybersecurity; and

- ***The SEC's Cooperation and Whistleblower Programs***, including the first award in an anti-retaliation whistleblower case, an award to a compliance officer, and additional settlements pursuant to the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC Initiative").



I. Supreme Court Cases Review

The United States Supreme Court issued three notable securities and regulatory enforcement-related decisions in the first half of 2015, relating to (i) when statements of opinion in a registration statement can give rise to liability under Section 11 of the Securities Act, (ii) the ongoing obligation that ERISA plan fiduciaries have to monitor plan investments, and (iii) the rulemaking process for changes to interpretive rules issued by federal regulatory agencies.

The Supreme Court has also granted certiorari in a case regarding the proper interpretation of Section 27 of the Exchange Act, relating to federal jurisdiction over certain securities actions.

The Supreme Court Limits Liability Arising From False Statements of Opinions in *Omnicare*

As we discussed in a previous Executive Alert, on March 24, 2015, the Supreme Court released its decision in *Omnicare Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, holding that incorrect statements of opinion in a registration statement do not give rise to liability under Section 11 of the Securities Act unless the statement of opinion was not held sincerely or contained an embedded statement of untrue fact.[1] Additionally, the Court held that statements of opinion that omitted material facts also could give rise to liability if those facts conflict with what a reasonable investor, reading the statement fairly and in context, would take from the statement itself.

At issue in *Omnicare* were two statements made by Omnicare Inc., a pharmacy services provider, in its registration statement. The first statement was "[w]e believe our contract arrangements . . . and our pharmacy practices are in compliance with applicable federal and state laws." The second statement was "[w]e believe that our contracts with pharmaceutical manufacturers are legally and economically valid." The respondents, pension funds that purchased Omnicare stock, brought suit under Section 11, which generally prohibits material misstatements or omissions in registration statements.

Notably, unlike claims brought under Section 10 of the Securities Act and Rule 10b-5, Section 11 does not contain a scienter requirement. The respondents argued that the statements were materially false and omitted material facts. Specifically, the respondents cited lawsuits the federal

[1] *Omnicare Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S.Ct. 1318 (2015).

government filed against Omnicare for asserted violations of anti-kickback laws, and asserted that the earlier statements were incorrect. Notably, the respondents did not assert that Omnicare knew the statements were in fact false at the time they were disclosed in the registration statement.

In reversing the district court's dismissal of the complaint, the United States Court of Appeals for the Sixth Circuit found that even though the statements at issue were "opinions" rather than "hard facts," the respondents need only allege that the stated belief was objectively false, and did not have to plead that anyone at Omnicare disbelieved the opinion at the time it was expressed.[2] The Sixth Circuit's holding conflicted with decisions by the United States Courts of Appeal for the Second and Ninth Circuits, which had dismissed Section 11 claims where the plaintiff had not pled subjective falsity—i.e., that the issuer knew the statement to be false at the time it made the statement.[3]

The Supreme Court vacated the Sixth Circuit's decision, and issued an opinion resolving the split between the circuits by essentially taking a middle path between the Sixth Circuit's objective falsity standard and the Second and Ninth Circuits' subjective falsity standard. The majority opinion held that for a material misstatement of opinion to be actionable under Section 11, the statement either had to be made with the speaker's knowledge of its falsity, or had to contain an embedded statement of untrue fact. In addition, the Court held that for a material omission in an opinion statement to be actionable under Section 11, the omitted facts need to conflict with what a reasonable investor, taking the statement fairly and in context, would take from the statement itself. The Court remanded the case to the lower courts for further proceedings consistent with its decision.

The Supreme Court's majority opinion also set forth a series of hypotheticals to illustrate its holding.[4] First, the Court stated that if a CEO declared, "I believe the TVs we manufacture have the highest resolution on the market," and sincerely believed it at the time, she could not be held liable for a false statement of fact—even if she afterward discovered that a competitor had introduced a higher-resolution TV a month before. This is because the words "I believe" transformed her statement into one of opinion and admitted the possibility that her statement could later prove erroneous. However, if the CEO knew that the competitor had introduced a higher-resolution TV at the time the statement was made, Section 11 would subject the issuer to liability (assuming the misstatement was material). Second, the Court stated that if a CEO stated, "I believe our TVs have the highest resolution available because we use a patented technology to which our competitors do not have access"—but in fact, the company did not use a patented technology—this would be an embedded statement of untrue fact that could also give rise to a Section 11 claim. Third, in the context of omissions, the Court stated that a CEO's statement "We believe our conduct was lawful" could give rise to liability if the CEO did not consult with a lawyer before issuing the statement, and again, the omission was material because the Supreme Court explained that in such a situation a reasonable investor, taking the statement fairly and in context, might have expected the CEO to seek legal advice before making such a statement.

The *Omnicare* decision is critical to issuers, directors, underwriters, accountants, and other actors covered by Section 11. It provides guidance regarding Section 11 claims relating to statements of opinion, and should limit the scope of Section 11 by forcing plaintiffs to specifically plead—and ultimately prove—that statements of belief in registration statements were known by the speaker to be false at the time they were made, contained embedded untrue facts, or contained unreasonable

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[2] *Ind. State Dist. Council of Laborers & HOD Carriers Pension & Welfare Fund v. Omnicare, Inc*., 719 F.3d 498 (6th Cir. 2013).

[3] *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 112 (2d Cir. 2011); *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156, 1162 (9th Cir. 2009).

[4] *Omnicare*, 135 S.Ct. at 1326-1330.

omissions. As the Court noted, Section 11 is not "an invitation to Monday morning quarterback an issuer's opinions" by finding liability for honest statements of opinion, which, with the benefit of hindsight, eventually turn out to be false. At the same time, by rejecting the pure subjective falsity standard adopted by the Second and Ninth Circuits, the Court left the door open for plaintiffs who do not have proof of subjective falsity at the pleading stage to assert Section 11 claims based on arguments regarding omissions or embedded untrue facts.

The Supreme Court Holds That 401(k) Plan Trustees Have a Continuing Duty to Monitor Plan Investments

The Supreme Court issued a recent decision of keen interest to any employer offering a 401(k) plan to its employees, or any market participant that operates or services such a plan. In *Tibble v. Edison Int'l*, the Court issued a unanimous opinion holding that 401(k) plan trustees have a continuing duty—separate and apart from the duty to exercise prudence in selecting investments at the outset—to monitor plans and remove imprudent plan investments.[5]

In *Tibble*, the petitioners were beneficiaries of the 401(k) plan offered by Edison International. In a lawsuit brought in 2007, the petitioners alleged that Edison International violated its fiduciary duty with respect to three mutual funds added to the plan in 1999 and three mutual funds added to the plan in 2002, because identical, lower-cost options were available. Because ERISA requires a breach of fiduciary duty claim to be filed no more than six years after the breach,[6] the district court held that the petitioners' claims as to the 1999 funds were untimely, a decision that the United States Court of Appeals for the Ninth Circuit affirmed.[7]

On May 18, 2015, the Supreme Court vacated the Ninth Circuit's opinion, issuing a unanimous opinion holding that the petitioners' claims as to the 1999 funds were not time barred. The Court noted that an ERISA fiduciary's duty is derived from the common law of trusts. Moreover, under trust law, a trustee has both a duty to exercise prudence in selecting investments at the outset as well as a continuing duty to monitor trust investments and remove imprudent ones. The Court thus remanded the case to the lower courts to consider the petitioners' claims in light of this continuing obligation.

The Court offered little guidance for what a plan trustee's ongoing obligation to monitor fund investments actually entails. The Court stated that it was up to the lower courts to determine whether the trustee's on going responsibility required a review of the contested mutual funds and, if so, what kind of review was required. The Court noted that ERISA fiduciaries must discharge their responsibilities "with the care, skill, prudence, and diligence" that a prudent person "acting in a like capacity and familiar with such matters" would use, and stressed the importance of considering analogous trust law.[8] The decision signals that the development of further case law on this issue will occur through litigation brought by plan participants.

[5] *Tibble v. Edison Int'l*, 135 S.Ct. 1823 (2015).

[6] 29 U.S.C. § 1113.

[7] *Tibble v. Edison Int'l*, 639 F. Supp.2d 1074 (C.D. Cal. 2009), *aff'd* 729 F.3d 1110 (2013).

[8] *Tibble,* 135 S. Ct. at 1829 (citing 29 U.S.C. § 1104(a) (1)).

The Supreme Court Finds That Federal Agencies Can Significantly Modify Existing Interpretive Rules Without First Providing Notice and an Opportunity for Comment

The Supreme Court issued a decision altering the procedures by which federal agencies can modify existing interpretive rules, granting additional discretion to regulators such as the SEC and Commodity Futures Trading Commission ("CFTC"). On March 9, 2015, the Court held in *Perez v. Mortgage Bankers Ass'n* that agencies could modify existing interpretive rules without having to first undertake the notice-and-comment process—even if the new interpretation deviates significantly from the agency's previously adopted interpretation.[9]

In *Perez,* the Supreme Court's majority opinion overturned the United States Court of Appeals for the D.C. Circuit's decision in *Paralyzed Veterans of America v. D.C. Arena L.P.*[10] *Paralyzed Veterans* had held that an agency must use the notice-and-comment process called for by the Administrative Procedure Act ("APA") before it could issue a new interpretation of a regulation that deviated significantly from a previously adopted interpretation. The Supreme Court held that *Paralyzed Veterans* was inconsistent with the plain language of Section 4 of the APA, which exempted interpretive rules—as opposed to legislative rules—from the notice-and-comment process.[11] The Supreme Court's majority decision noted that interpretive rules, unlike legislative rules, "do not have the force and effect of law" and are instead "issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers." Further, the Court noted that interpretive rules issued by agencies could be challenged in court and set aside if arbitrary and capricious. The Court reasoned that the APA does not require an agency to go through the formal notice-and-comment procedure before modifying an interpretive rule.

The decision is significant because it overturns a long-standing D.C. Circuit precedent and grants additional leeway to federal agencies, including those in the securities and financial services arena, to craft interpretive rules without public comment (or prior public notice) and impose them on regulated parties.

Of additional note, Justices Alito, Scalia, and Thomas each authored separate concurring opinions in *Perez*. These justices stated their agreement with the majority opinion as a matter of statutory interpretation, but expressed concern that the Court's existing precedents created an overly deferential standard for judicial review of agency-created interpretive rules. The concurring opinions suggest that these justices may be receptive to a future challenge to the line of precedent that provides deference to agency interpretations of ambiguities in the agency's own regulations.[12]

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[9] *Perez v. Mortgage Bankers Ass'n*, 135 S.Ct. 1199 (2015).

[10] *Paralyzed Veterans of America v. D.C. Arena L.P.*, 117 F.3d 579 (D.C. Cir. 1997).

[11] *Perez*, 135 S.Ct. at 1206 (citing 5 U.S.C. § 553 (b) (A)).

[12] *See Auer v. Robbins*, 519 US. 452, 461 (1997) (citing *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945)).

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

On June 30, 2015, the Supreme Court granted certiorari in *Merrill Lynch v. Manning* on the issue of whether Section 27 of the Exchange Act provides federal jurisdiction over state law claims seeking to establish liability based on violations of the Exchange Act or its regulations, or seeking to enforce duties created by the Exchange Act or its regulations.[13] Section 27 provides that the 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]."[14]

The plaintiffs brought suit in New Jersey state court, alleging that Merrill Lynch and other financial institutions had engaged in manipulative, "naked" short selling of shares of a stock held by the plaintiffs, and consequently caused them harm by driving the price of the shares down. The complaint was brought under New Jersey RICO and common law, but made extensive reference to the SEC's Regulation SHO, which specifies the circumstances under which naked short sales are permissible. The defendants sought to remove the lawsuit to federal court. The United States Court of Appeals for the Third Circuit ruled in the plaintiffs' favor, finding that removal to federal court was not appropriate under general principles of federal question jurisdiction and that Section 27 conferred no substantive grant of federal jurisdiction beyond that contemplated by other federal laws.[15] In so ruling, the Third Circuit noted the existence of a circuit split on the issue.[16] The United States Court of Appeals for the Third and Second Circuits have concluded that Section 27 does not create federal jurisdiction over actions within its scope unless there is another independent basis for federal jurisdiction, while the United States Court of Appeals for the Fifth and Ninth Circuits have concluded that the section can confer independent federal jurisdiction to resolve issues relating to the provisions of the Exchange Act.[17] In their petition for certiorari, the petitioners stressed the Exchange Act's central objective of creating a single, nationwide system of uniform securities regulation, and argued that allowing different state courts to effectively interpret federal securities law would disrupt this objective.[18]

The Supreme Court's anticipated ruling in *Merrill Lynch* will be significant because it is expected to clarify the proper jurisdictional forum for actions which are brought under state law but which involve asserted violations of, or liabilities and duties created by, the Exchange Act and its related regulations.

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[13] *Merrill Lynch v. Manning*, No. 14-1132, 2015 WL 1228591 (June 30, 2015) (granting cert.).

[14] 15 U.S.C. § 78aa(a).

[15] *Manning v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 772 F.3d 158 (3d Cir. 2014).

[16] *Id.* at 166-167.

[17] *See* Petition for a Writ of Certiorari, *Merrill Lynch v. Manning*, No. 14-1132, 2015 WL 1223714, at *13-*19 (Mar. 17, 2015).

[18] *Id.* at *3-*4.

II. Securities Law Cases

This first half of 2015 has seen notable securities law decisions outside the Supreme Court. Since January, courts in the United States Court of Appeals for the First, Second, Seventh, and Eleventh Circuits have issued decisions with potentially far-reaching implications for securities litigation.

Proof of Loss Causation and Misleading Statements Under Rule 10b-5

Glickenhaus & Co. v. Household International, Inc.

On May 21, 2015, the United States Court of Appeals for the Seventh Circuit further defined the elements of violations of Rule 10b-5. In *Glickenhaus & Co. v. Household International, Inc.*, the court *reversed* a $2.46 billion judgment against HSBC, finding that the plaintiffs failed to offer adequate proof of loss causation and that there were errors in the jury instructions based on what it means to “make” a false statement violation of Rule 10b-5. The defendants in a securities fraud class action appealed a $2.46 billion damage award given to the plaintiffs by the lower court, broadly based on an alleged failure to prove loss causation as required under Rule 10b-5.[19] The class action plaintiffs alleged that Household International Inc., a consumer lender, and its executives on “numerous occasions” had “misrepresented its lending practices, delinquency rates, and earnings from credit-card agreements.” The Seventh Circuit found merit in two of the defendants’ arguments on appeal: (i) alleged flaws in the plaintiffs’ damages expert’s loss causation model, and (ii) alleged errors in the jury instructions based on what constituted “making” the misrepresentations at issue.

As for loss causation, the plaintiffs were required to “establish that the price of the securities they purchased was ‘inflated’—that is, it was higher than it would have been without the false statements—and that it declined once the truth was revealed.” To do so, the plaintiffs’ expert used two models: a specific-disclosure model, which “identif[ies] each major disclosure event and then measure[s] the disclosure’s effect on the stock price on that specific day,” and a more complex “leakage” model, which “calculates every difference, both positive and negative, between the stock’s predicted returns . . . and the stock’s actual returns during the disclosure period” and assumes that the total sum of the residual returns is the effect of the disclosures. The court found

[19] *Glickenhaus & Co. v. Household Int’l, Inc.*, No. 13-3532, 787 F.3d 408 (7th Cir. May 21, 2015).

that the leakage model, ultimately adopted by the jury, did not account for "firm-specific, non-fraud-related information [which] may have affected the decline in Household's stock price during the relevant period."

As for what it means to be the "maker" of a false statement in violation of Rule 10b-5, the court referred to the Supreme Court's decision in *Janus Capital Group Inc. v. First Derivative Traders*, which was entered after the first phase of the *Household International* trial. *Janus* specified that "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[20] Following the *Janus* ruling, the defendants unsuccessfully moved the district court for a new trial, arguing that a jury instruction directing the jury to find that someone violated Rule 10b-5 if they "approved, or furnished information to be included in a false statement of fact," was a misstatement of the law. The Seventh Circuit disagreed with the district court's finding that the *Janus* holding "applied only to legally independent third parties (like the investment adviser in Janus itself), not corporate insiders like the individual defendants." The Seventh Circuit found the district court's limitation to be erroneous, and found that the jury instruction in the case widened the definition of "maker of a statement" beyond what *Janus* permitted. As a result, the Seventh Circuit remanded the case for a new trial.

Scienter and the Scope of Wrongdoing in Securities Fraud Claims

Two recent decisions emphasize the importance of properly pleading materiality and scienter when bringing securities law claims.

Mortgage-Backed Securities: *Stratte-McClure v. Morgan Stanley*

On January 12, 2015, the United States Court of Appeals for the Second Circuit decided *Stratte-McClure v. Morgan Stanley,* a putative securities fraud class action under Sections 10(b) and 20(a) of the Exchange Act.[21] In *Stratte-McClure*, the court held that a company's failure to disclose a known trend or uncertainty in its Form 10-Q filings, as required by Item 303 of SEC Regulation S-K, can give rise to liability under Section 10(b) of the Exchange Act if it is material.

The plaintiffs had appealed the dismissal of their action based on allegations that Morgan Stanley and six of its present and former officers had made material misstatements and omissions regarding certain positions Morgan Stanley held in subprime residential-mortgage-backed securities "in an effort to conceal Morgan Stanley's exposure to and losses from the subprime mortgage market." These actions allegedly inflated the stock price and caused the plaintiffs "to suffer financially when the market learned the truth about Morgan Stanley's exposure and losses."

The Second Circuit agreed with the plaintiffs that Item 303 of Regulation S - K, 17 C.F.R. § 229.303(a)(3)(ii) "imposes disclosure requirements on companies filing SEC-mandated reports, including quarterly Form 10-Q reports," and that "Item 303's affirmative duty to disclose in Form 10-Qs can serve as the basis for a securities fraud claim under Section 10(b)." However, the court also noted that "[t]he failure to make a required disclosure under Item 303 . . . is not by itself sufficient to state a securities claim under Section 10(b)," as only material omissions are actionable. The court therefore held that the plaintiffs would need to plead "an omission of material information that is necessary to make" the Form 10-Qs "not misleading," admitting its conclusion was at odds with a 2014 decision in the United States Court of Appeals for the Ninth Circuit holding that Item 303's disclosure duty was not actionable under Section 10(b).

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[20] *Id*. at 424 (quoting *Janus Capital Group Inc. v. First Derivative Traders*, 131 S.Ct. 2296, 2302 (2011)).

[21] *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015).

While the Second Circuit ultimately held that the plaintiffs had alleged a material omission in Morgan Stanley's failure to report on the deteriorating subprime mortgage market, the court also concluded the plaintiffs had failed to plead sufficient scienter. To do so, the plaintiffs needed to specifically plead that the defendants "were at least consciously reckless" in failing to provide adequate Item 303 disclosures. Instead, the complaint was "silent about when [Morgan Stanley] employees realized that the more pessimistic assessments of the market were likely to come to fruition and they would be unable to reduce" the securities positions at issue. Because the complaint pled that the defendants were "at worst negligent" in failing to release the information at issue, the court found the complaint failed to establish scienter and affirmed its dismissal.

Fire and Police Pension Association of Colorado v. Abiomed, Inc.

On February 6, 2015, the United States Court of Appeals for the First Circuit issued its decision in *Fire and Police Pension Association of Colorado v. Abiomed, Inc.*, affirming the lower court's dismissal of the plaintiffs' claims because the plaintiff-investors failed to allege the medical device maker had the intent to trick investors when it said company policy was to avoid off-label marketing, when in fact the company was heavily promoting off-label uses for a heart pump.[22] The court began its opinion with the pronouncement that "[n]ot all claims of wrongdoing by a company make out a viable claim that the company has committed securities fraud."

In *Abiomed*, the plaintiffs had alleged that Abiomed, Inc., and two of its officers had committed securities fraud in violation of, *inter alia*, Sections 10(b) and 20(a) of the Exchange Act and SEC Rule 10b-5, by falsely claiming company policy was to avoid off-label marketing and then downplaying the significance of a subsequent investigation by the Food and Drug Administration ("FDA"). The district court dismissed these claims, and the United States Court of Appeals for the First Circuit affirmed and denied leave to amend, finding that the plaintiffs had "failed to plead facts giving rise to a cogent and compelling inference of scienter, as is required under the Private Securities Litigation Reform Act of 1995."

As the First Circuit detailed, "[s]cienter is a mental state embracing intent to deceive, manipulate, or defraud" and "[a]n inference of scienter is strong if a reasonable person would deem it cogent and at least as compelling as any opposing inference one could draft from the facts alleged." Although the plaintiffs did allege that Abiomed and its officers participated in widespread off-brand marketing and an FDA inquiry resulted, their complaint did not specify how this amounted to an intent to deceive, manipulate, or defraud investors in violation of securities laws. In fact, Abiomed had "promptly disclosed" the warning letter received from the FDA and "did not promise a positive resolution" that its marketing would be found lawful. Noting that mere negligence and corporate mismanagement do not give rise to a private cause of action under Rule 10b-5, the court found in favor of Abiomed and awarded the company its costs.

Litigation Under SLUSA*: In re Harbinger Capital Partners Fund Investor Litigation*

As discussed in a previous Executive Alert, on March 30, 2015, the United States District Court for the Southern District of New York in *In re Harbinger Capital Partners Fund Investor Litigation* dismissed with prejudice the putative investor class action against Harbinger Capital Partners, LLC, *et al.,* under SLUSA.[23] The class action plaintiffs' state law claims originally centered on alleged fraud and negligent misrepresentation to investors with respect to Harbinger's acquisition of SkyTerra Communications Inc., which Harbinger subsequently took private and renamed Lightsquared Inc. Previously, in 2013, the court had found that SkyTerra transactions fell within the

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[22] *Fire & Police Pension Ass'n of Colo. v. Abiomed, Inc.*, 778 F.3d 228 (1st Cir. 2015).
[23] *In re Harbinger Capital Partners Fund Investor Litig.*, No. 12-cv-1244 (AJN), 2015 WL 1439520 (S.D.N.Y. Mar. 30, 2015).

purview of SLUSA. However, Lightsquared fell outside of SLUSA's "covered securities." Thus, in an attempt to revive the class action, the plaintiffs amended their complaint to raise state law claims centering on their allegations related to the later company, Lightsquared.

As summarized by the court, the defendants argued that the plaintiffs' "allegations of fraud and misrepresentation arising while Lightsquared was a private, uncovered security are inevitably intertwined with their allegations regarding the [Harbinger] Funds' purchase of SkyTerra—and thus that the alleged fraud was perpetrated 'in connection with the purchase of covered SkyTerra securities."[24] The court agreed, finding that—despite "artful pleading" by the plaintiffs—the state law claims related to Lightsquared were also precluded under SLUSA. As the court noted, the court "cannot turn a blind eye to allegations that would connect Defendants' fraud to a covered security, and the substance of the facts related to those allegations, simply because Plaintiffs ask the court to do so."[25]

Regulatory Securities Law Cases

The Dodd-Frank Act and the SEC's Administrative Enforcement Powers

In 2010, the Dodd-Frank Act expanded the SEC's ability to bring civil monetary proceedings for violations of the Exchange Act against "any person," whether registered or unregistered with the SEC, in a proceeding before a SEC-hired administrative law judge ("ALJ") rather than the federal courts, at the SEC's sole discretion.[26] Two recent decisions have explored the SEC's ability to bring such proceedings under the Dodd-Frank Act and the APA, 5 U.S.C. § 500, *et seq.*, and the scope of a respondent's recourse in federal court if named in an administrative proceeding.[27]

Hill v. Securities and Exchange Commission

On June 8, 2015, the United States District Court for the Northern District of Georgia in *Hill v. Securities and Exchange Commission* preliminarily enjoined the SEC from conducting an administrative proceeding brought against Charles Hill, Jr., finding a substantial likelihood that Hill would succeed on the merits of his claim that the SEC had violated the Appointments Clause of Article II of the U.S. Constitution.[28]

The plaintiff, Charles Hill, Jr., instituted the action in federal court to request a temporary restraining order or, alternatively, a preliminary injunction to prevent the SEC from continuing a separate administrative proceeding against him for alleged insider trading. Hill, who was not registered with the SEC, argued that the administrative proceeding was unconstitutional because (i) the ALJ appointment process violated Article II of the Constitution because ALJs are not appointed by the president, a court of law, or a department head; (ii) ALJs "are protected by two layers of tenure protection," also in violation of Article II; (iii) the SEC's authority to pursue cases before ALJs violated the delegation doctrine of Article I of the Constitution because it gives the SEC discretion to select an administrative rather than a judicial forum; and (iv) the administrative proceeding violated Hill's Seventh Amendment right to a jury trial.

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[24] *Id.* at *5.

[25] *Id.* at *8.

[26] *See* 15 U.S.C. § 78u-2.

[27] See 15 U.S.C. § 78y(a).

[28] *Hill v. Sec. Exch. Comm'n*, No. 15-CV-1801 (LMM) (N.D. Ga. June 8, 2015) (ECF No. 28).

The *Hill* court agreed with the SEC that Hill had not shown a likelihood of success on the merits for his claims under the nondelegation doctrine and the Seventh Amendment. However, the court granted a preliminary injunction with respect to Hill's Article II arguments, preventing the SEC from continuing its administrative action. The inquiry turned on whether ALJs are "inferior officers," requiring appointment pursuant to the Appointments Clause of Article II, or "mere employees," as the SEC argued. After carefully evaluating the role played by the ALJs, the court found that the ALJs exercised "significant authority," even if they did not have contempt power and could not issue final orders, and thus were inferior officers subject to the Appointments Clause. As the SEC had conceded that the ALJ in Hill's case was not appointed by an SEC commissioner or other eligible party, the administrative action could not proceed.

Tilton v. Securities and Exchange Commission

Later the same month, on June 30, 2015, the United States District Court for the Southern District of New York confronted a similar challenge in *Tilton v. Securities and Exchange Commission*.[29] The court found that it lacked jurisdiction to address the constitutional claims, as the SEC and then a federal appeals court have the "exclusive avenue of review" of an ALJ's decision.

The plaintiffs in *Tilton*, who were the subjects of an administrative cease-and-desist proceeding alleging that they violated federal securities laws, also alleged the SEC's ALJs presided in violation of the Appointments Clause of Article II of the Constitution. Just as the *Hill* court concluded, the *Tilton* plaintiffs contended that the ALJ was an "inferior officer" who must be appointed by the president, a court of law, or a department head.

The *Tilton* court, however, did not reach the issue of the propriety of the ALJ's appointment. Rather, the court found that the threshold matter of federal subject matter jurisdiction over the plaintiffs' claims had not been satisfied, and thus a federal district court could not enjoin the administrative proceeding on that basis. Following Supreme Court precedent, the court explored whether the SEC's administrative proceeding denied "all meaningful judicial review" to the plaintiffs, whether the plaintiffs' suit was "wholly collateral" to the administrative scheme, and whether the plaintiffs' claims were outside of the SEC's expertise. Although aware that the *Hill* court conducted the same analysis and reached the opposite conclusion, the *Tilton* court analyzed the statutory framework of the Dodd-Frank Act and concluded that the plaintiffs had failed to show that Congress "intended to exclude their claims from the designated statutory reviews scheme" to allow them to proceed in federal court.

FOREX Settlements

In March and May 2015, the Bank of New York Mellon Corporation (BNYM) reached two major settlements to resolve claims that BNYM had defrauded its clients in the context of trades on foreign exchanges in violation of U.S. securities laws.[30] Beginning with a whistleblower's complaint under the New York False Claims Act, BNYM faced multidistrict litigation over allegations that it misled its custody clients about its trading practices on foreign exchanges, costing these clients (which included various state agencies and pension plans) millions of dollars. BNYM's clients were

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[29] *Tilton v. Sec. Exch. Comm'n*, No. 15-CV-2472 (RA), 2015 WL 4006165 (S.D.N.Y. Jun. 30, 2015).

[30] *See* Press Release, N.Y. State Office of the Attorney General, "A.G. Schneiderman And U.S. Attorney Bharara Announce Groundbreaking Settlement With Bank Of New York Mellon Over Fraudulent Foreign Exchange Practices," (Mar. 19, 2015), ***available at*** http://www.ag.ny.gov/press-release/ag-schneiderman-and-us-attorney-bharara-announce-groundbreaking-settlement-bank-new (last visited Jul. 23, 2015) ("NYAG Press release"); The Bank of New York Mellon, U.S. Sec. & Exch. Comm'n Form 8-K (May 21, 2015), *available at* http://www.sec.gov/Archives/edgar/data/1390777/000119312515197053/d932113d8k.htm (last visited July 23, 2015) ("BNYM Form 8-K").

told that that they were receiving the "best rates" for trades conducted by BNYM on their behalf, but in fact, customers were given "prices at or near the worst interbank rates reported during the trading day."[31] This practice allowed BNYM to pocket the difference between the rates it charged its clients and the actual market price, generating substantial profits for the bank.

The first settlement, announced on March 19, 2015, resolved claims brought by the New York State Office of the Attorney General, the Office of the District Attorney for the Southern District of New York, the Securities and Exchange Commission, the U.S. Department of Labor, and other litigants.[32] BNYM agreed to pay $714 million to end a variety of litigation stemming from the suit, including $167.5 million each to the New York attorney general's and the S.D.N.Y district attorney's offices.[33] The bulk of the payment to the New York attorney general's office will be allocated to compensate the victims of the fraud. The remaining settlement funds are earmarked for payment to the Securities and Exchange Commission, the Department of Labor, and plaintiffs in a putative class-action lawsuit brought by BNYM's defrauded clients.

The terms of the settlement also required that BNYM admit the factual details of the fraud, reform its practices, and terminate the employment of certain executives who were involved. In announcing the settlement, the New York attorney general specially thanked the whistleblower who filed the initial complaint "for helping to bring BNYM's conduct to light."[34]

On May 21, 2015, in a filing with the Securities and Exchange Commission, BNYM reported that it had "reached a settlement in principle on a previously disclosed pending foreign-exchange-related putative class action lawsuit asserting securities laws violations."[35] BNYM reported that it had agreed to pay $180 million to the class action plaintiffs in exchange for "a full and complete release of all foreign exchange-related securities law claims brought against it or its affiliates by members of the alleged class."[36] With this second settlement, which is subject to court approval, BNYM will have resolved the extensive litigation surrounding its conduct on foreign exchanges, with the exception of a few remaining lawsuits brought by individual defrauded customers.[37] However, this resolution will come at a price tag of nearly $1 billion.

Concurrently, on May 20, 2015, Barclays PLC, Citigroup Inc., JPMorgan Chase & Co., and the Royal Bank of Scotland Group PLC pled guilty to criminal antitrust violations involving traders inside the banks who called themselves "the Cartel" and who colluded to rig the benchmark Forex rates.[38] The banks agreed to pay criminal fines totaling more than $2.5 billion. UBS AG agreed to plead guilty to manipulating the London Interbank Offered Rate (LIBOR) and pay a $203 million criminal penalty.

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[31] NYAG Press Release, at 1.

[32] *See The People of the State of New York v. The Bank of New York Mellon Corp.*, No. 09/114735 (N.Y. Sup. Ct. 2009); *United States v. The Bank of New York Mellon Corp.*, No. 11-cv-06969 (S.D.N.Y. 2011).

[33] NYAG Press Release, at 1.

[34] *Id.* at 2.

[35] BNYM Form 8-K, at 2; *see also Louisiana Municipal Police Employees' Retirement System v. The Bank of New York Mellon Corp.*, No. 11-cv-09175 (S.D.N.Y. 2011).

[36] BNYM Form 8-K, at 2.

[37] *Id.*

[38] *See* Press Release, Department of Justice, "Five Major Banks Agree to Parent-Level Guilty Pleas" (May 20, 2015), http://www.justice.gov/opa/pr/five-major-banks-agree-parent-level-guilty-pleas.

III. Insider Trading Cases

Post-*Newman* Insider Trading Cases

As discussed more fully in our 2014 Year-End Report, the United States Court of Appeals for the Second Circuit's decision in *United States v. Newman* effectively makes it more difficult for federal prosecutors to be successful in actions against alleged remote tippees.[39] The government petitioned for rehearing and rehearing *en banc*, which was denied by the Second Circuit in April 2015.[40] Although the government filed a petition for writ of certiorari on July 30, 2015, *Newman* is for now the law of the Second Circuit.

Following the *Newman* decision, a number of defendants have sought to use *Newman* to dismiss insider trading charges, vacate their convictions, or reduce penalties. Courts have applied *Newman* in a variety of cases before federal[41] and administrative courts,[42] mostly following *Newman*. However, three recent decisions show the uncertainty about what the government must prove in insider trading cases involving remote tippees.

On July 6, 2015, the United States Court of Appeals for the Ninth Circuit issued a decision that appears to call parts of *Newman* into question. The case, *United States v. Salman*,[43] was authored by Judge Rakoff, sitting by designation. The Ninth Circuit denied the defendant Bassam Yacoub Salman's appeal of his conviction for insider trading, finding sufficient evidence to uphold the conviction. In *Salman*, the tipper, an analyst for Citigroup, gave his brother (the tippee) confidential information about anticipated mergers and acquisitions involving Citigroup clients. The tippee then

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[39] 773 F.3d 438 (2d Cir. 2014). The tippees in *Newman* were three or four persons removed from the tipper.

[40] *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. Apr. 3, 2015).

[41] Opinion & Order, *SEC v. Payton*, No. 14-CV-04644-JSR, at *9-10 (S.D.N.Y. Apr. 6, 2015) ("[T]he Second Circuit, in *Newman*, stated unequivocally that '[t]he elements of tipping liability are the same, regardless of whether the tipper's duty arises under the "classical" or the "misappropriation" theory.' . . . [T]hese statements seem so clearly intended to give guidance to the lower courts of this Circuit that this Court takes them as binding.").

[42] *In the Matter of Gregory T. Bolan and Joseph C. Ruggieri*, Order, SEC Admin. Proc. Rel. No. 2309 (Feb. 12, 2015) ("While our case law at times emphasizes language from *Dirks* indicating that the tipper's gain need not be *immediately* pecuniary, it does not erode the fundamental insight that, in order to form the basis for a fraudulent breach, the personal benefit received in exchange for confidential information must be of some consequence.'") (quoting *Newman*, 773 F.3d at 452, with emphasis in original).

[43] No. 14-10204, 2015 WL 4068903 (9th Cir. July 6, 2015).

passed the information on to his family member through marriage (the remote tippee), who traded on the information. The court stated that the principle set forth in *Dirks*, that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend," governs the case. The court found that initially the tipper gave the confidential information to the tippee, his brother, in order to "benefit" him, which was the type of "gift" envisioned by *Dirks*. Furthermore, the remote tippee knew that the tipper was the source of the information, and he had agreed to keep the information confidential to "protect" the tipper.

The court distinguished *Newman* and held that "[p]roof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary element of insider trading." The factual circumstances of *Salman*, which involved tipping between close family members, are distinguishable from *Newman*, which involved remote tippee market participants three or four levels removed from the tipper. While *Salman* is therefore not in direct conflict with *Newman*, it does leave open the issue of inferring a benefit where there is a personal relationship.

On April 6, 2015, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York denied defendant Daryl M. Payton and Benjamin Durant III's motion to dismiss in *SEC v. Payton*. Payton and Durant's guilty pleas had been vacated in light of *Newman*. The court relied on *Riley* for support, stating that "[i]f a tip maintains or furthers a friendship, and is not simply incidental to the friendship that is circumstantial evidence that the friendship is a *quid pro quo* relationship." While Judge Rakoff appeared to be applying *Newman*, *Payton* appears to be a goal-oriented decision. The court found that the SEC had adequately pleaded a personal benefit in alleging that the tipper and tippee "shared a close mutually dependent financial relationship" as evidenced by a "history of personal favors" in which the tippee "pa[id] their shared expenses," "negotiated reductions in their utilities and rent payments," and helped the tipper defendant in an unrelated criminal matter. The court explained that, in contrast with the *Newman* defendants who knew "next to nothing" about the tippers, the SEC had put forth allegations that "the defendants knew the basic circumstances surrounding the tip." The court noted that it may draw an adverse inference against the defendants due to their knowledge, "their market sophistication," and the apparent facts that they "recklessly avoided discovering additional details" and they "took multiple steps to conceal their own trading."

On March 3, 2015, Judge Valerie Caproni of the United States District Court for the Southern District of New York declined to reverse defendant David Riley's conviction for insider trading in *United States v. Riley*.[44] Judge Caproni found that Riley, who had tipped a friend with confidential information, received three personal benefits—(i) help with his side business in the form of industry connections, (ii) investment advice in the form of stock tips, and (iii) assistance with securing his next job—which indicated a "*quid pro quo* relationship."

How insider trading cases, both civil and criminal, will play out post-*Newman* will continue to be heavily litigated. The SEC has signaled that *Newman* will not alter its approach to insider trading cases because the SEC has a lower burden of proof than criminal prosecutors.[45] Moreover, the SEC can bring insider trading cases in its administrative courts. Additionally, the types of cases that the SEC and the DOJ bring, and whether they involve remote tippees multiple steps removed, such as Newman and Chiasson, may be indicative of the influence of *Newman*. As described

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[44] Opinion & Order, *United States v. Riley*, No. 13-CR-339-1, at *10 (VEC) (S.D.N.Y. Mar. 3, 2015) (quoting *Newman*, 773 F.3d at 452 with edits in original).

[45] *See* Stephanie Russell-Kraft, *SEC's Ceresney Isn't Sweating 2nd Circ.'s Newman Ruling*, LAW360 (Feb. 10, 2015).

below, both the SEC and DOJ continue to bring insider trading actions against different types of individuals, including friends, fund managers, and foreign traders.

Insider Trading Among Friends and Family

SEC v. Sean R. Stewart & Robert K. Stewart, 15-cv-03719 (S.D.N.Y. May 14, 2015);

United States v. Sean Stewart and Robert Stewart, 15-MAG-1634 (S.D.N.Y. May 14, 2015)

On May 14, 2015, the SEC and the DOJ charged Robert Stewart and his son, Sean Stewart, with insider trading in violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder and Section 14(e) of the Exchange Act and Rule 14e-3 promulgated thereunder.[46] The DOJ charged Robert and Sean with conspiracy to commit securities fraud.[47]

Daniel M. Hawke, the chief of the Division of Enforcement's Market Abuse Unit, stated upon announcement of the charges, "Serial insider traders assume a huge risk that we will detect their pattern of trading and connect them to their source of confidential information. We have integrated new technological tools to quickly and easily identify relationships among traders and spot suspicious trading across multiple securities."

Between 2010 and 2014, Sean, who worked as a managing director at two separate investment banks during the relevant time frame, allegedly tipped his father, Robert, with confidential, nonpublic information regarding certain mergers and acquisitions involving the banks' clients. Robert, an accountant and CFO of a technology company, is alleged to then have traded ahead of the announcements, yielding approximately $1.1 million in illegal profits.

As alleged, Sean and Robert engaged in a scheme to conceal the trades from the authorities, including use of a third-party account and communicating via coded messages using golf terminology such as "saw local story about high cost of golf reservations since a foreign company purchased all—even more expensive than imagined" and "might have an opportunity to play golf—but would need to book the reservation as soon as the office opens Tuesday morning."[48] The DOJ's complaint and press release highlighted that Sean also allegedly benefited from the scheme, as Robert used the profits in part to finance Sean's wedding.

The SEC and DOJ cases are pending.

SEC v. John Gray, Christian Keller, Kyle Martin & Aaron Shepard, 15-cv-00551 (N.D. Ca. Feb. 5, 2015)

On February 5, 2015, the SEC announced that it had settled insider trading charges against John Gray, Christian Keller, Kyle Martin, and Aaron Shepard.[49] The complaint alleged that between 2009 and 2012, Keller, a financial analyst and later a VP for investor relations and finance at public companies, tipped Gray, his friend and a Barclays Capital analyst, with confidential information

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[46] Release, United States Securities and Exchange Commission, "SEC Charges Father and Son $1.1 Million Insider Trading Scheme," Rel. No. 2015-90 (May 14, 2015), http://www.sec.gov/news/pressrelease/2015-90.html.

[47] Press Release, United States Department of Justice, "Manhattan U.S. Attorney And FBI Announce Insider Trading Charges Against Managing Director Of Investment Bank And His Father," (May 14, 2015), http://www.justice.gov/usao-sdny/pr/manhattan-us-attorney-and-fbi-announce-insider-trading-charges-against-managing.

[48] Press Release, United States Securities and Exchange Commission, "SEC Charges Father and Son $1.1 Million Insider Trading Scheme," Rel. No. 2015-90 (May 14, 2015), http://www.sec.gov/news/pressrelease/2015-90.html.

[49] Press Release, United States Securities and Exchange Commission, "SEC Charges Four in California Insider Trading Ring," Rel. No. 2015-23 (Feb. 5, 2015), http://www.sec.gov/news/pressrelease/2015-23.html.

concerning certain acquisitions and negative financial results. The two individuals allegedly traded in advance of the acquisitions and negative news.

In order to conceal their trading activity, Keller and Gray allegedly conducted their trading through Martin's account by using disposable phones and paying kickbacks in cash. Martin and Shepard also allegedly conducted their own trades based upon confidential information received from Gray. In sum, Gray, Keller, Martin, and Shepard made nearly $750,000 in illegal profits.

Without admitting or denying the allegations, Gray, Keller, Martin, and Shepard settled with the SEC. Gray agreed to pay more than $750,000 in disgorgement, interest, and penalties, and agreed to be barred from the securities industry. Keller agreed to pay nearly $475,000 in disgorgement, interest, and penalties, and agreed to a 10-year bar from serving as a director or officer of a public company. Martin and Shepard agreed to pay a combined total of more than $435,000 in disgorgement and interest. According to the SEC release, Martin and Shepard were "not being assessed additional penalties due to their significant cooperation during the SEC's investigation." The settlement is subject to court approval.

Foreign Insider Trading

***In the Matter of Helmut Anscheringer*, Securities Exchange Act of 1934 Rel. No. 75172; Admin. Proc. No. 3-16589 (June 15, 2015)**

On June 15, 2015, the SEC filed an administrative proceeding settling charges of insider trading against a Swiss trader, Helmut Anscheringer.[50] Anscheringer is a Swiss resident who owns property in Florida. The SEC had alleged that Anscheringer traded on information about Apple Inc.'s proposed acquisition of AuthenTec, a Florida-based biometrics company. Anscheringer allegedly obtained the information from a former colleague with whom he had been friends for nearly three decades. That individual was related to an AuthenTec executive. Anscheringer purchased AuthenTec stock and call options days before the acquisition was announced. Upon the announcement, the AuthenTec stock price jumped 60% and Anscheringer made $1.8 million in illegal gains.

Anscheringer settled with the SEC without admitting or denying the allegations, and paid a total of $2.85 million in disgorgement, prejudgment interest, and penalties. In announcing the settlement, Glenn Gordon, the associate director of the SEC's Miami regional office, stated, "Foreign traders in U.S. stocks are not exempt from SEC scrutiny, as we traced the misconduct back to Anscheringer when investigating these significant purchases in a trading account belonging to an entity in the British Virgin Islands for which he was listed as the beneficiary."

[50] Press Release, United States Securities and Exchange Commission, "Swiss Trader to Pay $2.8 Million to Settle Insider Trading Charges," Rel. No. 2015-119 (June 15, 2015), http://www.sec.gov/news/pressrelease/2015-119.html.

IV. Investment Adviser and Hedge Fund Cases

SEC Targeting Conflicts of Interests

On February 26, 2015, Julie M. Riewe, SEC co-chief, Asset Management Unit ("AMU"), Division of Enforcement, gave a speech in Washington to the IA Watch 17th Annual IA Compliance Conference, announcing that AMU's 2015 enforcement priorities would focus on conflicts of interest in each of three areas: (i) registered investment companies, (ii) private funds (hedge funds and private equity funds), and (iii) other client accounts (e.g., separately managed accounts and/or retail accounts).[51]

As Ms. Riewe noted, "Conflicts of interest are material fact that investment advisers, as fiduciaries, must disclose to their clients." She stated that there are conflicts beyond facial incompatibility of interests, including "where an adviser's interests might potentially incline the adviser to act in a way that places its interest above clients' interests, intentionally or otherwise." She also said that there is "no exception to disclosure."

Ms. Riewe disclosed that the AMU is "intensely focused on conflicts of interest," in both the registered fund and hedge fund arenas, highlighting several 2014 enforcement actions and promising more this year. In the private equity fund area, the AMU will focus on fee arrangements and expense arrangements, which are "inherent conflicts."

Ms. Riewe advised that advisers, because of their fiduciary obligations, must identify and address the conflicts, either by removing or disclosing them. This includes reviewing all relevant documents, such as private placement memoranda, client agreements, and the like, to ensure that all conflicts are properly disclosed.

In the Matter of VCAP Securities, LLC, and Brett Thomas Graham

On February 19, 2015, the SEC announced a settled order against a brokerage firm, VCAP Securities, LLC ("VCAP"), and its CEO, Brett Thomas Graham ("Graham"), for allegedly deceiving

[51] Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, "Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View," (Feb. 26, 2015), transcript available at http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

participants in collateralized debt obligation ("CDO") auctions they conducted as liquidating agent.[52]

While running these CDO auctions, the respondents allegedly favored VCAP's investment adviser, to its benefit. After receiving all confidential, legitimate bids, Graham allegedly would instruct the third-party broker dealer to bid on certain bonds at prices slightly higher than the previous best bid. After winning the bonds at auction, the third party would allegedly sell them to VCAP's investment adviser for a small premium. The order alleges that the respondents made material misrepresentations to CDO trustees that VCAP and its affiliates would neither participate in the auctions nor use the nonpublic information they received.

Without admitting or denying the allegations, the respondents entered into a settlement with the SEC under which Graham is barred from the industry for three years, at which time he may reapply for reinstatement. Graham also must pay disgorgement, interest, and penalties of approximately $325,000. In addition to being censured, VCAP must disgorge approximately $1.15 million, including interest, but does not have to pay a penalty because of its financial condition.

In the Matter of Lynn Tilton; Patriarch Partners, LLC; Patriarch Partners VIII, LLC; Patriarch Partners XIV, LLC; and Patriarch Partners XV, LLC

On March 30, 2015, the SEC announced charges and a cease-and-desist order against an investment adviser ("Tilton") and her companies ("the "Funds"), accusing them of breaching their fiduciary duties to their clients by improperly valuing their assets.[53]

The Funds allegedly manage collateralized loan obligations ("CLOs") and have raised $2.5 billion since 2003; the Funds use this money to lend to distressed companies. According to the SEC, many of the Funds' borrowers have performed poorly and have missed or made only partial payments back to the Funds, yet Tilton has consistently reported to the Funds' investors that the value of the Funds' assets is unchanged from the time the assets were originated.

The SEC alleges that Tilton and the Funds have not used proper valuation methodologies for several years and that the Funds would have failed their ratio tests since at least 2009. These improper actions have led to the respondents' receiving at least $200 million in management and other fees they would not have otherwise received. The SEC also alleges that the respondents use a subjective accounting system not in compliance with GAAP, and that this methodology has not been reported to the Funds' investors. The SEC alleges that as a result, the respondents breached their fiduciary and contractual duties to their clients.

As discussed in the earlier securities section, on April 1, 2015, Tilton countersued the SEC, stating that the SEC's case is based solely on "financial statement technicalities" and that the SEC "fundamentally misrepresented the work of her advisory firm."[54] Tilton also stated that the SEC's

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[52] *In the Matter of VCAP Securities, LLC, and Brett Thomas Graham*, Investment Advisers Act Rel. No. 4026, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b)(4), 15(b)(6), and 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Exchange Act of 1934 Release No. 74305 (Feb. 19, 2015), http://www.sec.gov/litigation/admin/2015/34-74305.pdf.

[53] *Matter of Lynn Tilton; Patriarch Partners, LLC; Patriarch Partners VII, LLC; Patriarch Partners XIV, LLC; and Patriarch Partners XV, LLC*, 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, and Section 9(b) of the Investment Company Act of 1940, and Notice of Hearing, Investment Advisers Act of 1940 Release No. 4053 (Mar. 30, 2015), http://www.sec.gov/litigation/admin/2015/ia-4053.pdf.

[54] *See* Karma Allen, *Tilton, Patriarch Partners File Counter-Suit Against SEC*, CNBC, Apr. 1, 2015, http://www.cnbc.com/id/102546259 (last visited July 8, 2015).

use of an administrative court was in violation of her due process rights. In the wake of the SEC action, certain of the Funds' clients have sued the respondents in New York State Supreme Court, alleging fraud.[55]

SEC v. Nadel

On March 31, 2015, the United States District Court for the Eastern District of New York issued an opinion in the matter of *Securities & Exchange Commission v. Nadel*, in which Judge William F. Kuntz II granted the SEC's motion for summary judgment.[56] The SEC alleged, among other things, that the defendants—a broker-dealer, an investment adviser, and their principal—fraudulently induced clients to invest by misrepresenting their assets under management.

Defendants told prospective clients, through marketing materials and regular performance updates, that the investment adviser had more than $400 million under management. A review of its Form ADV, however, revealed it had far less, between $54 and $147 million, between 2007 and 2010.

The court found that these misrepresentations were material and that summary judgment was appropriate, stating, "Any reasonable investor would need accurate disclosures about assets under management to correctly evaluate an asset manager's performance. Without such information, an investor would have no baseline to determine the risk for his or her investment." The court also found the size of the misstatement, some $300 million or more, factored into its consideration of materiality.

The district court directed the magistrate to hold a hearing to determine the damages or other appropriate relief, including permanent injunction, disgorgement, and penalties.

SEC v. Interinvest Corp., Inc., and Hans Peter Black

On June 16, 2015, the SEC announced fraud charges against an investment advisory firm and its principal, Black, for funneling assets to distressed Canadian microcap companies in which Black had undisclosed financial interests.[57] The SEC alleged that Black unlawfully directed $17 million from Interinvest to the troubled companies and that, in turn, those companies paid a Black-controlled company $1.7 million (CAD).

Black is a Canadian citizen and is Interinvest's owner, president, chief compliance officer, chief investment officer, and primary client relationship manager. Black was on the board of each of the penny-stock Canadian companies that received the at-issue funds. The SEC alleges that Black made the transfers without disclosing them to Interinvest's investors over the period of several years, to the investors' detriment.

On June 25, 2015, the district court issued a preliminary injunction against Black and Interinvest, restraining them from further violations of the Advisers Act, the Exchange Act, and the Securities Act, and from exercising control over their clients' accounts. The court also froze Black's and Interinvest's bank accounts.

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[55] *See* Chris Dolmetsch and Matthew Robinson, *Lynn Tilton, Patriarch Partners Named in Investor Fraud Suit*, Bloomberg Business, May 18, 2015, http://www.bloomberg.com/news/articles/2015-05-18/lynn-tilton-patriarch-partners-sued-by-investors-claiming-fraud (last visited July 8, 2015).

[56] *SEC v. Nadel*, Case No. 11-CV-215, 2015 WL 1529815 (E.D.N.Y. Mar. 31, 2015).

[57] *SEC v. Interinvest Corp., Inc.*, Case No. 15-12350, D.E. 1 (D. Mass. June 16, 2015).

SEC v. Kalucha

Since the entry from our 2014 Mid-Year Report regarding this case, on June 18, 2015, the SEC agreed to voluntarily dismiss with prejudice all charges against George Palathinkal ("Palathinkal"), the chief financial officer of New York-based investment advisory firm Aphelion Fund Management ("Aphelion"), suggesting the SEC decided that the claims against him lacked merit. In the dismissal, the SEC waived all right to an appeal. On May 5, 2014, the SEC had filed fraud charges and sought emergency relief against Aphelion and two of its executives, Palathinkal and Vineet Kalucha ("Kalucha"), Aphelion's managing partner, majority owner, and chief investment officer.[58] The charges against Kalucha are still pending.

In the Matter of Kohlberg Kravis Roberts & Co., L.P. ("KKR")

On June 29, 2015, the SEC brought charges against KKR for allegedly misallocating deal expenses to its top private equity funds, a breach of its fiduciary duty.[59]

KKR incurred nearly $340 million in expenses related to unconsummated buyout deals from 2006 to 2011. Pursuant to fee-sharing arrangements KKR had with its flagship private equity funds, KKR generally bore 20% of these expenses. During this time, however, KKR allegedly did not properly allocate the deal expenses to co-investors nor, allegedly, did it disclose this fact, misallocating $17.4 million.

Because of the announced settlement, and without admitting or denying the charges, KKR will disgorge $18.7 million, including interest. KKR also agreed to pay a $10 million civil penalty.

In the Matter of Welhouse & Associates, Inc., and Mark P. Welhouse

On June 29, 2015, the SEC brought charges against an investment adviser and its principal, accusing them of allocating winning option trades to the principal's personal and business accounts while allocating losing trades to his clients.[60]

The principal made trades in a master account and then allocated the trades pro rata to the investment adviser's client accounts. The SEC discovered that when the principal made trades in the S&P 500 ETF's options, the principal allegedly did not allocate the trades pro rata, but allocated a disproportionate number of the profitable trades to accounts he controlled and the unprofitable trades to client accounts. The principal allegedly allocated the trades several hours after making them, giving the market time to adjust before apparently making decisions about which accounts would receive what allocations.

This matter is pending.

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[58] Complaint, *S.E.C. v. Kalucha*, No. 14 cv 3247 (S.D.N.Y. May 5, 2014), http://www.sec.gov/litigation/complaints/2014/comp-pr2014-92.pdf.

[59] *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.

[60] *In the Matter of Welhouse & Associates, Inc. and Mark P. Welhouse*, Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, Sec. Exchange Act of 1934 Release No. 75319 (June 29, 2015), http://www.sec.gov/litigation/admin/2015/34-75319.pdf.

V. CFTC Cases and Developments

The CFTC has been very active in its fight against spoofing and the regulation of interest rate manipulation. The CFTC continues to enforce existing rules and promulgate new rules designed to curtail spoofing, which occurs when high-frequency traders use complex algorithms to place and then cancel large trades in fractions of a second for the sole reason of exploiting the movements in the markets that those orders create. The CFTC's recent successes in this area have not only caused the CFTC to collect millions of dollars in civil penalties, but also allowed U.S. criminal authorities to bring criminal actions against financial institutions and their executives. The CFTC also continues to target large lending institutions that allegedly manipulated benchmark interest rates, such as LIBOR, in the past decade. Its recent successes in this area have allowed the CFTC to impose over $4.6 billion in civil penalties.[61]

The Fight Against Spoofing

The CFTC believes that spoofing-related activity in the futures markets was the culprit in the Flash Crash of 2010, which saw the Dow Jones Industrial Average plummet 1,000 points in a matter of minutes. Since then, spoofing remains commonplace in the financial industry because the laws and regulations have lagged behind the technological innovations that market participants use.

Legislating Against Spoofing

U.S. lawmakers have responded by passing new legislation designed to curtail spoofing. Congress passed the Dodd-Frank Act in 2010, which expressly made spoofing in the futures markets a criminal offense. Specifically, Section 747 of the Dodd-Frank Act amended the Commodity Exchange Act ("CEA") to prohibit disruptive trading practices in futures, options, or swaps trading. It 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. It also amended Section 6(c) of the CEA to prohibit the employment or attempt to employ any manipulative device or contrivance in connection with any swap or a commodity trade.

[61] Commodity Futures Trading Commission, "CFTC Orders Barclays to Pay $115 Million Penalty for Attempted Manipulation of and False Reporting of U.S. Dollar ISDAFIX Benchmark Swap Rates," Rel. No. PR7180-15 (May 20, 2015).

The CFTC has followed Congress's lead and implemented rules and regulations under the amendments to the CEA that relate to spoofing. Under these rules, individuals or institutions that intend to place and cancel large volumes of trades are subject to civil penalties and sanctions.

The CFTC will also bring enforcement actions against traders who are alleged to have recklessly employed a manipulative scheme or artifice to defraud through their spoofing in the futures and commodities markets. More regulatory action is on its way. The CFTC issued a white paper in 2012 seeking feedback on proposed regulations to target spoofing, such as "kill switches," trading pauses, and testing standards for trading algorithms.[62] Such regulatory activity would complement FINRA's recent proposed rules, which require developers of trading algorithms to register and undergo qualification examinations.[63] In May 2015, CFTC Chairman Timothy Massad stated that the CFTC has analyzed all the feedback to the white paper and "will make a determination in the near future on what additional measures, if any, might be necessary to address automated trading."[64]

Prosecuting Spoofing

Since the enactment of these anti-spoofing laws and regulations, the CFTC has initiated dozens of enforcement actions and disciplinary proceedings punishing spoofers. This aggressive approach has allowed the CFTC to collect millions of dollars in civil penalties and has spawned criminal proceedings against these institutions and their executives. As CTFC's director of enforcement recently stated, when it comes to prosecuting spoofing, there is "no substitute for putting actual human beings in jail."[65] The first spoofing-related criminal prosecution occurred on October 12, 2014, when the Department of Justice ("DOJ") indicted commodities trader Michael Coscia in the United States District Court for the Northern District of Illinois under six counts of commodities fraud and six counts of spoofing.[66] This indictment came a year after Coscia entered into a $2.8 million settlement agreement with the CFTC on similar charges.[67] Then, on January 12, 2015, the DOJ indicted Canadian resident Aleksandr Milrud in the United States District Court for the District of New Jersey under commodities fraud counts stemming from his spoofing-related activity.[68] In addition, on April 21, 2015, the DOJ indicted UK trader Navinder Singh Sarao in the United States District Court for the Northern District of Illinois under wire fraud and commodities fraud counts for his role in spoofing-related activity that led to the Flash Crash in 2010.[69]

The lack of precedent in this area of criminal law makes it difficult to predict the outcome of these criminal prosecutions. As with all financial crimes, proving intent will not be easy. There are dozens

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[62] Commodity Futures Trading Commission, "Concept Release on Risk Controls and System Safeguards for Automated Trading Environments"; proposed rule. 78 Fed. Reg 177 (Sept. 12, 2013), 56, 541–56, 574.
[63] Financial Regulatory Authority, "Registration of Associated Persons Who Develop Algorithmic Trading Strategies," Regulatory Notice 15-06 (Mar. 6, 2015).
[64] Timothy Massad, Chairman, Commodity Futures Trading Commission, Remarks of Chairman Timothy Massad before the Energy Risk Summit USA 2015 (May 12, 2015).
[65] Jean Eaglesham, *CFTC Turns Toward Administrative Judges*, Wall St. J., Nov. 9, 2014, available at http://www.wsj.com/articles/cftc-turns-toward-administrative-judges-1415573398.
[66] Press Release, Department of Justice, "High-Frequency Trader Indicted for Manipulating Commodities Future Markets In First Federal Prosecution For 'Spoofing'" (Oct. 2, 2014), available at http://www.justice.gov/usao/iln/pr/chicago/2014/pr1002_01.html.
[67] Press Release, Commodity Futures Trading Commission, "CFTC Orders Panther Energy Trading LLC and its Principal Michael J. Coscia to Pay $2.8 Million and Bans Them from Trading for One Year, for Spoofing in Numerous Commodity Futures Contracts" Rel. No. PR6649-13 (July 22, 2013), available at http://www.cftc.gov/PressRoom/PressReleases/pr6649-13.
[68] Press Release, Department of Justice, "Canadian Man Charged in First Federal Securities Fraud Prosecution Involving 'Layering'" (Jan. 13, 2015), available at http://www.justice.gov/opa/pr/canadian-man-charged-first-federal-securities-fraud-prosecution-involving-layering.
[69] Press Release, Department of Justice, "Futures Trader Charged with Illegally Manipulating Stock Market, Contributing to the May 2010 Market 'Flash Crash'" (April 21, 2015), available at http://www.justice.gov/opa/pr/futures-trader-charged-illegally-manipulating-stock-market-contributing-may-2010-market-flash.

of good reasons a trader may decide to cancel a trade order. The burden is on the DOJ to establish beyond a reasonable doubt that these traders never intended to execute them in the first place. Another challenge will be establishing that this practice materially affected the market price of the relevant security at issue.

To date, there is no clear method of establishing such correlation. Nevertheless, the DOJ's willingness to bring these actions and the CFTC's recent successes in securing civil penalties against spoofers indicate that spoofing is in the U.S. government's crosshairs.

Interest Rate Manipulation

Another area in which the CFTC has had recent successes is its enforcement cases for interest rate manipulation.

LIBOR and Euribor Manipulation

On April 23, 2015, the CFTC issued an order against Deutsche Bank AG ("Deutsche Bank") that brought and settled charges that the bank routinely manipulated the London Interbank Offered Rate ("LIBOR") and the Euro Interbank Offered Rate ("Euribor").[70] Deutsche Bank agreed to pay $800 million to the CFTC to settle these charges.[71] This settlement is just the latest in a string of payments by Deutsche Bank for its alleged manipulation of interest rate benchmarks, having already paid a $775 million penalty to the DOJ, a £226.8 million penalty to the UK Financial Conduct Authority, and a $600 million penalty to the New York State Department of Financial Services.

The LIBOR and the Euribor are interest rate benchmarks that affect the pricing of derivatives and other financial products. Large lending institutions such as Deutsche Bank submit their lending rates on a daily basis. These submissions are taken with those from other large lending institutions and compiled to establish the daily LIBOR and Euribor rates. According to the CFTC, for more than a six-year period Deutsche Bank manipulated these interest rate benchmarks by making false submissions. Rather than report the actual lending rate for a particular day, Deutsche Bank officials knowingly submitted lending rates that would positively affect the bank's trading positions in various financial markets, including New York.

Key to the CTFC's case against Deutsche Bank was the bank's lack of internal controls, procedures, and policies concerning its LIBOR and Euribor submission processes. This environment led to inadequate supervision and ultimately allowed Deutsche Bank's submitters to freely communicate with the traders at various desks on a regular basis regarding their financial positions. The CFTC's order also noted that Deutsche Bank had an opportunity to halt its misconduct in 2011 when the CFTC ordered the bank to conduct an in-depth internal investigation. While Deutsche Bank did conduct an investigation into these practices, the CFTC characterized it as insufficient and noted that the bank failed to either make any meaningful improvements to its internal controls or formalize a policy about the conflicts of interest among traders and submitters relating to LIBOR and Euribor submissions.

[70] Commodity Futures Trading Commission, "Deutsche Bank to Pay $800 Million Penalty to Settle CFTC Charges of Manipulation, Attempted Manipulation, and False Reporting of LIBOR and Euribor," Rel. No. PR7159-15 (Apr. 23, 2015).
[71] *Id.*

Swap Rate Manipulation

Similarly, on May 20, 2015, the CFTC issued two orders against Barclays PLC, Barclays Bank PLC, and Barclays Capital, Inc. (together, "Barclays"), that brought and settled charges of attempted manipulation and false reporting of various swap-related interest rate benchmarks.[72] Specifically, Barclays agreed to pay $115 million to settle charges relating to the U.S. Dollar International Swaps and Derivatives Association Fix and $400 million to settle charges relating to global foreign exchange benchmark rates. The CFTC noted that these orders were based on its own investigations as well as those conducted by the DOJ, the Federal Bureau of Investigation, and the UK Financial Conduct Authority.

As with LIBOR and Euribor, large lending institutions like Barclays make daily submissions related to these swap-related interest rates. These submissions indicate the rate at which a particular financial institution would buy or sell a reference swap. Once these rates are compiled, financial institutions around the world use them in millions of swap transactions involving foreign currencies, foreign exchanges, forwards, options, futures, and other financial derivative instruments.

The CFTC alleged that over a six-year period, Barclays attempted to manipulate these swap rate benchmarks by making false submissions or colluding with other financial institutions to engage in swap trades designed to move the pricing of these benchmarks in a direction that favored Barclays. Key to its decision to bring these charges was the CFTC's analysis of emails and instant message conversations that confirmed these improper trading practices had occurred. The CFTC also noted that these charges rested, in part, on Barclay's inadequate internal controls, procedures, and policies relating to its daily submissions of swap-related rates.

[72] Commodity Futures Trading Commission, "CFTC Orders Barclays to Pay $400 Million Penalty for Attempted Manipulation of and False Reporting of Foreign Exchange Benchmark Rates," Rel. No. PR7181-15 (May 20, 2015); Commodity Futures Trading Commission, "CFTC Orders Barclays to Pay $115 Million Penalty for Attempted Manipulation of and False Reporting of U.S. Dollar ISDAFIX Benchmark Swap Rates," Rel. No. PR7180-15 (May 20, 2015).

VI. Securities Policy and Regulatory Developments

In the first half of 2015, the SEC and other agencies continued to modernize and update their policies in response to the growth of the asset management industry and changes in the technological landscape, and to comply with the requirements of the Dodd-Frank Act.

SEC Proposes Rules to Enhance Data Reporting for Registered Investment Companies and Investment Advisers

On May 20, 2015, the SEC issued proposed rules and amendments with the aim of "modernizing" and enhancing the reporting and disclosure of information by investment companies and investment advisers due to the volume and complexity of information the SEC must analyze as a result of growth of the asset management industry.[73]

The proposed rules for investment companies would require additional data reporting for mutual funds, ETFs, and other registered investment companies by requiring a new monthly reporting form, Form N-Port, on which certain registered investment companies must report information about their monthly portfolio holdings to the SEC, and a new yearly reporting form, Form N-CEN, which would require the annual reporting of "certain census-type information." These new forms would require information be reported in a "structured data format," thereby allowing the SEC to effectively analyze this information. Additionally, the rules would require enhanced and standardized disclosures in financial statements as related to derivatives and would permit (but not require) certain investment companies to make shareholder reports accessible via a website.

The proposed amendments relate to Form ADV, the registration and reporting form for registered investment advisers. The SEC's proposed rulemaking would require investment advisers to provide additional information to allow the SEC and an adviser's investors to better understand the risk profile for the adviser and its industry by requiring the advisers to provide information related to assets held and to the use of borrowings and derivatives in separately managed accounts. Furthermore, the proposed rules would require additional information to be provided about an

[73] United States Securities and Exchange Commission, Investment Company Reporting Modernization, 17 CFR Parts 200, 210, 230, 232, 239, 240, 270, 274, https://www.sec.gov/rules/proposed/2015/33-9776.pdf; United States Securities and Exchange Commission, Amendments to Form ADV and Investment Advisers Act Rules, 17 CFR Parts 275 and 279, https://www.sec.gov/rules/proposed/2015/33-9776.pdf.

adviser's business, such as its branch office operations and the use of social media. The rules also would allow multiple private fund investment advisers that operate as a single investment advisory business to register with the SEC under "umbrella registration" on a single Form ADV. The proposals would additionally require advisers to maintain both performance calculations and performance-related communications.

Agencies Approve Policies Implementing Diversity Standards Enacted Under the Dodd-Frank Act

On June 9, 2015, six federal agencies—the SEC, the Federal Reserve Board, the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of Comptroller of the Currency—issued a final interagency policy statement establishing joint standards for assessing the diversity policies and practices of the entities they regulate.[74]

Section 342 of the Dodd-Frank Act required these agencies to establish an Office of Minority and Women Inclusion (OMWI), which would be responsible for all matters relating to diversity in management, employment, and business activities. Under the Dodd-Frank Act, each OMWI director is to develop standards to assess the diversity policies and practices of the agencies' regulated entities.

The agencies' final standards, which were the collective efforts of all six agencies, provide a framework for regulated entities to both create and strengthen their diversity policies and practices. These policies and practices are in four overarching areas: (i) organizational commitment to diversity, which addresses promoting diversity and inclusion across an organization; (ii) workforce and employment practices; (iii) procurement and business practices; and (iiii) practices to promote transparency of organizational diversity and inclusion within the entities' U.S. operations. Entities are encouraged to use the standards to undergo a self-assessment of their diversity policies and practices and to report their assessments to the agencies and the public.

The standards make clear that they do not create new legal obligations and that their implementation by a regulated entity is voluntary. Additionally, as each entity is unique with respect to characteristics including size, location, and structure, each entity is encouraged to use the standards in a manner appropriate to its unique characteristics.

SEC Issues Guidance on Cybersecurity at Brokerage and Advisory Firms

On February 3, 2015, the SEC released a risk alert and an investor bulletin focusing on cyber security at brokerage and advisory firms, offering suggestions to investors for how to protect their online investment accounts.[75] For its risk alert, the SEC's Office of Compliance Inspections and Examinations ("OCIE") examined numerous broker-dealers and registered investment advisers to better understand how they address the legal, regulatory, and compliance issues associated with cybersecurity in areas including identifying cybersecurity risks and establishing cybersecurity governance. The OCIE found that the vast majority of broker-dealers and investment advisers have adopted written cybersecurity policies, conduct periodic risk assessments to identify

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[74] Press Release, United States Securities and Exchange Commission, Department of the Treasury Office of Comptroller of the Current, et al., Final Interagency Policy Statement Establishing Joint Standards For Assessing the Diversity Policies and Practices of Entities Regulated By the Agencies, Rel. No. 2015-114, http://www.sec.gov/news/pressrelease/2015-114.html.

[75] Risk Alert, United States Securities and Exchange Commission, Cybersecurity Examination Sweep Summary, Volume IV, Issue 4, Feb. 3, 2015, http://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf; Investor Bulletin, United States Securities and Exchange Commission, Protecting Your Online Brokerage Accounts From Fraud, http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-protecting-your-online-brokerage-accounts-fraud.

cybersecurity threats, and have been the subject of a cyber-related incident. The investor bulletin provided ways for investors to safeguard their online investment accounts, such as choosing a "strong" password and exercising caution when using public networks and wireless connections.

FINRA Sanctions LPL Financial $11.7 Million for Widespread Supervisory Failures

On May 6, 2015, the Financial Industry Regulatory Authority (FINRA) announced that it fined LPL Financial LLP for broad supervisory failures in areas including the sales of nontraditional ETFs, variable annuity contracts, REITs, and other complex products, as well as its failure to monitor and report trades and deliver more than 14 million trade confirmations to customers.[76] In addition, FINRA ordered LPL to pay about $1.7 million in restitution to customers who purchased nontraditional ETFs. According to FINRA, LPL's supervisory failures were the result of failing to dedicate adequate resources to necessary compliance programs. For instance, with regard to ETFs, FINRA found that LPL both did not have a system to monitor the length of time that customers held these securities in its accounts and did not properly train its registered representatives on the risks of the products. LPL's flawed automated system to review a trade blotter resulted in LPL's failing to deliver over 14 million confirmations for trades in 67,000 customer accounts.

Merrill Lynch Pays Almost $11 Million to Settle Brokerage Units' Short-Sale Data Violations

On June 1, 2015, the SEC announced that it brought and settled charges against Merrill Lynch in connection with two of its brokerage units using inaccurate data in the course of executing short sale orders.[77]

According to the SEC's order instituting a settled administrative proceeding, the violations centered on Regulation SHO of the Exchange Act, which governs short-sale transactions. Regulation SHO prohibits a broker-dealer from accepting a short-sale order unless it has borrowed the security, has entered into a bona fide arrangement to borrow the security, or has "reasonable grounds" to believe the security can be borrowed so it can be delivered on the delivery date. As short sales involve the sale of borrowed securities, customers usually ask their brokers to locate stock available for short sales, and brokers prepare "easy-to-borrow" lists for customers containing this information. These lists may provide reasonable grounds that a security is available for borrowing.

Merrill Lynch personnel appropriately ceased using their easy-to-borrow list when the availability of certain shares of stock became restricted. However, their execution platforms were programmed to continue processing short-sale orders based on certain outdated easy-to-borrow lists and thus continued to execute short-sale orders. Merrill Lynch admitted that this violated Rule 203(b) of Regulation SHO. It agreed to pay almost $11 million and retain an independent compliance consultant to conduct a comprehensive review of its policies, procedures, and practices for accepting short-sale orders for execution, effecting short sales in reliance on the easy-to-borrow list, and monitor compliance.

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[76] Release, Financial Industry Regulatory Authority, FINRA Sanctions LPL Financial LLC $11.7 Million for Widespread Supervisory Failures Related to Complex Product Sales, Trade Surveillance and Trade Confirmations Delivery, https://www.finra.org/newsroom/2015/finra-sanctions-lpl-117-million-widespread-supervisory-failures.

[77] Release, Merrill Lynch Admits Using Inaccurate Data for Short Sale Orders, Agrees to $11 Million Settlement, Rel. No. 2015-105, http://www.sec.gov/news/pressrelease/2015-105.html.

Oppenheimer Pays $20 Million Fine in Connection With Penny-Stock Sales on Behalf of Customers

On January 27, 2015, the SEC and the Treasury Department's Financial Crimes Enforcement Network announced that Oppenheimer & Co. would pay $20 million and admit to wrongdoing to settle charges related to two separate violations of securities laws involving the selling of unregistered shares of penny stocks on behalf of customers.[78]

The first course of conduct took place between July 2008 and May 2009 and involved one of Oppenheimer's customers, Gibraltar Global Securities, a Bahamian brokerage firm that is not registered to do business in the United States. Oppenheimer executed sales of billions of shares of penny stocks for a supposed proprietary account in Gibraltar's name, even though it knew or was reckless in not knowing that Gibraltar was not trading for itself but on behalf of its U.S.-based customers. Gibraltar was exempt from paying U.S. taxes on its own profits from the sale of securities in the U.S., and used its exempt status to enable its U.S. customers to also avoid paying taxes. The SEC separately charged Gibraltar in 2013.

According to the SEC's order instituting a settled administrative proceeding, Oppenheimer failed to file Suspicious Activity Reports to report potential misconduct by Gibraltar. The order also found that Oppenheimer aided and abetted Gibraltar's violations of the Exchange Act, and violated various Exchange Act provisions by failing to properly report, withhold, and remit more than $3 million in backup withholding taxes from sales proceeds in Gibraltar's account and by failing to recognize improperly recorded transactions for Gibraltar's customers in its books and records.

The second course of misconduct again involved Oppenheimer engaging in unregistered sales of billions of shares of penny stocks on behalf of another customer. Oppenheimer's liability under Section 5(a) of the Securities Act was the result of failing to respond to red flags and to conduct an inquiry into whether the sales were exempt from the registration requirements of federal securities laws, and failing to reasonably supervise in order to detect and prevent violations of the registration process.

In addition to paying $20 million in monetary remedies, Oppenheimer agreed to retain an independent consultant to review its policies and procedures over a five-year period.

[78] Release, SEC Charges Oppenheimer With Securities Law Violations Related to Improper Penny Stock Sales, Rel. No. 2015-14, http://www.sec.gov/news/pressrelease/2015-14.html.

VIII. The SEC Cooperation and Whistleblower Programs

The SEC continued to emphasize its Cooperation and Whistleblower Programs as significant parts of its enforcement efforts during the first half of this year. In particular:

- The director of the SEC's Division of Enforcement, Andrew Ceresney, repeatedly underscored the real, tangible benefits of cooperation and the adverse consequences of not self-reporting, given the increasing amount of whistleblower tips received by the SEC;
- Consistent with Director Ceresney's message, the SEC provided substantial whistleblower awards, including to a company officer and a compliance officer, and brought an enforcement action against a company for policies and procedures that hindered the ability of employees to report misconduct to the government;
- The SEC provided cooperation credit to defendants in connection with Foreign Corrupt Practices Act ("FCPA") cases, including a deferred prosecution agreement with The PBSJ Corporation; and
- The SEC announced its first-ever settlements against municipal underwriters under its MCDC Initiative.

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 by self-reporting.

Director Ceresney Encourages Cooperation and Self-Reporting

On May 13, 2015, Director Ceresney reflected on the first five years of the Cooperation Program.[79] Among other things, his speech provided the following significant insights into the program:

- The Seaboard Report "continues to provide a framework under which entities can receive cooperation credit in settlements."

[79] Speech, SEC Director of Division of Enforcement Andrew Ceresney, "The SEC's Cooperation Program: Reflection on Five Years of Experience," Remarks at University of Texas School of Law's Government Enforcement Institute (May 13, 2015), http://www.sec.gov/news/speech/sec-cooperation-program.html.

- A company is "gambling" if it fails to self-report violations, because the SEC may learn about the violation from another source (e.g., through its Whistleblower Program), and the SEC will scrutinize why the company either failed to detect the violation or declined to report it to the SEC.[80]

- The SEC prefers cooperation agreements (entering into more than 80 since 2010) to deferred prosecution agreements and non-prosecution agreements (entering into five of each since 2010.

- Although cooperation occurs in all types of cases, it is most common in FCPA and insider trading cases.

Director Ceresney also explained the SEC's "cooperation calculus" and outlined the following ways that cooperation may benefit a defendant:

- First, cooperation affects the SEC's charging decisions. In particular, the SEC may decline to charge peripheral or lower-level players who cooperate and can provide valuable evidence to make a case against others who are more senior and more involved with the misconduct. Although Director Ceresney did not disclose the number of defendants who have avoided enforcement actions based on cooperation, he did state that "a significant percentage" of the SEC's cooperation agreements resulted in declinations.

- Second, cooperation affects the monetary relief sought by the SEC. Director Ceresney explained that the SEC's use of bifurcated settlements allows the SEC to determine the civil penalty amount to seek after the cooperation is complete. He noted that in these situations, two-thirds of the time no civil penalty has been sought. Director Ceresney also noted that although the SEC ordinarily will continue to seek disgorgement, it may in limited circumstances take a more narrow view in calculating the amount, based on cooperation.[81]

- Third, cooperation affects the remedial relief sought by the SEC (e.g., industry suspensions or bars) because it bears directly on the defendant's recognition of wrongdoing and sincere intent to reform.

[80] This point echoed a speech Director Ceresney made earlier in the year in which he stated, "This risk of suffering adverse consequences from a failure to self-report is particularly acute in light of the continued success and expansion of our whistleblower program. The SEC's whistleblower program has changed the calculus for companies considering whether to disclose misconduct to us, knowing that a whistleblower is likely to come forward. Companies that choose not to self-report are thus taking a huge gamble because if we learn of the misconduct through other means, including through a whistleblower, the result will be far worse." Speech, SEC Director of Division of Enforcement Andrew Ceresney, FCPA, Disclosure, and Internal Controls Issues Arising in the Pharmaceutical Industry, Remarks at CBI's Pharmaceutical Compliance Congress (March 3, 2015), http://www.sec.gov/news/speech/2015-spch030315ajc.html.

[81] For example, a recent settled order notes, "Respondent acknowledges that the Commission is not imposing a civil penalty based upon his cooperation in a Commission investigation and his agreement to cooperate in any related enforcement action. If at any time following the entry of the Order, the Division of Enforcement . . . obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission or in a related proceeding, the Division may, at its sole discretion and with prior notice to the Respondent, petition the Commission to reopen this matter and seek an order directing that the Respondent pay a civil money penalty." *In the Matter of Michael Hedrick*, 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 Release No. 74625 (Apr. 1, 2015), http://www.sec.gov/litigation/admin/2015/34-74625.pdf.

Aside from these benefits, one alarming development Director Ceresney noted was that the SEC in some cases will require a cooperator to admit to wrongdoing to "lock in a witness's version of events before trial to ensure predictable testimony."

SEC Continues to Promote Its Whistleblower Program Through Additional Awards and an Enforcement Action for a Whistleblower Rule Violation

As Director Ceresney pointed out, the Whistleblower Program provides additional incentive for defendants to consider self-reporting and cooperating with the SEC before it is tipped to misconduct by someone else, including corporate insiders. To date, the SEC has awarded 17 whistleblowers with payouts totaling over $50 million out of an investor protection fund established by Congress. Several of these awards were paid out this past half-year to various insiders who each provided original, high-quality information about a securities fraud that resulted in an SEC enforcement action with sanctions exceeding $1 million.

For example, in March 2015, the SEC announced a whistleblower award payout between $475,000 and $575,000 to a former company officer.[82] The SEC explained that officers, directors, trustees, or partners generally are not eligible to receive whistleblower awards, but there is an exception when they report the information to the SEC more than 120 days after other responsible compliance personnel possessed the information and failed to adequately address the issue. This whistleblower award was the first one paid out under this exception. Director Ceresney applauded the whistleblower's actions, stating, "Corporate officers have front-row seats overseeing the activities of their companies, and this particular officer should be commended for stepping up to report a securities law violation when it became apparent that the company's internal compliance system was not functioning well enough to address it."

Then, in April 2015, the SEC announced a whistleblower award payout between $1.4 million and $1.6 million to a compliance professional who reported fraud where there was a reasonable basis to believe that disclosure to the SEC was necessary to prevent imminent misconduct from causing substantial financial damage to the compliance professional's company or investors.[83] This award was the second one paid out to a whistleblower who performed the audit or compliance function.

That same month, the SEC announced a whistleblower award payout of over $600,000 to the whistleblower in the SEC's first anti-retaliation case (which we previously discussed in our 2014 Mid-Year Report).[84] Chief of the SEC's Office of the Whistleblower Sean McKessy stated, "My hope is that the award today encourages whistleblowers to come forward in light of our demonstrated commitment to protect them against retaliatory conduct and make significant financial awards to whistleblowers who suffer employment hardships as a result of reporting possible securities law violations."

The SEC also announced a settled order with KBR Inc. in April 2015 for violating the whistleblower protection rule enacted under the Dodd-Frank Act.[85] According to the settled order, prior to the enactment of the Dodd-Frank Act's whistleblower provisions in 2010, KBR adopted a form

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[82] Press Release, United States Securities and Exchange Commission, "Former Company Officer Earns Half-Million Dollar Whistleblower Award for Reporting Fraud Case to SEC," Rel. No. 2015-45 (Mar. 2, 2015), http://www.sec.gov/news/pressrelease/2015-45.html.

[83] Press Release, United States Securities and Exchange Commission, "SEC Announces Million-Dollar Whistleblower Award to Compliance Officer," Rel. No. 2015-73 (Apr. 22, 2015), http://www.sec.gov/news/pressrelease/2015-73.html.

[84] Press Release, United States Securities and Exchange Commission, "SEC Announces Award to Whistleblower in First Retaliation Case," Rel. No. 2015-75 (Apr. 28, 2015), https://www.sec.gov/news/pressrelease/2015-75.html.

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

confidentiality statement for use in internal investigations, which was included in KBR's Code of Business Conduct Investigations Procedures Manual and which stated in relevant part, "I understand that in order to protect the integrity of this review, I am prohibited from discussing any particulars regarding this interview and the subject matter discussed during the interview, without the prior authorization of the Law Department. I understand that the unauthorized disclosure of information may be grounds for disciplinary action."

Although the SEC was "unaware of any instances in which (i) a KBR employee was in fact prevented from communicating directly with Commission Staff about potential securities laws violations, or (ii) KBR took action to enforce the form confidentiality agreement or otherwise prevent such communications," it still considered that the confidentiality provisions violated the whistleblower rule.

As a result, without admitting or denying its findings, KBR agreed to enter into the settled administrative order, which required KBR (i) to cease and desist from future violations of SEC Rule 21F-17, (ii) to pay a $130,000 civil penalty, and (iii) to make reasonable efforts to contact KBR employees in the U.S. who signed the confidentiality statement between August 21, 2011, and the present, providing them with a copy of the order and notifying them that they are not required to seek permission of KBR's legal department before communicating with the government.

In agreeing to the order, the SEC considered KBR's remedial step of amending its confidentiality statement to include the following text: "Nothing in this Confidentiality Statement prohibits me from reporting possible violations of federal law or regulation to any governmental agency or entity, including but not limited to the Department of Justice, the Securities and Exchange Commission, the Congress, and any agency Inspector General, or making other disclosures that are protected under the whistleblower provisions of federal law or regulation. I do not need the prior authorization of the Law Department to make any such reports or disclosures and I am not required to notify the company that I have made such reports or disclosures."

FCPA Cooperation Cases

The first half of this year witnessed several resolutions of FCPA investigations in which defendants were credited for their cooperation.[86] For example, in January 2015, the SEC announced a deferred prosecution agreement with **The PBSJ Corporation** in connection with bribery and books and records violations of the FCPA relating to offers and promises of payment and other benefits in the amount of $1.4 million to Qatari government officials on or about 2009 to secure two multimillion-dollar development contracts in Qatar and Morocco.[87] Pursuant to the DPA, the SEC agreed to defer prosecution of the violations for a period of two years in exchange for PBSJ's agreement to (i) accept responsibility for its misconduct; (ii) pay disgorgement in the amount of $2,892,504, prejudgment interest in the amount of $140,371, and a civil penalty in the amount of $375,000 (which is nearly one-eighth of the disgorgement amount); and (iii) comply with certain undertakings that appear to be no more onerous than what is merely required by law (e.g., annually review and update its internal controls and policies and procedures; certify compliance

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[86] Other FCPA settlements in which defendants received cooperation credit are *In the Matter of Flir Systems, Inc.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, Securities Exchange Act of 1934 Release No. 74673 (Apr. 8, 2015), http://www.sec.gov/litigation/admin/2015/34-74673.pdf, and *In the Matter of BHP Billiton Ltd. and BHP Billiton Plc*, 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, Rel. No. 74998 (May 20, 2015), http://www.sec.gov/litigation/admin/2015/34-74998.pdf.

[87] Release, United States Securities and Exchange Commission, "SEC Charges Former Executive at Tampa-Based Engineering Firm With FCPA Violations, Securities Exchange Act of 1934," Rel. No. 2015-13 (Jan. 22, 2015), http://www.sec.gov/news/pressrelease/2015-13.html.

with code of conduct; and train officers, managers, and employees).[88] Pursuant to the DPA, the SEC credited PBSJ for taking quick steps to end the misconduct after self-reporting to the SEC and for cooperating with the SEC's investigation by, among other things, providing factual chronologies, timelines, internal summaries, and full forensic images.

MCDC Initiative

On June 18, 2015, the SEC announced settled administrative orders against 36 municipal underwriting firms for selling municipal bonds using offering documents that contained materially false statements or omissions about the issuers' compliance with continuing disclosure obligations and for failing to conduct adequate due diligence on these disclosures.[89] These cases were the first ones brought against municipal underwriters in connection with the SEC's MCDC Initiative (as discussed in our 2014 Year-End Report and 2014 Mid-Year Report) in which the SEC provides cooperation credit to municipal issuers and underwriters who self-reported violations by late 2014. According to the settled orders, each underwriter agreed to cease and desist from such violations in the future, to retain an independent consultant to review its policies and procedures on due diligence for municipal securities underwriting, and to 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.

[88] Deferred Prosecution Agreement between United States Securities and Exchange Commission and The PBSJ Corporation (Jan. 21, 2015), http://www.sec.gov/news/press/2015/2015-13-dpa.pdf.

[89] Release, United States Securities and Exchange Commission, "SEC Charges 36 Firms for Fraudulent Municipal Bond Offerings," Rel. No. 2015-125 (June 18, 2015), http://www.sec.gov/news/pressrelease/2015-125.html.

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