2016 Year-End Securities Litigation and Enforcement Highlights

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Welcome to the 2016 Year-End Report from the BakerHostetler Securities Litigation and Regulatory Enforcement Practice Team.

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

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

This Report highlights recent, significant developments, including, but not limited to:

Supreme Court Cases, including clarifying the meaning of “personal gain” in the insider trading context; declining to stay the United States Securities and Exchange Commission’s (“SEC”) enforcement action despite constitutional challenge to the use of in-house courts; the Circuit split on whether the SEC’s use of its in-house courts is constitutional; and the potential to determine the scope of Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) preemption;

Securities Law Cases, including the endorsement of “price maintenance” theory; finding rebuttal of the fraud-on-the-market presumption if investor would have purchased securities even while knowing of alleged fraudulent misstatements; the acceptance of the materialization-of-risk standard for loss causation; finding class action tolling doctrine does not apply to statutes of repose and extension of *IndyMac* ruling to the Securities Exchange Act of 1934 (“Exchange Act”); and applying the disgorgement provision of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley Act”) based on the issuer’s misconduct, even if corporate officers did not engage in personal misconduct;

Insider Trading Cases, including the continued post-*Newman* and *Salman* impact; the role of data analytics in increasing insider trading charges; highlighting the SEC’s commitment to pursuing insider trading charges derived from pre-merger trades; and other recent, noteworthy insider trading cases;

Settlements, including historic settlements with financial institutions stemming from litigation derived from the financial crises and the SEC’s strong enforcement trend with respect to the critical importance of corporate oversight;

Investment Adviser and Hedge Fund Cases, including the SEC's adoption of new reporting rules for investment advisers; the SEC's imposition of penalties on investment advisory firms for advertising false performance; and the first Foreign Corrupt Practices Act ("FCPA") charges against a hedge fund;

SEC Cooperation and Whistleblower Programs, including emphasizing the benefits of cooperation and rewarding remediation and self-reporting; issuing millions of dollars of awards and sanctioning companies for violating the Whistleblower Protection Rule through restrictive severance agreements and retaliatory actions; and conducting a sweep examination of registered investment advisers and broker-dealers to assess their compliance with the whistleblower rules of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act");

Commodities and Futures Regulation and Cases, including numerous actions focusing on spoofing, benchmark rigging, anti-fraud enforcement and compliance with regulatory requirements; and the resignation of the current CFTC Chairman; and

Securities Policy and Regulatory Developments, including the SEC's proposal of: (i) amendments to disclosure requirements as part of disclosure effectiveness review; (ii) rules to enhance order handling information available to investors; (iii) rule amendment to expedite the process for settling securities transactions; and (iv) universal proxy rule in contested director elections; the SEC's adoption of: (i) rules to enhance information reported by investment advisers; and (ii) new rules for intrastate and regional securities offerings; the Department of Labor's fiduciary rule; and the SEC's approval of the Financial Industry Regulatory Authority's ("FINRA's") pay-to-play rule.

Supreme Court Cases Review

Supreme Court Cases Review

The Supreme Court issued its long-awaited decision on the issue of "insider trading" in the case styled as *Salman v. United States* ("*Salman*").[1] The decision in *Salman* goes to the meaning of "personal gain" in the insider trading context – an issue that goes to the scope of the insider trading laws. The Supreme Court's decision resolved a split between the Ninth and Second Circuit Courts of Appeals, siding with the former's broader interpretation that providing an insider trading tip to a friend or relative is presumptively improper, even without any evidence of a *quid pro quo* arrangement. Other significant securities-related matters in the second half of 2016 include the Supreme Court's refusal to stay an SEC administrative proceeding, notwithstanding a constitutional challenge about that proceeding, the emergence of a Circuit split on that same constitutional issue, and the filing of a petition for the Supreme Court to adjudicate whether SLUSA removes state courts' jurisdiction over class actions brought under the Securities Act of 1933 ("Securities Act").

The Supreme Court Clarified the Meaning of "Personal Gain" in the Insider Trading Context

In *Salman*, the Supreme Court tackled the question of whether an insider violates Section 10(b) of the Exchange Act and SEC Rule 10b-5, thereunder, if he/she provides a family relative or friend with confidential information without any proof that he/she received any monetary or tangible "personal gain" in return.[2] This question arises under the Supreme Court's 1983 decision in *Dirks v. SEC* ("*Dirks*"), where it held that "absent some personal gain," there can be no liability under the insider trading laws.[3] The Second and Ninth Circuits were split on this issue, with the former ruling in a separate litigation that "personal gain" in this context required some tangible benefit, usually monetary in nature, or at the very least the prospect of such a benefit. The Ninth Circuit rejected that ruling, holding instead that a tipper in the insider trading context can receive a "personal gain" that is intangible for him/her and still be liable under the insider trading laws. After the Supreme Court granted certiorari, it issued a unanimous decision affirming the Ninth Circuit's holding and rewarding the U.S. Government's aggressive interpretation of the insider trading laws.[4]

This was the first insider trading decision by the Supreme Court in decades. In 2015, the Supreme Court declined to review the aforementioned Second Circuit ruling in the *United States v. Newman* ("*Newman*") litigation,[5] which dealt with similar legal issues as *Salman*, although with different facts. For example, in *Newman*, the U.S. Government brought insider trading charges against tippee defendants who were not related to the tippers, or even alleged to be "close" to them.[6] There was no proof in that case the insiders received a monetary reward or any other pecuniary benefit in return for their trading tip, or that the defendants knew that the information they traded on came from the insiders.[7] Ultimately, the Second Circuit reversed the defendants' convictions, basing its decision in part on the legal holding that, for "personal gain" to exist, there should be a *quid pro*

1 *Salman v. United States*, 137 S.Ct. 420 (2016).

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

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

4 *Salman v. United States*, 137 S.Ct. 420 (2016). *See also* Marc D. Powers, Andrew Reich, and Jonathan A. Forman, *Top 10 SEC Enforcement Highlights of 2016* (Jan. 20, 2017).

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

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

7 *Id.* at 452-53.

quo agreement whereby the tipper receives some pecuniary benefit in exchange for the tip.[8] In so doing, it rejected the U.S. Government's theory that friendship and association, alone, was enough to satisfy the "personal gain" requirement under *Dirks. See* our 2015 Year-End Report and 2016 Mid-Year Report.

The Supreme Court granted certiorari in *Salman* because the Ninth Circuit Court of Appeals' decision in this case was now in direct conflict with the *Newman* decision. The Ninth Circuit Court of Appeals heard the appeal of Mr. Salman, a Chicago grocery wholesaler, whom a jury found guilty of violating the insider trading laws after he traded on nonpublic information that he received from his brothers-in-law.[9] Mr. Salman asked the Ninth Circuit Court of Appeals to follow the *Newman* decision and find that the insider trading laws require a *quid pro quo* arrangement between the tipper and tippee, whereby the tipper receives some monetary benefit.[10]

The Ninth Circuit Court of Appeals rejected Mr. Salman's request, and instead adopted the U.S. Government's position that the scope of the insider trading laws was broad enough to encompass Mr. Salman's conduct in this case.[11] Judge Jed S. Rakoff, who was visiting from the Southern District of New York, wrote on behalf of a unanimous Ninth Circuit Court of Appeals panel that limiting "personal gain" to a *quid pro quo* exchange – as the Second Circuit partly held in *Newman* – effectively provided a glitch whereby friends and family of insiders could trade and profit on confidential information without any legal consequences.[12]

The Supreme Court granted Mr. Salman's petition for certiorari on January 19, 2016, presumably to resolve the split between the Ninth and Second Circuits.[13] On October 5, 2016, the parties presented oral argument to the Supreme Court. Mr. Salman's counsel urged the Supreme Court to adhere to its long-standing principle of construing federal criminal statutes narrowly.[14] More specifically, she asked the Supreme Court to hold that an individual can only be criminally liable for insider trading if the tippers received some tangible monetary benefit in exchange for the tip.[15] Several of the Supreme Court Justices – including Ruth Bader Ginsburg, Stephen Breyer, Elena Kagan, and Sonia Sotomayor – expressed significant doubt about adopting such a narrow standard. Notably, Justice Breyer referred to the fact that the disclosure forms that Supreme Court Justices themselves fill out require several disclosures about the Justices' families because "helping a close family member is like helping yourself."[16] Still, several Justices noted that, if they adopt the U.S. Government's position – that a gift of confidential information to anyone, not just a trading relative or friend, is enough to violate the insider trading laws – there will likely be abundant confusion as to what a tipper has to receive, if anything, for the alleged tip to be violative of the insider trading laws.[17]

8 *Id.*

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

10 *Id.* at 1092.

11 *Id.* at 1093-94.

12 *Id.*

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

14 Transcript, *United States v. Salman*, No. 15-628 (Oct. 6, 2015) at pp. 16, 21.

15 *Id.* at p. 20.

16 *Id.* at pp. 7-8.

17 *Id.* at pp. 24-51.

Supreme Court Cases Review

Justice Samuel Alito authored the Supreme Court's unanimous December 6, 2016, decision. Its clear takeaway is that the Supreme Court wants to remain true to its prior holding in *Dirks*.[18] The decision notes a passage in *Dirks* that defines a "personal gain" as receiving something of value in exchange for the tip *or making "a gift of confidential information to a trading relative or friend."*[19] Based on this passage, Justice Alito wrote that the U.S. Government satisfied its burden in *Salman* by showing that the tipper disclosed the insider trading tip to a relative, even if there was no showing of an actual or potential pecuniary gain. While the decision notes that there may be instances when showing a "personal gain" will prove "difficult," it finds that these factual hypotheticals are inapplicable here because the alleged conduct in *Salman* falls within the "heartland" of the conduct envisioned in *Dirks*.[20] In so doing, the decision characterized the Second Circuit's holding in *Newman* as too narrow and inconsistent with *Dirks*.[21]

Off its loss in *Newman*, this was a significant victory for the U.S. Government, since it ratifies an aggressive enforcement approach to pursuing tippees even absent any evidence of a *quid pro quo* arrangement between the tippee and the tipper. However, it remains unclear whether the *Salman* decision is a complete abandonment of *Newman* and an expansion of the U.S. Government's enforcement powers in insider trading actions, as Preet Bharara – the U.S. Attorney for the Southern District of New York – said in a public statement after the Supreme Court issued its *Salman* decision.[22] There are material factual differences between the *Newman* and *Salman* litigations and, as the Supreme Court acknowledged,[23] the *Newman* decision rested, at least in part, on the U.S. Government's failure to show that the defendants knew of the insiders' breaches of their fiduciary duties, which is an indispensable element of insider trading claims. Time will tell if *Salman* will be strictly limited to its facts or revisited under a set of more "difficult" facts, as foreshadowed by the Supreme Court.[24] The Court makes clear that defendants are at risk if they trade profitably using material nonpublic information from friends or relatives.

For more insight, please review BakerHostetler's December 9, 2016, Executive Alert titled "The Supreme Court's Limited Insider Trading Ruling: *Salman* Decision Narrowly Affirms *Dirks* and Leaves Portions of *Newman* Intact."[25]

The Supreme Court Declined to Stay SEC Enforcement Action Despite Constitutional Challenge

On September 27, 2016, the Supreme Court declined to stay the SEC's enforcement action against Lynn Tilton ("Tilton"), the head of investment firm Patriarch Partners LLC, which is currently pending in front of an SEC Administrative Law Judge ("ALJ").[26] The SEC brought this enforcement

18 *Salman*, 136 S.Ct. at 427-29.

19 *Id.* at 426-28 (emphasis added).

20 *Id.*

21 *Id.* at 428-29.

22 Press Release, Statement of U.S. Attorney Preet Bharara On The Supreme Court's Decision In Salman v. U.S. (Dec. 6, 2016), available at https://www.justice.gov/usao-sdny/pr/statement-us-attorney-preet-bharara-supreme-court-s-decision-salman-v-us.

23 *Salman*, 136 S.Ct. at 425, n.1.

24 *Id.* at 429.

25 This Executive Alert, authored by Marc D. Powers, Mark A. Kornfeld, and Joshua D. Rog, is available at https://www.bakerlaw.com/alerts/the-supreme-courts-limited-insider-trading-ruling-salman-decision-narrowly-affirms-dirks-and-leaves-portions-of-newman-intact.

26 *Tilton v. SEC*, No. 16A242 (2016).

action against Ms. Tilton in March 2015 under allegations that she violated the Investment Advisers Act of 1940 ("Advisers Act").[27] Two days later, Ms. Tilton filed a lawsuit in the District Court for the Southern District of New York, seeking to enjoin the enforcement action on the ground that, among other things, it is unconstitutional for an SEC ALJ to adjudicate the SEC's claims against her.[28] On June 30, 2015, the District Court ruled against Ms. Tilton and fully dismissed her constitutional challenge on the ground that it was not ripe for review.[29] Ms. Tilton appealed this decision to the Second Circuit Court of Appeals, which ultimately affirmed the District Court's decision, on June 1, 2016.[30] Ms. Tilton then petitioned the Supreme Court to stay the enforcement action against her so that she could focus on readying a petition for certiorari that would seek to appeal the Second Circuit's decision.

Traditionally, the SEC sought civil penalties against an individual or entity in federal court. But section 929P(a) of the Dodd-Frank Act allows the SEC to seek these penalties in its in-house courts. Targets of those investigations, like Ms. Tilton, have since argued that this practice violates the Appointments Clause under Article II of the U.S. Constitution because the ALJs who preside over these proceedings are not appointed by the President, but are instead hired by the SEC. The SEC has responded by arguing that its ALJs are mere employees who do not issue final decisions, and thus, need not be appointed by the President.

Additionally, the second argument advanced to invalidate the SEC's use of in-house courts and ALJs revolves around due process. Targets have contended that the use of administrative proceedings deprives them of their Seventh Amendment right to a jury trial. Indeed, courts have acknowledged the position that the SEC's claims concern "public rights" since the SEC acts as a sovereign in the implementation of its executive functions in connection with its enforcement actions.

In dismissing Ms. Tilton's constitutional challenge, the Second Circuit Court of Appeals held that Ms. Tilton's challenge was not yet ripe since the administrative proceeding against her had not yet concluded and federal appellate review was only proper at the conclusion of that proceeding.[31] In so doing, the Second Circuit held that Ms. Tilton will obtain "meaningful judicial review" of her constitutional claims if she pursues a federal court appeal at the conclusion of her administrative proceeding.[32]

By bringing her stay motion, Ms. Tilton hoped to halt the SEC enforcement action until after the Supreme Court could ascertain whether the Second Circuit committed legal error in dismissing her constitutional challenges. But to prevail on her motion, Ms. Tilton had to show it was substantially likely that the Supreme Court would grant her petition for certiorari. At the time, since there was no split among the Circuit Courts of Appeals on the issue of the constitutionality of section 929P(a), and the Supreme Court twice denied petitions for certiorari on this issue,[33] it was not surprising that the Supreme Court motions panel unanimously ruled that Ms. Tilton failed to meet her burden.

27 *Tilton v. SEC*, 824 F.3d 276, 280 (2d Cir. 2016).

28 *Id.*

29 *Tilton v. SEC*, No. 15-CV-2472 (RA), 2015 WL 4006165 (S.D.N.Y. June 30, 2015).

30 *Tilton*, 824 F.3d at 291.

31 *Id.* at 281-91.

32 *Id.* at 282-84.

33 *See Bebo v. SEC*, 136 S.Ct. 1500 (Mar. 28, 2016) and *Pierce v. SEC*, 136 S.Ct. 1713 (Apr. 25, 2016).

For more analysis on the issue of whether the SEC's use of its in-house courts is unconstitutional, please review the *New York Law Journal's* September 21, 2016, article "Administrative Proceedings Remain Likely for SEC Enforcement Actions," authored by BakerHostetler's Mark A. Kornfeld, Jessie M. Gabriel, and David Choi.[34]

The Supreme Court Will Likely Soon Decide the Issue of Whether the SEC's Use of Its In-House Courts Is Constitutional

The constitutionality of the SEC's practice of bringing enforcement actions seeking civil penalties in its in-house courts may now be subject to Supreme Court review given the recent Tenth Circuit Court of Appeals decision in the case styled as *Bandimere v. SEC* ("*Bandimere*"),[35] which created a Circuit split (with the D.C. Circuit) on this issue.

On December 27, 2016, the Tenth Circuit held in *Bandimere* that the ALJs, who preside over the SEC's in-house courts, are indeed "inferior officers" subject to the Appointments Clause under Article II of the Constitution.[36] As explained in the prior section of this Report, the Appointments Clause establishes that only the President has the authority to appoint "inferior officers." The SEC has long taken the position that its ALJs are not "inferior officers," but mere employees. Courts have largely ratified this position and found that, because of this distinction, these ALJs need not be appointed by the President.

But the Tenth Circuit found that the SEC's ALJs hold all three characteristics of an "inferior officer" that the Supreme Court previously identified in its 1991 holding in *Freytag v. Commissioner of Internal Revenue* ("*Freytag*").[37] Specifically, in *Freytag*, the Supreme Court held that "inferior officers" hold three characteristics: (i) their position was "established by Law;" (ii) "the[ir] duties, salary, and means of appointment ... are specified by statute;" and (iii) they "exercise significant discretion" in "carrying out ... important functions."[38] In *Bandimere*, the SEC argued that the third *Freytag* factor does not apply to its ALJs given these judges' inability to issue final decisions and the fact that the SEC can overturn their decisions on appeal.[39] The Tenth Circuit acknowledged these facts but nevertheless held that these judges often exercise significant discretion and carry out important functions such as holding trial-like hearings and entering default judgments.[40] In so holding, the Tenth Circuit reversed the ALJ's ruling in *Bandimere* under the rationale that he lacked the authority to issue such a ruling because he was not appointed by the President, in contravention of the Appointments Clause.[41]

The Tenth Circuit's holding in *Bandimere* is important because it officially creates a Circuit split on this issue. Four months earlier, on August 9, 2016, the D.C. Circuit Court of Appeals upheld the constitutionality of the SEC's practice of bringing enforcement actions seeking civil penalties in its

34 This article is available at http://www.newyorklawjournal.com/id=1202767976167/Administrative-Proceedings-Remain-Likely-for-SEC-Enforcement-Actions?slreturn=20170017131008.

35 --- F.3d ----, 2016 WL 7439007 (10th Cir. Dec. 27, 2016).

36 *Id.* at *15.

37 501 U.S. 868 (1991).

38 *Id.* at 881-82.

39 *Bandimere,* 2016 WL 7439007, No. 15-9586, at *10-13.

40 *Id.*

41 *Id.* at *15.

in-house courts, in the litigation styled as *Raymond J. Lucia Companies, Inc. v. SEC*.[42] Indeed, the D.C. Circuit was the first appellate court to consider this issue on the merits, and it adopted the SEC's position that its ALJs are mere employees and not "inferior officers" under the Appointments Clause.[43]

Unlike the Tenth Circuit, the D.C. Circuit found that the third factor under the *Freytag* test did not apply to SEC ALJs. Specifically, it found that these judges do not exercise significant discretion or carry out sufficiently important functions because the "Commission retains discretion to review an ALJ's initial decision either on its own initiative or upon a petition for review filed by a party or aggrieved person"[44] and that "the initial decision becomes final when, and only when, the Commission issues the finality order and not before then."[45]

Based on the foregoing, there is a clear split between the Tenth and D.C. Circuit opinions on this issue that only the Supreme Court can resolve. It is expected that the SEC will petition the Supreme Court to review the Tenth Circuit's decision in *Bandimere* and that such a petition will be successful in light of the aforementioned split. For more information on this issue, please review BakerHostetler's January 11, 2017, Executive Alert titled "Tenth Circuit Creates Circuit Split on the Constitutionality of SEC Administrative Law Judges."[46]

The Supreme Court May Determine the Scope of SLUSA Preemption

Out of the handful of securities-related petitions for certiorari that are pending in the Supreme Court, the petition in the case *Cyan Inc. v. Beaver County Employees Retirement Fund* has the potential to be the most significant.[47] This case concerns a securities class action in which the plaintiff class alleges that petitioner Cyan, Inc. ("Cyan"), violated sections 11, 12(a)(2), and 15 of the Securities Act by filing an inaccurate and misleading registration statement and prospectus that did not disclose issues with the company's revenue stream that later became public. Even though the plaintiff class alleges violations of federal law, it brought this action in California State Superior Court.

Cyan moved to have the Superior Court dismiss this litigation on the ground that it is barred by SLUSA. Cyan argues that Congress enacted SLUSA to make federal law the principal vehicle for asserting securities class actions, and to prevent avoidance of the Private Securities Litigation Reform Act ("PSLRA") – which, among other things, imposes strict pleading requirements – through state court litigation. For these reasons, Cyan asserts that the Superior Court lacks subject matter jurisdiction to adjudicate the federal securities issues in this litigation. But the Superior Court rejected this argument without issuing a written opinion. Instead, the Court referred the parties to its opinion at oral argument, which essentially was that the Court was bound by a 2011 California appellate court decision, *Luther v. Countrywide Financial Corp.* ("*Countrywide*

42 832 F.3d 277 (D.C. Cir. 2016).

43 *Id.* at 283-89.

44 *Id.* at 282.

45 *Id.* at 286.

46 This Executive Alert, authored by Mark A. Kornfeld, Jessie M. Gabriel, and David Choi, is available at https://www.bakerlaw.com/alerts/tenth-circuit-creates-circuit-split-on-the-constitutionality-of-sec-administrative-law-judges.

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

Financial"),[48] that held that SLUSA preemption did not reach claims under the Securities Act.[49] Specifically, in *Countrywide Financial,* the California Court of Appeal undertook a technical review of the Securities Act and its provisions and ruled that the concurrent jurisdiction provisions under the Act – which provided that state courts and federal courts each had jurisdiction to adjudicate matters under the Act – survived the PSLRA amendments.[50] In so doing, the Court noted that its decision is in direct conflict with those from several federal courts that have interpreted the PSLRA amendments as doing away with concurrent jurisdiction via SLUSA preemption.[51]

The California Court of Appeal and the California Supreme Court each declined to review the Superior Court's decision in *Cyan*, leading to this petition for certiorari. Cyan argues in its petition that Supreme Court review is paramount to resolve the "chaos" created by the Superior Court decision and the earlier *Countrywide Financial* decision. Cyan notes that, since the latter, California state court securities class action filings have spiked by 1,400 percent and that there is a clear conflict between *Countrywide Financial* (and the four California trial courts that have since followed it) and the federal courts that have held that state courts lack subject matter jurisdiction to adjudicate federal securities claims under SLUSA. The plaintiff class opposes Cyan's petition, and the parties have now fully briefed the matter.

Should the Supreme Court decide to grant Cyan's petition, any subsequent ruling could significantly change the landscape of securities class action litigation. For example, if the Supreme Court affirms the Superior Court ruling, the rest of the country can expect to see an exponential increase in state securities class action litigation, similar to the recent spike in California state courts. Conversely, if the Supreme Court overturns the Superior Court's ruling, it will likely cause a dramatic reduction in the state securities class action litigation pending in California and throughout the United States.

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

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

50 *Luther*, 195 Cal. App. 4th at 797.

51 *Id.*

Securities Law Cases

Securities Law Cases

In the latter half of 2016, there were many notable developments in securities litigation, particularly at the appeals-court level. The Second Circuit and Sixth Circuit issued significant decisions related to proving reliance and loss causation in securities fraud class actions, and the Second Circuit also reaffirmed *IndyMac*, extending the decision to find that the class action tolling doctrine does not apply to statutes of repose in the Exchange Act. As further detailed below, these and other decisions will have wide-ranging implications for the litigation of securities actions in 2017.

Second Circuit Endorses "Price Maintenance" Theory

On September 27, 2016, the U.S. Court of Appeals for the Second Circuit, in its decision in the action *In re Vivendi, S.A. Sec. Litig.* ("*Vivendi*"),[52] rejected an attempt by French media company Vivendi Universal S.A. ("Vivendi") to overturn a 2010 jury verdict finding Vivendi liable for violations of Section 10(b) of the Exchange Act and SEC Rule 10b-5 and a resulting award of approximately $50 million in damages and interest. The case was a rare instance in which a civil securities fraud case went to trial, rather than settling or being dismissed before trial. Notably, on appeal, the Second Circuit used the case as an opportunity to endorse "price maintenance" theory to prove the element of reliance in asserting claims under Section 10(b) of the Exchange Act and SEC Rule 10b-5.

In 1998, Vivendi began a transformation from a French utilities company into a media and telecommunications conglomerate. To accomplish this, it spent 2000 and 2001 acquiring an array of media and communications businesses. By 2001 and 2002, although Vivendi began to have liquidity issues, it made numerous "persistently optimistic representations" to the public that suggested a healthy financial outlook. Vivendi's stock price fell after its liquidity problems were made public, which led investors who had bought Vivendi stock between 2000 and 2002 to bring a class action lawsuit against the company. The plaintiffs alleged that Vivendi made material misstatements that artificially inflated Vivendi's stock price, in violation of Section 10(b) of the Exchange Act and SEC Rule 10b-5. The case ultimately went to trial, with the jury finding that Vivendi was liable for all 57 misstatements that the plaintiffs alleged.

On appeal, Vivendi argued that an alleged misrepresentation must have a "price impact," meaning that a misrepresentation affected the market price, and that the majority of the 57 misstatements that were identified did not correlate with specific increases in the price of Vivendi's stock.[53] The "price impact" requirement that Vivendi referred to arises in the context of reliance, the element of a Section 10(b) claim that requires demonstrating a connection between a defendant's misrepresentation and a plaintiff's injury. In *Basic v. Levinson* ("*Levinson*"), the Supreme Court established a rebuttable presumption of reliance in securities fraud cases, which rests on the fraud-on-the-market theory, whereby courts may "assume … that an investor relies on public misstatements whenever he 'buys or sells stock at the price set by the market.'"[54] Defendants can attempt to rebut the presumption of reliance by introducing evidence that the misrepresentation did not in fact affect the stock price.[55]

52 838 F.3d 223 (2d. Cir. 2016).

53 *Id.* at 256-57.

54 *Id.* at 257 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 244, 247 (1988)).

55 *Id.* at 257 (citing *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398, 2414, 189 L.Ed2d 339 (2014)). *See also* our 2014 Mid-Year Report; 2015 Year-End Report; and 2016 Mid-Year Report.

The Court rejected Vivendi's argument that the "price impact" requirement inherent in the reliance element of a private Section 10(b) action "means that an alleged misstatement must be associated with an increase in [price] inflation to have any effect on a company's stock price."[56] The Court found that "it is hardly illogical or inconsistent with precedent to find that a statement may cause [price] inflation not simply by adding to the stock, but by maintaining it."[57] Thus, the *Vivendi* case is the first in which the Second Circuit has endorsed the "price maintenance" theory – that a misrepresentation can be actionable because it prevented a stock's artificially inflated price from falling. Previously, as detailed in our 2016 Mid-Year Report, the Court emphasized in *In re Pfizer Inc. Sec. Litig.* that it was abstaining from determining whether such price maintenance theory is "either legally or factually sustainable."[58] With the *Vivendi* decision, the Second Circuit joins the Seventh and Eleventh Circuits in its acceptance of this theory of securities liability.[59] However, the Second Circuit did not address the theory in the context of class certification, and, notably, some have interpreted the Eighth Circuit's decision in *IBEW Local 98 Pension Fund v. Best Buy Co.* as a rejection of the theory in this context.[60]

On October 11, 2016, Vivendi moved for panel rehearing and rehearing *en banc.*[61] In the petition, Vivendi primarily argued that the Second Circuit should not have adopted the "controversial" price maintenance theory as a viable theory of loss causation, as the decision conflicts with Supreme Court precedent in *Levinson*[62] requiring that the misrepresentation must have "actually caused" the plaintiff's loss[63] and deepens a Circuit split.[64] On November 10, 2016, the Second Circuit rejected the petition.[65]

Second Circuit Finds the Fraud-on-the-Market Presumption Is Rebutted If The Investor Would Have Purchased Securities Even If The Investor Knew of Alleged Fraudulent Misstatements

The same day as the *Vivendi* decision, the Second Circuit issued its opinion in *GAMCO Inv'rs, Inc. v. Vivendi Universal, S.A.* ("*GAMCO*").[66] The decision arises from the same underlying facts as *Vivendi*. The plaintiffs were a number of "value funds" controlled by GAMCO Investors, Inc. (collectively, "GAMCO"), that opted out of the *Vivendi* class action lawsuit. As value investors, GAMCO makes their own estimation as to the "intrinsic" value of a publicly traded company's securities and attempts to buy such securities when the market price is lower than its own valuation, betting that the market price will rise over time. [67] GAMCO purchased shares of Vivendi

56 *Id.* at 260.

57 *Id.* at 258.

58 *In re Pfizer Inc. Sec. Litig.*, 819 F.3d 642, 661 (2d Cir. 2016).

59 *See, e.g.*, *Glickenhaus & Co. v. Household Int'l, Inc.*, 787 F.3d 408 (7th Cir. 2015); *FindWhat Inv'r Grp. v. FindWhat.com*, 658 F.3d 1282 (11th Cir. 2011).

60 818 F.3d 775 (8th Cir. 2016).

61 Petition for Rehearing En Banc, *In re Vivendi, S.A. Sec. Litig.*, No. 15-180 (2d Cir. Oct. 11, 2016).

62 485 U.S. 224, 244, 247 (1988).

63 *Vivendi,* 838 F.3d at 1.

64 The Second Circuit's acceptance of this "maintenance theory" of loss causation is consistent with holdings of the Seventh and Eleventh Circuits, *see, e.g., Glickenhaus & Co. v. Household Int'l, Inc.*, 787 F.3d 408 (7th Cir. 2015), *FindWhat Inv'r Grp. v. FindWhat.com*, 658 F.3d 1282 (11th Cir. 2011), but arguably inconsistent with Eighth and Fifth Circuit precedent, *see IBEW Local 98 Pension Fund v. Best Buy Co.*, 818 F.3d 775 (8th Cir. 2016), *Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657, 665 (5th Cir. 2004).

65 Order, *In re Vivendi, S.A. Sec. Litig.*, No. 15-180 (2d Cir. Nov. 10, 2016).

66 838 F.3d 214 (2d Cir. 2016).

67 *Id.* at 216.

between 2000 and 2002, and brought a securities fraud action under Section 10(b) and Rule 10b-5 after the nature of Vivendi's liquidity situation came to light, resulting in the price of Vivendi's securities dropping dramatically.

After a bench trial, the District Court for the Southern District of New York held that Vivendi had rebutted the fraud-on-the-market presumption of reliance by showing that the opt-out plaintiffs likely would have made the same purchasing decisions even if they had known about the fraud, and thus dismissed the plaintiff's claims.[68] The plaintiffs appealed. On appeal, GAMCO argued that the District Court erred in concluding that because GAMCO are value investors, GAMCO did not rely on the integrity of the market in purchasing Vivendi securities.[69] GAMCO's purchasing decisions relied on calculating the "intrinsic value" of a company and then comparing this calculation with the market price, with GAMCO frequently reflecting that the market was "irrational."[70]

At the outset of its analysis, the Second Circuit noted that the Supreme Court found in *Halliburton Co. v. Erica P. John Fund, Inc.*[71] that the fact that an investor is a value investor is not sufficient by itself to rebut the presumption as "there is no reason to suppose that … the value investor is as indifferent to the integrity of market prices as [the defendant] suggests."[72] The Second Circuit, however, declined to "explicate on the contours of *Halliburton*."[73] Rather, the Court found that the District Court did not base the holding of its decision on GAMCO's status as value investors, but on the narrower theory that, given the facts in the record, Vivendi proved that GAMCO did not rely on the market price of Vivendi shares in acquiring their stock and would have purchased Vivendi even if it had known of Vivendi's alleged fraud.[74]

The Court considered GAMCO's argument that it would be unthinkable that a sophisticated investor would purchase securities if the investor was aware that the security's market price was tainted by fraud.[75] However, in rebutting this argument the Court highlighted the evidence in the trial record that supported the District Court's findings: (i) GAMCO's chief investment officer stating that there was a ten percent possibility (in the abstract) that he would purchase securities where the price was inflated due to fraudulent misstatements; (ii) the revelation of Vivendi's liquidity problems did not alter GAMCO's investment; and (iii) GAMCO continuing to purchase Vivendi securities as the full extent of Vivendi's fraud came to light, which suggests that GAMCO continued to believe, even after the revelation of the misstatements, that a "catalyst" event would still occur and cause the share price to rise.[76] Thus, the decision underpins that an investor's

68 *Id.* at 220-21.

69 *Id.* at 217-18.

70 *Id.* at 218.

71 134 S.Ct. 2398 (2014); *see* "Basic is Dying a Slow Death: The Supreme Court Upholds the Fraud-on-the-Market Presumption in Halliburton but Allows Rebuttal," BakerHostetler Client Alert, Marc Powers, Mark Kornfeld, Deborah Renner, and Jessie Gabriel (June 26, 2014), https://www.bakerlaw.com/alerts/basic-is-dying-a-slow-death-the-supreme-court-upholds-the-fraud-on-the-market-presumption-in-halliburton-but-allows-rebuttal. *See also* our 2014 Mid-Year Report; 2015 Year-End Report; 2016 Mid-Year Report; and Mark A. Kornfeld and Deborah H. Renner, *Inside the Minds: New Developments in Securities Litigation, Trends in Recent Developments in Securities Class Actions and Regulatory Enforcement Proceedings*, pp. 55-63 (2016 ed.).

72 *GAMCO*, 838 F.3d at *217, n.3 (quoting *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398, 2411 (2014)).

73 *Id.* at 218.

74 *Id.* at 220.

75 *Id.* at 219.

76 *Id.* at 220-23.

unique investment strategy may impede proving reliance as to alleged misstatements, even where such misstatements were found to be fraudulent and a court upheld the fraud-on-the-market presumption on behalf of a plaintiff class.

Sixth Circuit Accepts Materialization-of-Risk Standard for Loss Causation

On July 20, 2016, the Sixth Circuit, in its decision in *Ohio Public Employees Retirement System v. Fed. Home Loan Mortgage Corporation*,[77] reversed the dismissal of a proposed shareholder class action against the Federal Home Loan Mortgage Corporation and four senior officers (collectively, "Freddie Mac") based on Freddie Mac's alleged concealment of its overexposure of subprime mortgages in 2007.

The plaintiff, the Ohio Public Employees Retirement System ("OPERS"), an Ohio state pension fund serving Ohio public employees, purchased Freddie Mac's stock between August 2006 and November 20, 2006. OPERS alleged that the value of these shares plummeted when risks in Freddie Mac's investments, risk management system, financial condition, and results were revealed. OPERS brought a securities class action alleging that Freddie Mac violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. To succeed on a claim under Section 10(b) and Rule 10b-5, a plaintiff must demonstrate, among other elements, proof of loss causation, which requires that the subject of the fraudulent statement or omission was the cause of the actual loss suffered. The District Court granted Freddie Mac's motion to dismiss the suit, finding that OPERS failed to adequately plead loss causation.

At the outset of its opinion, the Sixth Circuit detailed how courts have found loss not only with a corrective disclosure theory (where a plaintiff alleges cause-in-fact on the ground that the market reacted negatively to a corrective disclosure of fraud), but also based on an alternative theory: "materialization-of-risk."[78] Under this theory, a plaintiff may allege "proximate cause on the ground that negative investor inferences, drawn from a particular event or disclosure, caused the loss and were a foreseeable materialization of the risk concealed by the fraudulent statement."[79]

The District Court rejected OPERS's materialization-of-risk argument, finding that such a theory had not been adopted, nor found persuasive, by the Sixth Circuit.[80] However, on appeal, the Sixth Circuit joined a majority of Circuit Courts of Appeal in finding this theory to be viable in demonstrating loss causation.[81] The Circuit Court found that OPERS sufficiently alleged loss causation, as it propounded that Freddie Mac's stock lost 29 percent in value when it disclosed a $2 billion loss, which was directly attributable to the market's reaction to the revelations of the nature, extent, and impact of fraud at Freddie Mac.[82] In its decision, the Circuit Court emphasized that it is mindful of the "dangerous incentive" that can arise when the success of a plaintiff's loss causation argument is contingent upon a defendant's acknowledgment that it misled investors, and that defendants accused of securities fraud would not be able to escape liability merely by avoiding the creation of a corrective disclosure.[83]

77 *Ohio Pub. Emp. Retirement Sys. v. Fed. Home Loan Mortgage Corp.*, 830 F.3d 376 (6th Cir. 2016).

78 *Id.* at 384-85.

79 *Id.* at 385 (citations omitted).

80 *Id.*

81 *Id.*

82 *Id.* at 388.

83 *Id.* at 385.

Notably, as discussed above, the Second Circuit in *Vivendi* also considered and rejected a similar argument. Like the Sixth Circuit, the Second Circuit found that as a plaintiff's theory of loss causation rests on the revelation of the truth, the Court's loss causation analysis will not be altered whether the truth comes out due to a "corrective disclosure describing the precise fraud inherent in the alleged misstatements" or "through events constructively disclosing the fraud."[84]

The Second Circuit Reaffirms *IndyMac*, Finding Class Action Tolling Doctrine Does Not Apply to Statutes of Repose and Extends Ruling to the Exchange Act

On July 8 and July 14, 2016, the Second Circuit issued two decisions, *In re Lehman Brothers Securities & ERISA Litigation* ("*Lehman Brothers*")[85] and *SRM Global Master Fund Limited Partnership v. Bear Stearns Companies* ("*Bear Stearns*"),[86] respectively. In these decisions, the Second Circuit reaffirmed its holding in *Police & Fire Ret. Sys. v. IndyMac MBS, Inc.* ("*IndyMac*")[87] that the class action tolling doctrine does not apply to statutes of repose and provided an avenue for the Supreme Court to evaluate the decision.

In 1974, the Supreme Court found in *American Pipe & Construction Co. v. Utah* ("*American Pipe*") that the filing of a class action lawsuit may toll a statute of limitations for all putative class members.[88] As detailed in our 2016 Mid-Year Report, since the Supreme Court ruled in *American Pipe*, Circuit Courts have been split on the issue of whether *American Pipe*'s tolling doctrine applies to statutes of repose. In 2013, the Second Circuit held in *IndyMac* that the tolling doctrine established in *American Pipe* does not apply to the three-year statute of repose in Section 13 of the Securities Act.[89] Thirteen years earlier, in *Joseph v. Wiles*,[90] the Tenth Circuit found that *American Pipe* does apply to the Securities Act's statute of repose. On March 30, 2014, the Supreme Court granted the plaintiff's petition in *IndyMac* for a writ of certiorari, but then dismissed the writ shortly after the main parties entered into a proposed settlement agreement disposing of many of the claims at issue.[91]

In *Lehman Brothers*, the plaintiffs, the California Public Employees' Retirement System ("CalPERS") alleged Securities Act claims against Lehman Brothers after opting out of a class action settlement and later filed its own putative class action. The District Court found CalPERS' claims fell outside the three-year statute of repose contained in Section 13 of the Securities Act. However, on appeal, the plaintiffs argued that, unlike in *IndyMac*, the statute of repose was tolled on its claim because it was a member of the putative class with proper standing before exercising its rights to opt out and file its own complaint, and therefore its claims were filed within the statute of repose.[92]

84 *Vivendi*, 838 F.3d at 262.

85 No. 15-1879, 2016 WL 3648259 (2d Cir. 2016).

86 829 F.3d 173 (2d Cir. 2016).

87 721 F.3d 95, 106-109 (2d Cir. 2013).

88 414 U.S. 538 (1974).

89 721 F.3d at 106-109.

90 223 F.2d 114, 1166-68 (10th Cir. 2000).

91 *Public Emps.' Ret. Sys. of Mississippi v. IndyMac MBS, Inc.*, 135 S. Ct. 41 (2014).

92 2016 WL 364259 at *1.

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The Second Circuit rejected this argument, finding that the *IndyMac* Court made no reference to the standing of named plaintiffs when it found that *American Pipe* did not apply to Section 13's statute of repose; rather, the inapplicability of *American Pipe* turned on the nature of the tolling rule and its ineffectiveness against statutes of repose.[93]

In *Bear Stearns*, the plaintiff, SRM Global Master Fund LP ("SRM"), a registered investment fund, asserted that defendants Bear Stearns Cos. LLC and Deloitte & Touche LLP had made material misrepresentations in violation of Section 10(b) and 20(a) of the Exchange Act and SEC Rule 10b-5.[94] The defendants had previously settled similar claims in a consolidated class action, but SRM, at its own request, was excluded from the settlement class and initiated its own action. The District Court dismissed the complaint, finding that *American Pipe*'s class action tolling rule did not apply to 28 U.S.C. § 1658(b)(2), the five-year statute of repose that limits the time in which plaintiffs may bring claims under Section 10(b) and Rule 10b-5. The Second Circuit affirmed, extending *IndyMac* to cover the statute of repose under the Exchange Act as well.[95]

In concluding its decision in *Lehman Brothers*, the Second Circuit noted that its *IndyMac* decision created a Circuit split with the Tenth Circuit, and that the question of whether *American Pipe* tolling applies to statutes of repose "may be ripe for resolution by the Supreme Court."[96] The plaintiffs in *Bear Stearns* appear to be taking this as an opportunity for the Supreme Court to reconsider this issue after it was unable to rule on *IndyMac* as, on September 22, 2016, SRM filed a petition for writ of certiorari on the issue.[97] However, as the Circuit Court noted in *Lehman Brothers*, if the Supreme Court does not grant a writ of certiorari and finds that *IndyMac* was erroneously decided, the decision will stand.

Ninth Circuit Rules The Sarbanes-Oxley Act's Disgorgement Provision Applies Based on The Issuer's Misconduct and Even If There Was No Personal Misconduct From Corporate Officers

In the action *SEC v. Jensen*,[98] the U.S. Court of Appeals for the Ninth Circuit became the first appellate court to hold that the Sarbanes-Oxley Act's disgorgement provision, which compels disgorgement of certain CEO and CFO compensation when an issuer restates its financial statements "as a result of misconduct," [99] allows the SEC to clawback this compensation in the event of a restatement, even if the officers were not involved in the misconduct. This case appears to be the first appellate court to address this issue.

Section 304 of the Sarbanes-Oxley Act provides "[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under securities laws, the chief executive officer and chief financial officer shall reimburse the issuer."[100] At play was the interpretation of the phrase "as a

93 *Id.*

94 829 F.3d at 174.

95 *Id.* at 176-77.

96 2016 WL 3648259 at *2.

97 Petition for Writ of Certiorari, Bear Stearns (No. 14-507-cv).

98 835 F.3d 1100 (9th Cir. 2016).

99 15 U.S.C. § 7243(a).

100 15 U.S.C. § 7243(a).

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result of misconduct."[101] The District Court held that the disgorgement provision does not apply unless the CEO or CFO personally engaged in the misconduct.[102] On appeal, the SEC argued that this conclusion was legally erroneous because the provision is not concerned with individual misconduct, but the misconduct of the issuer.[103] The Ninth Circuit agreed and found that the phrase "as a result of misconduct" modifies the phrase "the material noncompliance of the issuer," suggesting that it is the issuer's misconduct that matters, not the personal misconduct of the CEO or CFO.[104]

101 *Jensen*, 835 F.3d at 1114.

102 *Id.*

103 *Id.*

104 *Id.* at 1114-16.

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Despite the U.S. Supreme Court's highly publicized denial of certiorari in *Newman*[105] in 2015 – which effectively limited the scope of insider trading liability, making it more difficult for the government to win certain insider trading convictions – the SEC pursued its enforcement actions with increased vigor in 2016. The SEC's 2016 efforts featured several high-profile insider trading charges and settlements, including that of hedge fund manager Steven A. Cohen,[106] founder of SAC Capital, who was ultimately barred from managing outside money until 2018 for failing to supervise a former employee who engaged in insider trading. According to Andrew Ceresney, outgoing Director of the SEC's Enforcement Division, before Mr. Cohen "can handle outside money again," an independent consultant would have to ensure "there are legally sufficient policies, procedures, and supervision mechanisms in place to detect and deter any insider trading."[107] Moreover, on December 6, 2016 (as discussed), the Supreme Court partially overturned *Newman* in perhaps the most significant securities decision of the year – *Salman*.[108] The SEC's reach is only likely to expand under the *Salman* decision, which effectively rejected the "pecuniary gain" requirement outlined in *Newman*.[109]

In 2016, the SEC increasingly brought actions against institutions and managers who failed to adequately supervise their employees, and protect against insider trading. The year's insider trading actions cut across a variety of relationships and industries, and included actions involving individuals with access to nonpublic pre-merger information, cases involving failure to monitor red flags and even cases between friends trading inside information in exchange for favors. Indeed, from mere friendships to sophisticated corporate relationships, the SEC has left no stone unturned with respect to insider trading. Financial institutions, fund managers, and broker-dealers, alike, must continue to remain vigilant, but the need to engage experienced and skilled counsel to assist in the creation and implementation of compliance policies and procedures is as pressing as ever.

Data and Analytics Lead to Increased Insider Trading Charges

The SEC won five U.S. District Court jury or bench trials during Fiscal Year 2016, several of which involved insider trading.[110] Using data and analytics to spot suspicious trading activity, the SEC charged 78 parties in cases involving trades based on inside information.[111] The SEC's increasing use of technology, data and analytics has led to increased success in cracking complex insider trading rings, which will likely continue through 2017.[112] Although the SEC's aggressive financial regulatory policies have become the norm, it remains to be seen whether the administration of President Trump will have any effect on the current landscape.[113] We remain confident, however, that the use of data mining and analytics by the SEC will likely continue in the

105 *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), cert. denied, 136 S. Ct. 242 (2015).

106 Press Release, U.S. Securities and Exchange Commission, "Steven A. Cohen Barred From Supervisory Hedge Fund Role," Rel. No. 2016-3 (Sept. 21, 2016), https://www.sec.gov/news/pressrelease/2016-3.html.

107 *Id.*

108 *Salman v. United States*, 137 S. Ct. 420 (2016); *cf. Newman*, 136 S. Ct. at 242.

109 *See Newman*, 773 F.3d at 452; *cf. Salman*, 137 S. Ct. at 428.

110 Press Release, U.S. Securities and Exchange Commission, "SEC Announces Enforcement Results for FY 2016, Successful Litigation," Rel. No. 2016-212 (Oct. 11, 2016), https://www.sec.gov/news/pressrelease/2016-212.html.

111 Press Release, U.S. Securities and Exchange Commission, "SEC Announces Enforcement Results for FY 2016, Rooting Out Insider Trading Schemes Through Innovative Uses of Data and Analytics," Rel. No. 2016-212 (Oct. 11, 2016), https://www.sec.gov/news/pressrelease/2016-212.html.

112 *Id.*

113 Michael Washburn, *BakerHostetler Panel Analyzes Shifts in Enforcement Policies and Tactics As Industry Anticipates New Administration and SEC Chair* (Part One of Two), The Hedge Fund Law Report, Jan. 5, 2017, at 1, 4.

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Trump administration, therefore increasing the need for companies to proactively adopt parallel approaches to data analytics in order to curb style drift, irregular trading or volume trading beyond its proper scope, among other issues.[114]

The SEC started the first quarter of 2016 with three insider trading actions. On February 5, 2016, the SEC charged an executive at Harman International Industries, ("Harman") a Stamford, Connecticut-based electronics company, with insider trading in Harman's stock.[115] The SEC alleged that the executive made "more than $130,000 in illegal profits by trading on nonpublic information he learned on the job in advance of Harman's release of its fiscal year 2014 first quarter earnings."[116] The U.S. Attorney's Office for the District of Connecticut announced a parallel criminal action on the same day. According to the SEC's complaint, the executive: (i) "reviewed Harman's earnings and learned the company would report stronger-than-expected results for its FY14 first quarter, which spanned from July 1 to Sept. 30, 2013"; (ii) "purchased 17,000 shares of Harman stock at a cost of more than $1.2 million" the day before Harman released its financial results; (iii) "liquidated his position when the quarterly results were publicly announced"; and (iv) "produced one-day profits in excess of $130,000."[117]

On March 9, 2016, the SEC announced a settlement involving a Florida man trading on insider information in advance of a pharmaceutical merger between Gilead Sciences and Pharmasset.[118] The use of data and analytics was instrumental to the outcome. Indeed, after the settlement, Joseph G. Sansone, the Co-Chief of the SEC's Market Abuse Unit, noted that the SEC continues "to develop and refine analytical tools to uncover illicit trading activity and hold accountable those abusing the markets for their own financial gain."[119] The Market Abuse Unit "has an Analysis and Detection Center dedicated to crunching trading data to identify suspicious trading patterns."[120]

The Florida defendant ultimately paid back more than $700,000 in illegal profits, plus $60,000 in interest earned after allegedly purchasing stock and call options in Pharmasset Inc. based on his friend's tip.[121] According to the SEC, the defendant "cashed in when Pharmasset's stock rose 84 percent after its acquisition by Gilead Sciences was publicly announced" and "paid kickbacks to his friend who provided the nonpublic information."[122] The tipper ultimately "agreed to pay back the cash kickbacks he received" and "pleaded guilty in a parallel criminal case."[123] The SEC filed its complaint in federal district court in Newark, New Jersey, and the U.S. Attorney's Office for the District of New Jersey announced parallel criminal charges.

114 *Id.* at 5.

115 Press Release, U.S. Securities and Exchange Commission, "SEC Charges Company Executive With Insider Trading," Rel. No. 2016-24 (Feb. 5, 2016), https://www.sec.gov/news/pressrelease/2016-24.html.

116 *Id.*

117 *Id.*

118 Press Release, U.S. Securities and Exchange Commission, "Insider Traders Returning Illegal Profits and Kickbacks," Rel. No. 2016-44 (Mar. 9, 2016), https://www.sec.gov/news/pressrelease/2016-44.html.

119 *Id.*

120 *Id.*

121 *Id.*

122 *Id.*

123 *Id.*

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On May 19, 2016, in one of the SEC's high-profile charges of the year, the SEC announced insider trading charges against Las Vegas sports gambler, William "Billy" Walters ("Walters"), who allegedly made $40 million based on illegal stock tips from a corporate insider at Dean Foods Company ("Dean Foods"), Thomas C. Davis ("Davis"), who allegedly owed Walters money.[124] According to the SEC's complaint, Davis allegedly "shared inside information about Dean Foods with Walters in advance of market-moving events, using prepaid cell phones and other methods in an effort to avoid detection."[125] According to the SEC, "while Walters made millions of dollars insider trading using the confidential information, he provided Davis with almost $1 million and other benefits to help Davis address his financial debts."[126] The SEC also alleged that "professional golfer Phil Mickelson traded Dean Foods's securities at Walters's urging and then used his almost $1 million of trading profits to help repay his own gambling debt to Walters."[127] Although Walters and Davis were charged with insider trading, Mickelson was only named as a relief defendant.[128]

In a parallel action, the U.S. Attorney's Office for the Southern District of New York announced criminal charges against Walters and Davis. The use of data and analytics was critical to bringing the charge against the defendants, as after "certain suspicious trades had been identified, the SEC's investigation analyzed years of trading data and other information and followed the leads back to Walters and Davis, including their use of a variety of prepaid cell phone numbers."[129]

The SEC Cracks Down on Pre-Merger Trades

On April 13, 2016, the SEC brought charges against a research analyst who allegedly made more than $1.5 million through trades he made with his mother's brokerage account, based on nonpublic information concerning a prospective merger between The ADT Corporation and Apollo Global Management ("Apollo Global").[130] The defendant found out about the impending acquisition when Apollo Global approached the investment firm where he was employed to discuss potential debt financing for a public-to-private deal.[131] According to the SEC, the defendant "accessed several highly confidential, deal-related documents on [his employer's] computer network and purchased thousands of high-risk, out-of-the-money ADT call options in his mother's account in anticipation that ADT's stock price would rise when the transaction was publicly announced."[132] The defendant sold all the ADT options in his mother's account after the deal was made public.[133]

The Director of the SEC's San Francisco Regional Office noted that "[i]nsider traders should have learned by now that trying to hide their illegal activity in a relative's account ultimately won't work,"

124 Press Release, U.S. Securities and Exchange Commission, "SEC Announces Insider Trading Charges in Case Involving Sports Gambler and Board Member," Rel. No. 2016-92 (May 19, 2016), https://www.sec.gov/news/pressrelease/2016-92.html.

125 *Id.*

126 *Id.*

127 *Id.*

128 *Id.*

129 *Id.*

130 Press Release, U.S. Securities and Exchange Commission, "SEC: Research Analyst Is Insider Trading in Mother's Brokerage Account," Rel. No. 2016-67 (Apr. 13, 2016), https://www.sec.gov/news/pressrelease/2016-67.html.

131 *Id.*

132 *Id.*

133 *Id.*

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and that "[o]n behalf of the millions of traders in our markets who play by the rules," the SEC "will continue to detect and expose those who don't."[134]

The second quarter of 2016 saw an uptick in insider trading actions, particularly with respect to actions involving pre-merger trades. On May 2, 2016, the SEC announced a $500,000 settlement involving a Silicon Valley executive who allegedly traded on inside information received from a board member at FSI International ("FSI").[135] According to the SEC, the board member informed the defendant that "a Japan-based semiconductor equipment company called Tokyo Electron Ltd. was negotiating to acquire FSI."[136] The SEC's complaint alleged that the defendant "misused the confidential information entrusted to him about FSI's potential merger plans and bought 105,000 FSI shares during the next six months."[137] The defendant also "recommended the trade to his brother, who purchased 1,000 shares of FSI stock."[138] The defendant ultimately, without admitting or denying the allegations, agreed "to be permanently enjoined from future violations and [was] ordered to pay $254,858 in disgorgement of ill-gotten gains plus interest of $24,587 and a penalty of $254,858 for a total of $534,303."[139]

On May 31, 2016, the SEC announced insider trading charges against an investment banker and his close friend, a plumber, who allegedly helped remodel his bathroom.[140] The SEC's Analysis and Detection Center within the SEC's Market Abuse Unit "detected an illicit pattern of trading" by the plumber, whom the investment banker allegedly "tipped with nonpublic information on 10 different occasions ahead of public merger announcements."[141] According to the Co-Chief of the SEC Enforcement Division's Market Abuse Unit, the SEC "will continue enhancing [its] market surveillance techniques to detect patterns of insider trading and expose schemes, even when alleged perpetrators … attempt to avoid detection by providing in-person tips and cash payments."[142]

On June 9, 2016, the SEC also announced that a former consultant to two China-based private equity firms agreed to pay more than $756,000 to settle insider trading charges.[143] The SEC alleged that the defendant "traded on confidential information he obtained while advising the two firms as they pursued a buyout of Silicon Valley-based OmniVision Technologies ("OmniVision"), a maker of optical semiconductor devices."[144] According to the SEC, the defendant "attended key meetings and performed technical due diligence related to the potential acquisition of OmniVision, and he received timeline and strategy documents from the firms."[145] The defendant

134 *Id.*

135 Press Release, U.S. Securities and Exchange Commission, "Silicon Valley Executive Settles Insider Trading Charges," Rel. No. 2016-79 (May 2, 2016), https://www.sec.gov/news/pressrelease/2016-79.html.

136 *Id.*

137 *Id.*

138 *Id.*

139 *Id.*

140 Press Release, U.S. Securities and Exchange Commission, "Investment Banker and Plumber Charged With Insider Trading," Rel. No. 2016-96 (May 31, 2016), https://www.sec.gov/news/pressrelease/2016-96.html.

141 *Id.*

142 *Id.*

143 Press Release, U.S. Securities and Exchange Commission, "Consultant to Chinese Private Equity Firms Settles Insider Trading Charges," Rel. No. 2016-115 (June 9, 2016), https://www.sec.gov/news/pressrelease/2016-115.html.

144 *Id.*

145 *Id.*

allegedly “stockpiled 39,373 shares of OmniVision stock through a series of purchases in April and May 2014 while possessing nonpublic information,” and generated $367,387 in illegal profits after “OmniVision’s stock price rose 15 percent when the proposed acquisition was publicly announced.”[146] The defendant, without admitting or denying the SEC’s allegations, “agreed to pay disgorgement of $367,387 plus interest of $21,986 and a penalty of $367,387.”[147]

The SEC’s momentum continued through the third and fourth quarters of the year. On August 11, 2016, the SEC charged a stockbroker and his acquaintance with participating in insider trading in advance of a pharmaceutical merger involving Ardea Biosciences.[148] According to the SEC, an Ardea Biosciences employee tipped the broker “ahead of the company’s announcement of an agreement to license a cancer drug and later tipped him in advance of its acquisition by AstraZeneca PLC.”[149] The defendants allegedly made “approximately $90,000 in illicit profits by trading ahead of those announcements based on nonpublic information that flowed to them.”[150] In a parallel action, the U.S. Attorney’s Office for the Southern District of California brought criminal charges against the defendants.

On September 28, 2016, the SEC charged two lawyers and a brokerage firm manager in Peru with insider trading prior to the merger of two mining companies, Canadian-based HudBay Minerals Inc. (“HudBay Minerals”) and Augusta Resource Corp., whose principal business involved an Arizona copper mine.[151] The SEC alleged that the defendant who worked at HudBay Minerals tipped a close friend and fellow attorney “with material nonpublic information about a tender offer his company submitted to acquire the shares of Augusta Resource Corp.”[152] The defendant’s friend “allegedly traded on the inside information through a brokerage account held by a shell company he set up in the British Virgin Islands in an attempt to avoid having the trades traced back to him.”[153] The SEC alleged that the HudBay Minerals defendant and his friend made more than $112,000 in illicit profits from the unlawful trades.[154]

The SEC also alleged that the HudBay Minerals defendant tipped a fellow attorney (the “attorney defendant”) when seeking counsel on how to make illegal trades untraceable.[155] According to the SEC, the attorney defendant obtained $73,000 in alleged profits by exploiting “the inside information and caus[ing] his brokerage firm to purchase Augusta Resource shares ahead of the tender offer announcement.”[156] The Director of the SEC’s New York Regional Office declared

146 *Id.*

147 *Id.*

148 Press Release, U.S. Securities and Exchange Commission, “SEC Charges Stockbroker and Friend With Insider Trading,” Rel. No. 2016-160 (Aug. 11, 2016), https://www.sec.gov/news/pressrelease/2016-160.html.

149 *Id.*

150 *Id.*

151 Press Release, U.S. Securities and Exchange Commission, “SEC Files Insider Trading Charges Against Peruvian Traders Using Overseas Accounts,” Rel. No. 2016-198 (Sept. 28, 2016), https://www.sec.gov/news/pressrelease/2016-198.html.

152 *Id.*

153 *Id.*

154 *Id.*

155 *Id.*

156 *Id.*

that, "[t]ry as they might, overseas traders shouldn't presume they can cover their tracks to avoid detection and scrutiny from U.S. law enforcement when they violate insider trading laws."[157]

On October 21, 2016, the SEC charged a Tennessee-based lawyer who allegedly made more than $56,000 in ill-gotten gains, based on nonpublic information he learned about an impending merger. [158] The defendant served on the executive committee of the board of directors at Nashville-based Pinnacle Financial Partners ("Pinnacle").[159] According to the SEC, the defendant purchased securities "in Pinnacle's acquisition target, Avenue Financial Holdings, prior to the banks' joint public announcement later that month."[160] The SEC alleged that the defendant "learned confidential details about the planned merger during a board executive committee meeting on Jan. 5, 2016, and proceeded to place his first order to purchase Avenue Financial stock while that executive committee meeting was still in progress."[161] The defendant was charged with violations of Section 10(b) of the Exchange Act and Rule 10b-5.[162]

When Failure to Monitor Red Flags Leads to Insider Trading Liability

On October 13, 2016, the SEC announced that a hedge fund advisory firm, San Francisco-based Artis Capital Management ("Artis Capital"), and a senior research analyst have agreed to settle charges related to their failures to maintain adequate procedures and policies to prevent insider trading by one of their employees.[163] According to the SEC, Artis Capital and the employee's supervisor, specifically, "failed to respond appropriately to red flags that should have alerted them to the misconduct."[164] Artis Capital agreed to settle the SEC's charges by disgorging approximately $5.17 million in illicit trading profits that were wrongly generated for the firm, plus approximately $1.13 million and $2.58 million in interest and penalties, respectively.[165] According to the Senior Associate Director of the SEC's New York Regional Office, "Hedge fund advisory firms and supervisors must take all reasonable measures necessary to prevent insider trading," and Artis Capital "failed to take any action at all in response to [its employees] highly profitable and suspiciously timed trading recommendations."[166]

The SEC Pursues Hackers Seeking Nonpublic Information

On December 5, 2016, the SEC announced insider trading charges against a San Francisco-based information technology specialist who worked in Expedia's corporate IT services department.[167] The specialist allegedly hacked into the email accounts of senior executives at the online travel

157 *Id.*

158 Press Release, U.S. Securities and Exchange Commission, "SEC Charges Board Member With Insider Trading During and After Board Meeting," Rel. No. 2016-222 (Oct. 21, 2016), https://www.sec.gov/news/pressrelease/2016-222.html.

159 *Id.*

160 *Id.*

161 *Id.*

162 *Id.*

163 Press Release, U.S. Securities and Exchange Commission, "Hedge Fund Firm and Supervisor Charged With Failing to Prevent Insider Trading," Rel. No. 2016-214 (Oct. 13, 2016), https://www.sec.gov/news/pressrelease/2016-214.html.

164 *Id.*

165 *Id.*

166 *Id.*

167 Press Release, U.S. Securities and Exchange Commission, "IT Specialist Settles Charges of Insider Trading on Hacked Nonpublic Information," Rel. No. 2016-256 (Dec. 5, 2016), https://www.sec.gov/news/pressrelease/2016-256.html.

Insider Trading Cases

company and traded on company secrets.[168] According to the SEC, the IT specialist "illegally traded in advance of nine company news announcements from 2013 to 2016 and generated nearly $350,000 in profits."[169] In its complaint, the SEC alleged that the specialist "exploited administrative access privileges designated for IT personnel to remotely hack into computers and email accounts of senior executives and review confidential documents and pre-earnings reports."[170] The specialist "allegedly used this nonpublic information to make highly profitable trades in Expedia securities ahead of the announcements."[171] To settle the charges, the specialist agreed to pay "disgorgement of $348,515.72 plus interest of $27,391.30 for a total of $375,907.02."[172]

Similarly, on December 27, 2016, the SEC announced that three traders were charged with fraudulently trading on hacked nonpublic market-moving information.[173] The information was allegedly stolen from two New York-based law firms, and allegedly resulted in a gain of approximately $3 million in illicit profits.[174] The enforcement action marked the first time the SEC "charged hacking into a law firm's computer network."[175] The SEC complaint alleged that the traders "executed a deceptive scheme to hack into the networks of two law firms and steal confidential information pertaining to firm clients that were considering mergers or acquisitions."[176] The alleged incidents involved "installing malware on the law firms' networks, compromising accounts that enabled access to all email accounts at the firms, and copying and transmitting dozens of gigabytes of emails to remote internet locations."[177] According to the Acting Director of the SEC's Enforcement Division, Stephanie Avakian, the action represented the SEC's "commitment and effectiveness in rooting out cyber-driven schemes no matter how sophisticated."[178]

As noted above, financial institutions, fund managers, broker-dealers, and even law firms must continue to remain vigilant regarding potential insider trading threats. Given the ever-changing landscape of insider trading and the contours of resulting liability, it would be prudent to seek counsel whenever in doubt, and to ensure that your institution is protected with effective policies and procedures to prevent insider trading.

168 *Id.*

169 *Id.*

170 *Id.*

171 *Id.*

172 *Id.*

173 Press Release, U.S. Securities and Exchange Commission, "Chinese Traders Charged With Trading on Hacked Nonpublic Information Stolen From Two Law Firms," Rel. No. 2016-280 (Dec. 27, 2016), https://www.sec.gov/news/pressrelease/2016-280.html.

174 *Id.*

175 *Id.*

176 *Id.*

177 *Id.*

178 *Id.*

Settlements

Settlements

According to analysis conducted by NERA Economic Consulting, settlement amounts increased steadily for the second year in a row.[179] The 2016 average settlement amount was $72 million, an increase of over 35% higher than the $53 million 2015 average.[180] The median settlement in 2016 was $9.1 million.[181] NERA's analysis of the ten-year trend in average and median settlements revealed that a few large settlements fueled the recent increase in the average settlement amount, while many small settlements kept the median relatively stable.[182]

On the regulatory front, the SEC announced a new single-year high for enforcement actions for the fiscal year that ended September 30, 2016.[183] The SEC filed 868 enforcement actions, including the most ever cases involving investment advisers or investment companies (160). The agency also brought a record 548 stand-alone or independent enforcement actions and obtained judgments and orders totaling more than $4 billion in disgorgement and penalties.

Civil Settlements

JPMorgan's RMBS Settlement

On August 12, 2016, the New York State Supreme Court Commercial Division approved a $4.5 billion settlement that resolved institutional investors' claims that JPMorgan Chase ("JPMorgan") misled customers into purchasing subprime residential mortgage-backed securities.[184] The Court found that the agreement the parties had reached in 2013 was negotiated in good faith by the investors' trustees. The $4.5 billion cash settlement payment will resolve the trusts' representation and warranty and servicing claims. JPMorgan also agreed to implement servicing changes to mortgage loans in the trusts.

Lawrence E. Jaffe Pension Plan et al. v. Household International, Inc. ("Household International") et al., No. 1:02-cv-05893 (N.D. Ill.)

On October 20, 2016, the United States District Court of the Northern District of Illinois granted final approval of $1.575 billion to settle a class action and allegations that Household International and its former top executives committed securities fraud. The shareholders claimed that the defendants lied about the company's lending practices, financial accounting and bond issuances.[185] They also alleged that the defendants' fraudulent behavior forced Household International to restate nine years' worth of revenue, a restatement meant to correct $386 million in intentionally overstated revenue during that period. In 2009, a jury found in favor of the shareholders, and the court entered a $2.4 billion partial final judgment in 2013. The defendants appealed, and last year, the Seventh Circuit reversed and sent the case for a new trial. The District Court approved the settlement on the eve of the second trial.

179 Stefan Boettrich and Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2016 Full-Year Review, 28* (Jan. 23, 2017) http://www.nera.com/content/dam/nera/publications/2017/PUB_2016_Securities_Year-End_Trends_Report_0117.pdf.

180 *Id.* at 28. The increase in the average settlement amount was driven by two large, long-standing cases: *Household International,* which settled for $1.58 billion, and *Merck & Co.*, which settled in early 2016 for $1.06 billion. *Id.* at 1; *see Lawrence E. Jaffe Pension Plan et al. v. Household International, Inc. et al.*, No. 1:02-cv-05893 (N.D. Ill. 2016) (described herein); *and In re Merck & Co., Inc., Sec., Derivative & ERISA Lit.*, No. 2:05-cv-01151 (D. N.J. 2016). As NERA notes, after excluding these settlements, the average settlement amount fell to $43 million. *Id.* at 28.

181 *Id.* at 31.

182 *Id.*

183 Press Release, United States Securities and Exchange Commission, "SEC Announces Enforcement Results for FY 2016," Rel. No. 2016-212 (Oct. 11, 2016), https://www.sec.gov/news/pressrelease/2016-212.html

184 Decision, *U.S. Bank N.A. et al. v. Fed. Home Loan Bank of Boston et al.*, No. 652382/2014 (N.Y. Sup. Ct. 2016), ECF No. 593.

185 Complaint at 1-2, *Lawrence E. Jaffe Pension Plan et al. v. Household International, Inc. et al.*, No. 1:02-cv-05893 (N.D. Ill. 2002), ECF No. 1.

Settlements

Regulatory Settlements

Apollo Global Management

On August 23, 2016, four private equity fund advisers affiliated with Apollo Global Management ("Apollo") agreed to pay $52.7 million to settle charges by the SEC that they misled fund investors about fees and a loan agreement and failed to supervise a senior partner who charged personal expenses to the funds.[186] The SEC alleged that Apollo advisers failed to adequately disclose the benefits they received to the detriment of fund investors by accelerating the payment of future monitoring fees owed by the funds' portfolio companies upon a sale or initial public offering of those companies. The lump sum payments received by the advisers reduced the portfolio companies' value prior to their sale or IPO and reduced amounts available for distribution to fund investors. The SEC also alleged that one Apollo adviser failed to disclose information about interest payments on a loan between the adviser's affiliated general partner and five funds. The loan was intended to defer taxes on carried interest due the general partner. The SEC's press release noted: "A common theme in our recent enforcement actions against private equity firms is their failure to properly disclose fees and conflicts of interest to fund investors. Investors in Apollo funds were not adequately informed about accelerated monitoring fees and separately allocated loan interest, and therefore were unable to gauge their impact on their investments."[187]

Ernst & Young

On September 19, 2016, the SEC announced that Ernst & Young agreed to pay a total of $9.3 million to settle two separate claims that a pair of the firm's audit partners got too close to their clients on a personal level in violation of auditor independence rules.[188] The SEC alleged that Ernst & Young failed to recognize red flags that one partner had an inappropriately close friendship with the chief financial officer of one client and another partner became romantically involved with the chief accounting officer of another client. Ernst & Young misrepresented in its audit reports for the respective clients that it maintained its independence.

"These are the first SEC enforcement actions for auditor independence failures due to close personal relationships between auditors and client personnel," said Andrew J. Ceresney, Director of the SEC's Division of Enforcement. "Ernst & Young did not do enough to detect or prevent these partners from getting too close to their clients and compromising their roles as independent auditors."

186 Press Release, United States Securities and Exchange Commission, "Apollo Charged With Disclosure and Supervisory Failures," Rel. No. 2016-165 (Aug. 23, 2016), https://www.sec.gov/news/pressrelease/2016-165.html.

187 *Id.*

188 Press Release, United States Securities and Exchange Commission, "Ernst & Young, Former Partners Charged With Violating Auditor Independence Rules," Rel. No. 2016-187 (Sep. 19, 2016), https://www.sec.gov/news/pressrelease/2016-187.html.

Settlements

Admissions of Wrongdoing

Merrill Lynch

On June 23, 2016, the SEC announced that Merrill Lynch agreed to pay $415 million and admit wrongdoing to settle charges that it misused customer cash on option trades and failed to safeguard customer securities, so that it could generate profits.[189] The SEC alleged that Merrill Lynch violated the SEC's Customer Protection Rule by misusing cash that it should have safeguarded in a reserve account, and by artificially reducing the required deposit of customer cash. Merrill Lynch also failed to keep customer securities in lien-free accounts and shielded from third-party claims. The SEC confirmed that Merrill Lynch cooperated fully with the SEC's investigation and has engaged in extensive remediation, including the retention of an independent compliance consultant to review its compliance with the Customer Protection Rule. Merrill Lynch agreed to pay $57 million in disgorgement and interest and a $358 million penalty.

189 Press Release, United States Securities and Exchange Commission, "Merrill Lynch to Pay $415 Million for Misusing Customer Cash and Putting Customer Securities at Risk," Rel. No. 2016-128 (Jun. 23, 2016), https://www.sec.gov/news/pressrelease/2016-128.html.

Investment Adviser and Hedge Fund Cases

Investment Adviser and Hedge Fund Cases

In the second half of 2016, the SEC continued to pursue hedge funds and investment advisers for myriad violations of the federal securities laws. Several actions involved misleading clients about fees and overcharging them, as well as those concerning stealing client assets. Advisers, hedge fund managers, administrators and other third-party professionals should seek to tighten their compliance efforts to avoid being on the wrong end of an enforcement action.

SEC Adopts New Reporting Rules for Investment Advisers

On August 25, 2016, the SEC adopted new Advisers Act rules regarding registration and reporting.[190]

The new rules amend Form ADV disclosures and are designed to provide additional information about investment advisers, including that of advisers' managed account businesses. The rules also allow multiple private fund advisers operating a single advisory business to file a single Form ADV, called an umbrella registration.

Other changes to the rules include requiring advisers to make and keep supporting documentation reflecting the distribution of materials that includes an adviser's rates of return. The SEC believes this rule will protect investors from fraudulent performance claims.

There are a host of other technical rules incorporated as part of this adoption, many of them technical in nature. However, the SEC believes that the rules will not create a large imposition on advisers, and estimates that small advisers subject to the Form ADV changes will spend only five hours each to meet the new requirements.

The SEC Penalizes 13 Investment Advisory Firms for Advertising False Performances

On August 25, 2016, the SEC announced penalties against several investment advisory firms for violating securities laws by spreading false claims made by F-Squared, an investment firm, about one of its products.[191]

The SEC stated that the firms: (i) relied on F-Squared's statements that it had outperformed the S&P 500 for several years; (ii) failed to adequately investigate those statements' validity; and (iii) had no reasonable basis for believing those statements. The firms disseminated these statements to their investors and caused them to be misled, thereby committing violations of Advisers Act Sections 204 and 206(4) and the relevant rules thereunder.

The firms paid between $100,000 and $500,000 each (collectively, $2.2 million) to settle these charges.

In the Matter of Laurence I. Balter d/b/a Oracle Investment Research ("Balter")

On October 4, 2016, the SEC announced cease-and-desist proceedings against Balter, an

190 17 CFR Parts 275 and 279, Rel. No. IA-4509; File No. S7-09-15, Form ADV and Investment Advisers Act Rules, Aug. 25, 2016, available at https://www.sec.gov/rules/other/2016/ia-4511.pdf

191 Press Release, United States Securities and Exchange Commission, "Investment Advisers Paying Penalties for Advertising False Performance Claims," Rel. No. 2016-167 (Aug. 25, 2016), https://www.sec.gov/news/pressrelease/2016-167.html.

investment adviser, revolving around accusations of cherry-picking trades for his own account ahead of his clients' accounts, and misleading clients about fees and risks.[192]

While nominally engaged in a long-term capital appreciation strategy for his clients (who were largely elderly), Balter had switched to a day-trading strategy without informing his clients. Balter's Form ADV stated he would trade for his clients before himself. In reality, however, he executed trades in an omnibus account, but did not pre-allocate them. Instead, he allocated the profitable trades to his own account and the account of one other client. The SEC alleges that trading in this manner conflicted with his Form ADV and was inconsistent with his policies and procedures, and constituted breaches of Balter's fiduciary duties to his clients.

The SEC stated that Balter's day-trading violated his stated investing policies, including taking such large positions as to no longer be a "diversified" company. This change without telling his clients comprised a misrepresentation and a breach of his fiduciary duties.

The SEC also accused Balter of double-charging his clients by charging advisory and management fees, which he explicitly told clients he would not do. The SEC alleged such misrepresentations constituted a further breach of his fiduciary duties.

The matter is currently pending.

In the Matter of Raymond James & Associates, Inc. ("Raymond James") and In the Matter of Robert W. Baird & Co., Inc. ("Baird")

On September 8, 2016, the SEC announced settlements with two investment advisory firms, Raymond James and Baird (collectively, the "Firms"), which were accused of wrap fee program compliance failures.[193] Specifically, the SEC cited the Firms for failing to establish procedures to determine the commissions their clients were charged when sub-advisers "traded away" with broker-dealers outside the wrap program.

Lacking the ability to understand these commissions, the Firms could not adequately inform their clients and did not consider the commissions when determining suitability. Generally, the Firms' clients participating in the wrap program paid no commissions when the Firms acted as broker-dealer for the clients in executing their trades. However, when the Firms used sub-advisers to execute instead, the clients were subject to commissions on top of their wrap fees.

The Firms agreed to make disclosures to clients and potential clients about this practice. Raymond James paid a $600,000 penalty and Baird paid a $250,000 penalty in connection with their corresponding settlements.

192 *In the Matter of Laurence I. Balter d/b/a Oracle Investment Research*, Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Rel. No. 10228, Oct. 4, 2016.

193 *In the Matter of Raymond James & Associates, Inc.*, 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, Rel. No. 4525, Sept. 8, 2016; *In the Matter of Robert W. Baird & Co., Inc.*, 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, Rel. No. 4526, Sept. 8, 2016.

Investment Adviser and Hedge Fund Cases

SEC v. Platinum Management (NY) LLC; Platinum Credit Management, L.P.; Mark Nordlicht; David Levy; Daniel Small; Uri Landesman; Joseph Mann; Joseph Sanfilippo; and Jeffrey Shulse

On December 19, 2016, the SEC filed a complaint ("the "Complaint") against Platinum Partners' founder ("Nordlicht") and two of its flagship hedge fund advisory firms ("Platinum Funds") and other Platinum officers and employees (collectively, the "Platinum Defendants"). The Complaint alleged that the Platinum Defendants inflated asset values and illicitly moved investors' funds to cover losses and to meet liquidity needs.[194]

The SEC claimed that Platinum Partners Value Arbitrage Fund L.P. ("PPVA") had incurred liquidity problems since as early as 2012, as investors submitted requests for what Nordlicht termed "daunting" and "relentless" redemptions while not receiving enough subscriptions.[195] Among other things, the Complaint also alleged that the Platinum Defendants inflated the value of certain of Platinum's investments. The Platinum Defendants are also accused of false claims to auditors that high-interest loans (needed to keep the funds afloat) were used to complete "investment transactions." Additionally, the SEC alleged that the Platinum Defendants paid redemptions in a preferential manner.[196]

This matter is pending, and there is a parallel criminal proceeding currently pending in the Eastern District of New York.[197]

SEC v. Marc D. Broidy ("Broidy") and Broidy Wealth Advisors, LLC ("BWA")

On October 27, 2016, the SEC filed an action in the Eastern District of New York against an investment adviser, BWA, and its sole owner and principal, Broidy, for, among other things, intentionally overbilling clients whom Broidy allegedly used to pay his personal expenses.[198]

The SEC alleged that Broidy doctored 1099 forms to reflect lower fees than the clients were charged. Broidy allegedly overcharged five clients a total of $643,000. BWA engaged two broker-dealers in connection with its advisory business. These broker-dealers became suspicious of the fee activity in certain client accounts and, after inquiring, terminated their relationships with BWA.

The SEC also accused Broidy of misappropriating assets from two clients' trust accounts for which Broidy was trustee. He withdrew cash and securities from the account with which he paid personal credit card debts.

Broidy is accused of violating Section 17(a) of the Securities Act, and 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as Sections 206(1) and (2) of the Advisers Act.

This matter is pending.

194 *SEC v. Platinum (NY) LLC, et al.*, No. 16-cv-06848 (DLI) (E.D.N.Y filed Dec. 19, 2016).

195 *Id.*

196 *Id.*

197 *SEC v. Nordlicht, et al.*, No. 16-cr-640 (E.D.N.Y filed Dec. 14, 2016).

198 *SEC v. Broidy*, Case No. 16-cv-05960 (E.D.N.Y. filed Oct. 27, 2016).

Investment Adviser and Hedge Fund Cases

SEC v. Matrix Capital Markets, LLC ("Matrix") and Nicholas M. Mitsakos ("Mitsakos")

On August 11, 2016, the SEC filed suit against an individual, Mitsakos, and his investment advisory firm, Matrix, charging Mitsakos with stealing client assets.[199]

Mitsakos falsely claimed to a potential client that he managed over $60 million at Matrix, but actually managed none. The duped investor gave Matrix money to manage based on these false claims, and Mitsakos is alleged to have stolen that client's money.

Mitsakos created a model portfolio in which he claimed to hold and trade certain assets and reflected that he returned 25% to 66% returns. After the client sent cash to Matrix, Mitsakos is alleged to have taken $600,000 from the client and used it to pay personal expenses.

This matter is currently pending. The U.S. Attorney's office is seeking a stay of the matter during the pendency of its parallel criminal action in the Southern District of New York.

In the Matter of Donald F. ("Jay") Lathen, Jr. ("Lathen"), Eden Arc Capital Management, LLC, and Eden Arc Capital Advisors, LLC, (collectively, the "Lathen Defendants")

On August 15, 2016, the SEC announced charges against Lathen, a hedge fund manager, his hedge fund and its adviser, accusing them of defrauding terminally ill investors.[200]

The SEC alleged that Lathen signed up terminally ill investors to participate in an investment scheme that involved buying fixed income instruments that contained "survivor options" or "death puts." Upon the death of the account holder, the fixed income securities would be sold back to the issuer. Lathen allegedly became a joint account holder with his investors and benefited from these survivor options, collecting upon the joint account holders' deaths.

The SEC claimed that Lathen paid more than sixty victims $10,000 each to participate in the scheme. Lathen purchased approximately 2,350 survivor option instruments from dozens of issuers and cashed in over $100 million in payments through his fraud.

The SEC accused the Lathen Defendants of several violations of federal securities laws. This matter is pending.

SEC v. Onix Capital LLC ("Onix") and Alberto Chang-Rajii ("Chang")

On December 1, 2016, the SEC brought a claim for injunctive and other relief against Onix, an asset management company, and Chang, its principal, for violations of the anti-fraud provisions of the federal securities laws in connection with running a Ponzi-like scheme.[201]

Chang is accused of defrauding investors through the purchase of promissory notes with "guaranteed" returns and swindling others, convincing them they were investing in start-up

199 *SEC v. Matrix Capital Markets, LLC*, Case No. 16-cv-06395 (S.D.N.Y. filed Aug. 11, 2016).

200 *In the matter of Donald F. ("Jay") Lathen, Jr., Eden Arc Capital Management, LLC, and Eden Arc Capital Advisors, LLC*, Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, 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. Act. Rel. No. 10120, Aug. 15, 2016.

201 *SEC v. Onix Capital, LLC, et al.*, No. 16-cv-24678-MGC (S.D. Fla. filed Dec. 1, 2016). The SEC filed an amended complaint on December 1, 2016 (the "Amended Complaint"). *See id.* at ECF No. 41.

companies like Uber and Snapchat. In reality, the would-be start-up investors' funds were given to other investors.

The SEC alleged that Chang and Onix violated several sections of the Securities Act, the Exchange Act, the Advisers Act, and various rules promulgated thereunder. The SEC is seeking, among other things, an order freezing Onix's and Chang's assets, a receiver over Onix, and disgorgement of investor assets.

This matter is pending.

In the Matter of Adrian D. Beamish, CPA ("Beamish")

On October 31, 2016, the SEC announced an action against a PricewaterhouseCoopers audit partner, Beamish, for failure to scrutinize payments made by a venture capital fund.[202] Beamish is accused of failing to determine whether the fund's advisor had the proper authorization and rationale for making the payments, and he allegedly failed to make sure the transactions were properly disclosed.

The fund's founder arranged for the fund to pay companies that he owned and controlled, by characterizing them as "advances on future management fees," which were paid months or years before they were earned. The founder used the money to pay personal expenses and to fund his other businesses.

Beamish allegedly rejected his team's suggestion to disclose the payments. He is also accused of improperly signing audit reports with unqualified opinions for several years, and those financial statements did not comply with Generally Accepted Accounting Principles ("GAAP").

Beamish faces a potential suspension from appearing or practicing before the SEC, which will be determined by an ALJ at a public hearing.

In the Matter of Och-Ziff Capital Mgmt. Group LLC, OZ Mgmt. LP, Daniel S. Och, and Joel M. Frank ("Och-Ziff")

On September 29, 2016, Och-Ziff Capital Management Group LLC ("Och-Ziff"), a capital management group, along with one of its wholly-owned investment advisers, ("OZ Africa"), its management company ("OZ Management"), its founder, chairman, and CEO, and its CFO, agreed to settle FCPA charges brought by the Department of Justice and the SEC.[203] Och-Ziff entered into a deferred prosecution agreement with the Department of Justice after it was charged with conspiracy to violate the anti-bribery provisions of the FCPA, falsifying books and records, and failing to implement adequate internal controls.[204] OZ Africa pled guilty to one count of conspiring to violate the anti-bribery provisions of FCPA.

This is the first time FCPA charges were brought against a hedge fund. Och-Ziff admitted to

202 *In the Matter of Adrian D. Beamish, CPA, Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice*, Sec. Exch. Act. Rel. No. 79193, Oct. 31, 2016.

203 See Marc D. Powers, Andrew Reich, and Jonathan A. Forman, *Top 10 SEC Enforcement Highlights of 2016* (Jan. 20, 2017).

204 *In the Matter of Och-Ziff Capital Mgmt. Group LLC, OZ Mgmt. LP, Daniel S. Och, and Joel M. Frank*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, and Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, Imposing Remedial Sanctions, and a Cease-and-Desist Order, and Notice of Hearing, Exch. Act Rel. No. 78989 (Sept. 29, 2016).

paying bribes to foreign officials in several African countries, including the Democratic Republic of the Congo ("DRC"). In that situation, Och-Ziff entered into a partnership with a businessman operating in the DRC and used him to pay high-ranking DRC officials for access to mining industry investment opportunities. The SEC's order found that Och-Ziff and OZ Management violated FCPA anti-bribery, books and records, and internal controls provisions.

The SEC alleged that Och-Ziff's bribes, inaccurate recording of those payments, and failure to maintain controls, also constituted violations of Exchange Act Sections 13(b)(2)(A) and (B). The order also alleged that OZ Management violated Advisers Act Sections 206(1) and (2) for failure to prevent the misuse of managed investor funds.

The order further stated that Och-Ziff's CEO and CFO personally approved the expenditure of the funds used in the DRC venture. While they did not know the bribes would be paid, they "were aware of the high risk of corruption" in the DRC transactions.

Och-Ziff and OZ Management agreed to pay a $199 million disgorgement (including prejudgment interest) to retain a compliance monitor for three years and to implement various internal controls. The CEO agreed to pay $2.2 million in disgorgement (reflecting his estimated share gain to Och-Ziff owing to the DRC transactions) including prejudgment interest. In a parallel settlement with the Department of Justice, OZ Africa agreed to pay a $213 million criminal penalty.[205]

Expansive Interpretation of Advisers Act Rule Targets Fund Administrators as Gatekeepers

Fund administrators have been the target of several recent SEC enforcement actions that seek to hold administrators liable for the misconduct of fund managers and their principals.[206] These aggressive enforcement actions are the first of their kind to argue that administrators serve in a gatekeeper role. The most recent ones were brought against Apex Fund Services (US), Inc. ("Apex"), in June 2016 for allegedly violating Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder in connection with its administrative services for ClearPath Wealth Management, LLC ("ClearPath"),[207] and EquityStar Capital Management, LLC ("EquityStar"),[208] each of which were subject to separate enforcement actions for fraud.

In both enforcement actions, the SEC alleged that Apex contracted with each of ClearPath and EquityStar to maintain records and prepare financial statements and investor account statements but failed to take reasonable steps in response to red flags indicating each fund manager was misappropriating assets. Those red flags included: (i) undisclosed withdrawals, margin accounts and pledged assets; (ii) a warning from a prior fund administrator; and (iii) a background check on one of the adviser's principals, revealing a previous wire fraud conviction. In each settled order, Apex allegedly continued to prepare inaccurate NAV statements and reports despite being aware of these red flags. Pursuant to the settled orders in which Apex neither admitted nor denied

205 Plea Agreement, *United States v. OZ Africa Management GP, LLC*, 16-cr-515 (E.D.N.Y. filed Sept. 29, 2016).

206 *See* Marc D. Powers and Jonathan A. Forman, *Liability of Hedge Fund Service Providers – "Gatekeeper" Actions by the SEC and Investors Against Administrators Challenge Private Fund Industry*, The Hedge Fund Law Report (Sept. 8, 2016); and Marc D. Powers, Andrew Reich, and Jonathan A. Forman, *Top 10 SEC Enforcement Highlights of 2016* (Jan. 20, 2017).

207 *In the Matter of Apex Fund Services (US), Inc.*, No. 3-17299 (June 16, 2016), https://www.sec.gov/litigation/admin/2016/ia-4428.pdf.

208 *In the Matter of Apex Fund Services (US), Inc.*, No. 3-17300 (June 16, 2016), https://www.sec.gov/litigation/admin/2016/ia-4429.pdf.

the findings, Apex was required to retain an independent compliance consultant to review and recommend improvements to its policies and procedures and to pay approximately $185,000 in disgorgement, $16,000 in prejudgment interest, and $150,000 in civil penalties.

These enforcement actions, which were not litigated, are significant because they imposed liability on Apex by expansively interpreting existing statutes to regulate its conduct as an administrator where they would not otherwise be subject to the SEC's explicit regulation. In particular, the SEC supported this apparent expansion by citing Section 203(k) of the Advisers Act, which allows the SEC to impose a cease-and-desist order upon, among others, any "person that is, was, or would be a cause of [a violation of the Advisers Act], due to an act or omission the person knew or should have known would contribute to such violation." In this sense, it appears that the SEC viewed Apex as being complicit in the misconduct because it contributed to the environment that supported the underlying fraud. Indeed, Andrew Ceresney, outgoing Director of the SEC Division of Enforcement, noted in the press release announcing these settlements that "Apex failed to live up to its gatekeeper responsibility and essentially enabled the schemes to persist at each of these advisory firms until the SEC stepped in."[209]

It will be interesting to see if the SEC attempts to use this untested and expansive interpretation to broaden its regulatory purview in 2017.

209 Press Release, United States Securities and Exchange Commission, "Private Fund Administrator Charged With Gatekeeper Failures," Rel. No. 2016-120 (June 16, 2016), https://www.sec.gov/news/pressrelease/2016-120.html.

SEC Cooperation and Whistleblower Programs

SEC Cooperation and Whistleblower Programs

The SEC's Cooperation and Whistleblower Programs continued to play a major role in its enforcement program during the second half of 2016. The following are some of the most significant developments during this time.

Cooperation Program

Unlike previous periods, the SEC did not enter into any deferred prosecution or non-prosecution agreements during the last half of 2016. Nevertheless, the SEC still rewarded cooperation in the form of decreased sanctions, including reduced penalties and even publicized declinations. The following cases in particular illustrate how the SEC rewards remediation and self-reporting as part of its Cooperation Program.

Unnamed Broker-Dealer Declination

In August 2016, the SEC announced an enforcement action against a former registered representative, Tianyu "Arnie" Zhou ("Zhou"), for violating Sections 17(a) and 13(b)(5) of the Exchange Act and Rules 17a-3 and 13b2-1 thereunder, by allegedly mismarking certain loans held on his employer's books and providing inaccurate information to its internal control function.[210] Without admitting or denying the findings, Zhou agreed to industry and penny stock bars with the right to reapply in three years and a $50,000 civil penalty. Meanwhile, Zhou's employer was able to avoid an enforcement altogether and was not even referenced by name in the settled order and accompanying release based on "the firm's efforts at self-policing that eventually led to the discovery of Zhou's misconduct, prompt self-reporting, thorough remediation, and significant cooperation in the SEC's investigation."[211]

Apollo Global Management, LLC Settled Order

In August 2016, the SEC brought an enforcement action against four private equity fund advisers affiliated with Apollo Global Management, LLC ("Apollo"), for allegedly violating Sections 203(e)(6), 206(2), 206(4), and 206(8) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder, in the following ways: [212]

- First, for nearly four years, the advisers failed to disclose the benefits that the funds received from accelerating the payment of future monitoring fees owed by the funds' portfolio companies upon their sale. Because such fees reduced the amount available for distribution to investors, the SEC viewed them as a conflict of interest that required disclosure.[213]
- Second, one of the advisers failed to disclose certain information about how loan interest was allocated between the adviser's affiliated general partner and five of the adviser's funds. Instead of allocating the interest to the funds as disclosed in their financial statements, the interest

210 *In the Matter of Tianyu Zhou*, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b) 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, No. 3-17386 (Aug. 15, 2016), https://www.sec.gov/litigation/admin/2016/34-78571.pdf.

211 Press Release, United States Securities and Exchange Commission, "SEC Announces Charges Against Former CMBS Trader Who Mismarked Positions; Broker-Dealer Not Charged Due to Cooperation with SEC," Rel. No. 3-17386 (Aug. 15, 2016), https://www.sec.gov/litigation/admin/2016/34-78571-s.pdf.

212 Press Release, United States Securities and Exchange Commission, "Apollo Charged With Disclosure and Supervisory Failures," Rel. No. 2016-165 (Aug. 23, 2016), https://www.sec.gov/news/pressrelease/2016-165.html.

213 *In the Matter of Apollo Management V, L.P., Apollo Management VI, L.P., Apollo Management VII, L.P., and Apollo Commodities Management, L.P.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order, No. 3-17409 (Aug. 23, 2016), https://www.sec.gov/litigation/admin/2016/ia-4493.pdf.

was allocated solely to the general partner, thus making those financial statement disclosures misleading.[214]

- Third, the advisers failed reasonably to supervise a senior partner who improperly charged personal items and services to Apollo-advised funds and their portfolio companies. After repeated reprimands of and instructions of repayment by the partner, the advisers voluntarily reported the expense issues to the SEC and executed a formal separation agreement with the partner.[215]
- And fourth, as is common in most enforcement actions these days, the advisers were found to have failed to adopt and implement policies and procedures reasonably designed to prevent the other violations.[216]

Without admitting or denying the SEC's findings, the four Apollo advisers agreed to pay approximately $37.5 million in disgorgement, $2.7 million in prejudgment interest, and $12.5 million in civil penalties. It appears that the advisers were able to limit the civil penalty to one-third the possible amount and avoid even stiffer sanctions "based upon their cooperation" that included, among other things, conducting their own reviews of the expense issues, self-reporting those issues to the SEC, and voluntarily and promptly providing documents and information to the staff during the investigation.[217]

Calvert Investment Management, Inc., Settled Order

In October 2016, the SEC announced an enforcement action against the mutual fund adviser Calvert Investment Management, Inc. ("Calvert"), for allegedly violating Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder and Sections 17(a) and 34(b) of the Investment Company Act of 1940 and Rules 22c-1 and 38a-1 thereunder, by improperly valuing certain fund holdings between March 18, 2008, and October 18, 2011, and failing to disclose material aspects of its remediation attempts.[218] According to the settled order, Calvert collected excessive fees as a result of the valuations that inflated the funds' net asset values ("NAVs").[219] After Calvert discovered the valuation errors, it allegedly attempted to remediate them by paying $27 million to the mutual funds and the funds' shareholders to make them whole. The SEC found, however, that the $27 million payment was based on an estimated loss amount that was not calculated in accordance with the funds' procedures. Calvert allegedly failed to disclose to investors this flawed remediation calculation and the fact that the remediation payments were made differently depending on whether a client invested directly or through an intermediary. Calvert also allegedly caused one of the mutual funds to engage in a transaction with one of its affiliates without satisfying an exemption from the principal transaction prohibition.[220]

214 *Id.*

215 *Id.*

216 *Id.*

217 *Id.*

218 Press Release, United States Securities and Exchange Commission, "Mutual Fund Adviser Settles With SEC for Fair Valuation and Disclosure Failures," Rel. No. 3-17630 (Oct. 18, 2016), https://www.sec.gov/litigation/admin/2016/ia-4554-s.pdf.

219 *In the Matter of Calvert Investment Management, Inc.*, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Rel. No. 3-17630 (Oct. 18, 2016), https://www.sec.gov/litigation/admin/2016/ia-4554.pdf.

220 *Id.*

Without admitting or denying the SEC's findings, Calvert agreed to: (i) recalculate the NAVs and make payments to affected clients and (ii) pay a civil penalty in the amount of $3.9 million. The order recognized that the civil penalty was limited based on Calvert's cooperation and remedial acts (albeit imperfect), which included enhancing its compliance and fair valuation policies and procedures, and providing detailed summaries of relevant information.[221] The terms of this settlement are significant because they appear to show how far remediation, even flawed remediation, may go in limiting sanctions, because the civil penalty was less than one-sixth the amount it could have been. Had Calvert remediated effectively in the eyes of the SEC, it is possible it could have avoided an enforcement action altogether here.

Whistleblower Program

Over the past half year, the SEC furthered its Whistleblower Program by issuing tens of millions of dollars of awards, sanctioning companies for violating the Whistleblower Protection Rule through restrictive severance agreements and retaliatory actions, and conducting a sweep examination of registered investment advisers and broker-dealers to assess their compliance with the whistleblower rules of the Dodd-Frank Act.[222]

Whistleblower Awards

The SEC's Office of the Whistleblower increased the incentives to report misconduct by handing out over $50 million in awards to five whistleblowers in the last half of 2016, including, among others:

- $22 million to "a whistleblower whose detailed tip and extensive assistance helped the agency halt a well-hidden fraud at the company where the whistleblower worked";[223]
- $20 million to "a whistleblower who promptly came forward with valuable information that enabled the SEC to move quickly and initiate an enforcement action against wrongdoers before they could squander the money";[224] and
- $900,000 to "a whistleblower whose tip enabled the SEC to bring multiple enforcement actions against wrongdoers."[225]

Since the inception of the Whistleblower Program,[226] the SEC has received more than 14,000 tips from whistleblowers in every state in the United States and from over 95 foreign countries.[227] These tips have resulted in more than $136 million awarded to 37 whistleblowers and more than $504 million being ordered in sanctions, including more than $346 million in disgorgement and interest

221 *Id.*

222 *See, e.g.*, BakerHostetler presentation, *The Ins and Outs of the SEC Enforcement Program and Its Arsenal Against Hedge Funds*, New York Yacht Club, Nov. 16, 2016.

223 Press Release, United States Securities and Exchange Commission, "$22 Million Whistleblower Award for Company Insider Who Helped Uncover Fraud," Rel. No. 2016-172 (Aug. 30, 2016), https://www.sec.gov/news/pressrelease/2016-172.html.

224 Press Release, United States Securities and Exchange Commission, "SEC Issues $20 Million Whistleblower Award," Rel. No. 2016-237 (Nov. 14, 2016), https://www.sec.gov/news/pressrelease/2016-237.html.

225 Press Release, United States Securities and Exchange Commission, "SEC Awards Nearly $1 Million to Whistleblower," Rel. No. 2016-260 (Dec. 9, 2016), https://www.sec.gov/news/pressrelease/2016-260.html.

226 *See* our 2015 Year-End Report and 2016 Mid-Year Report.

227 Speech, SEC Director of Enforcement Andrew Ceresney, "The SEC's Whistleblower Program: The Successful Early Years," (Sept. 14, 2016), https://www.sec.gov/news/speech/ceresney-sec-whistleblower-program.html.

for harmed investors.[228] These big-ticket awards no doubt will further incentivize whistleblowers to report potential misconduct to the SEC. As outgoing SEC Chair Mary Jo White[229] emphasized in a speech at the end of 2016: "The whistleblower program has had a transformative impact on enforcement and that impact will only increase in the coming years as the program becomes more well-known and the significant rewards of participating in it become clearer to whistleblowers."[230]

Whistleblower Protection Enforcement Actions

To protect whistleblowers, the SEC brought enforcement actions against four different types of companies – a global brewer, an American health care insurance provider, an American building products distributor, and an American technology company—for allegedly violating Rule 21F-17 of the Exchange Act through their use of agreements that impeded the ability of whistleblowers to report misconduct to the SEC.[231] Rule 21F-17 provides that "no person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement … with respect to such communications."

All four enforcement actions involved various types of severance agreements that either: (i) required former employees to waive their right to a whistleblower award; (ii) required them to notify the company's legal department prior to providing confidential information to a third-party pursuant to legal process; (iii) outright prohibited former employees from communicating with the SEC; and/or (iv) imposed liquidated damages or forfeiture of severance payments for violating the agreement's confidentiality provision. These actions were settled without admissions and imposed civil penalties of at least $180,000. Three of these actions required undertakings to remediate the alleged misconduct by revising agreements and/or notifying former employees. Notably, the SEC alleged that former employees were impeded from communicating with the SEC with respect to only two of the companies. This demonstrates that the SEC will pursue enforcement actions even where there is no showing that the perceived impediments actually prevented someone from communicating with the SEC.

The SEC also brought its first stand-alone retaliation case, against International Game Technology ("IGT"), a casino-gaming company, for allegedly removing an employee from significant work assignments weeks after he raised concerns internally about the company's cost accounting model and terminating him three months later.[232] According to the settled order, IGT's internal investigation

228 Press Release, United States Securities and Exchange Commission, "SEC Whistleblower Program Surpasses $100 Million in Awards," Rel. No. 2016-173 (Aug. 30, 2016), https://www.sec.gov/news/pressrelease/2016-173.html.

229 President Trump plans to nominate Jay Clayton ("Clayton"), a mergers and acquisitions partner at Sullivan & Cromwell LLP, to serve as the next chair of the SEC. Clayton has experience in Foreign Corrupt Practices Act enforcement.

230 Speech, SEC Chair Mary Jo White, "A New Model for SEC Enforcement: Producing Bold and Unrelenting Results," (Nov. 18, 2016), https://www.sec.gov/news/speech/chair-white-speech-new-york-university-111816.html.

231 Press Release, United States Securities and Exchange Commission, "Company Punished for Severance Agreements That Removed Financial Incentives for Whistleblowing," Rel. No. 2016-164 (Aug. 16, 2016), https://www.sec.gov/news/pressrelease/2016-164.html; Press Release, United States Securities and Exchange Commission, "Company Paying Penalty for Violating Key Whistleblower Protection Rule," Rel. No. 2016-157 (Aug. 10, 2016), https://www.sec.gov/news/pressrelease/2016-157.html; Press Release, United States Securities and Exchange Commission, "SEC Charges Anheuser-Busch InBev With Violating FCPA and Whistleblower Protection Laws," Rel. No. 2016-196 (Sept. 28, 2016), https://www.sec.gov/news/pressrelease/2016-196.html; *In the Matter of Neustar, Inc.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, No. 3-17736 (Dec. 19, 2016), https://dlbjbjzgnk95t.cloudfront.net/0874000/874566/34-79593.pdf.

232 Press Release, United States Securities and Exchange Commission, "SEC: Casino Gaming Company Retaliated Against Whistleblower," Rel. No. 2016-204 (Sept. 29, 2016), https://www.sec.gov/news/pressrelease/2016-204.html.

into these concerns concluded that the financial statements contained no misstatements. Without admitting or denying the order's findings, IGT agreed to pay a $500,000 civil penalty.[233]

These enforcement actions appear to be a sign of things to come, because the SEC's Office of the Whistleblower stated in its 2016 Annual Report that "[a]ssessing confidentiality, severance, and other kinds of agreements that may stifle a would-be whistleblower from reporting his or her information to the agency" and "[i]dentifying fact patterns of retaliation" will continue to be its "top priority."[234]

Whistleblower Rule Sweep Examination

To facilitate the above objective, in October 2016, the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced a sweep examination of investment advisers and broker-dealers to assess their compliance with key whistleblower provisions of Dodd-Frank.[235] In particular, OCIE indicated it would "review[], among other things, compliance manuals, code of ethics, employment agreement, and severance agreements to determine whether provisions in those documents pertaining to confidentiality of information and reporting of possible securities laws violations may raise concerns under Rule 21F-17."[236]

OCIE advised firms to: "(i) assess their supervisory, compliance and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems." As guidance for such appropriate changes, OCIE listed the remedial measures that were taken in recent enforcement actions, including:

- "revising documents on a going-forward basis to make it clear that nothing contained in those documents prohibits employees or former employees from voluntarily communicating with the Commission or other authorities regarding possible violations of law or from recovering a Commission whistleblower award";
- "providing general notice to employees, or notice to employees who signed restrictive agreements, of their right to contact the Commission or other authorities"; and
- "contacting former employees who signed severance agreements to inform them that the company does not prohibit them from communicating with the Commission or seeking a whistleblower award."[237]

Although OCIE did not explicitly address as such, it appears these measures are the SEC's baseline remediation for any firm that currently or historically utilized agreements that impede communications with the SEC.

233 *In the Matter of International Game Technology*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21 of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, No. 3-17596 (Sept. 29, 2016), https://www.sec.gov/litigation/admin/2016/34-78991.pdf.

234 United States Securities and Exchange Commission, 2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program (Nov. 15, 2016), https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2016.pdf. *See* Michael Washburn, *BakerHostetler Panel Analyzes SEC Use of Administrative Proceedings and Whistleblower Incentives, and Provides Guidance for Fund Managers Facing an Examination* (Part Two of Two), The Hedge Fund Law Report, Jan. 19, 2017.

235 SEC Risk Alert, Examining Whistleblower Rule Compliance (Oct. 24, 2016), https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-examining-whistleblower-rule-compliance.pdf.

236 *Id.*

237 *Id.*

CFTC Cases and Developments

CFTC Cases and Developments

The U.S. Commodity Futures Trading Commission ("CFTC") oversees the nation's futures, options and swaps markets, seeking to protect market participants from fraud, manipulation and abusive practices, and to protect the public and the economy from systemic risk related to derivatives. Indeed, the CFTC oversees some of the riskiest corners of the financial world. For example, derivatives are traded in a $600 trillion global market and were blamed for fueling the financial crisis that struck in the fall of 2008. With the passage of the Dodd-Frank Act, the CFTC's budget and power as a federal regulator have been increasing.

In 2016, the CFTC filed numerous actions focusing on spoofing, benchmark rigging and anti-fraud enforcement.[238] The CFTC continues to recognize the danger of spoofing in the new high-frequency trading era we live in today. Benchmark rigging is also a new area for regulatory oversight. Although the CFTC has been actively involved with prosecuting crimes resulting from new and innovative frauds, the CFTC has not lost sight of the threat to the industry created by unregistered individuals posing as Commodity Trading Advisors ("CTAs"). With the recent resignation of the CFTC Chairman, a new era of enforcement may be in store for the agency.

Spoofing

In 2016, the CFTC continued its recent trend of bringing enforcement actions targeting spoofing-related activity under Section 747 of the Dodd-Frank Act. Spoofing is a market manipulation and market disrupting tactic whereby traders place sham orders to artificially inflate or depress the price of a security, with the intent to cancel the order and profit off of the manipulated price.

Following the conviction of futures trader Michael Coscia, the first person to be found guilty of disrupting U.S. financial markets by spoofing, courts and financial enforcement agencies continue to send a strong message to the industry regarding spoofing. In fact, the CFTC has been especially active in the fight to regulate high-frequency trading. In October 2016, the CFTC settled a spoofing action against Igor B. Oystacher ("Oystacher") and his firm 3Red Trading LLC. Although the details of the settlement have yet to be made available, the Oystacher action was unique in that Oystacher did not undertake high-frequency electronic trades through sophisticated algorithms.[239]

Furthermore, in November 2016, a federal court entered a consent order resolving the CFTC's price manipulation and spoofing action against United Kingdom resident Navinder Sing Sarao ("Sarao"). [240] The order from the U.S. District Court for the Northern District of Illinois requires Sarao to pay a $25,743,174.52 civil monetary penalty and $12,871,587.26 in disgorgement. Further, Sarao admitted to: (i) successfully manipulating the E-mini S&P on at least 12 days between April 27, 2010 and March 10, 2014 (including May 6, 2010, commonly known as Flash Crash Day); (ii) attempting to manipulate the E-mini S&P tens of thousands of times between April 2010 and April 17, 2015; (iii) placing tens of thousands of bids and offers that he intended to cancel before execution, commonly known as spoof orders, between July 16, 2011 and April 17, 2015; and (iv) employing or attempting to employ a manipulative device, scheme, or artifice to defraud in

238 *See* our 2016 Mid-Year Report; Tracy Cole, Mark A. Kornfeld, and Jacqlyn Rovine, "This Is Not a Test: The CFTC Joins the SEC and IRS in Awarding Substantial Whistleblower Bounties," BakerHostetler Client Alert (April 14, 2016), https://www.bakerlaw.com/alerts/this-is-not-a-test-the-CFTC-joins-the-sec-and-IRS-in-awarding-substantial-whistleblower-bounties.

239 "Chicago Trader Settles CFTC's Spoofing Suit," https://www.law360.com/articles/852728/chicago-trader-settles-cftc-s-spoofing-suit (Oct. 19, 2016).

240 Press Release, Commodity Futures Trading Commission, "Federal Court in Chicago Orders U.K. Resident Navinder Singh Sarao to Pay More than $38 Million in Monetary Sanctions for Price Manipulation and Spoofing," Rel. No PR7486-16 (Nov. 17, 2016).

connection with his spoof orders between August 15, 2011 and April 17, 2015. Consequently, in addition to receiving monetary sanctions of more than $38 million, Sarao also received permanent prohibitions against further violations of the Commodity Exchange Act and CFTC Regulations, and a permanent trading and registration ban.

Finally, in November 2016, in addition to its litigation efforts, the CFTC also approved a supplemental proposal on automated trading in order to bolster its efforts to combat manipulations of the market through the use of high-frequency trading.[241] As such, clients must now take notice of the CFTC's actions throughout the year, and be sure to implement corresponding corporate policies/initiatives in order to be in the position to answer for any abnormalities related to their commodity trades.

Benchmark Rigging

In 2016, the CFTC expanded its enforcement proceedings with respect to the regulation of benchmark rigging. On December 21, 2016, Goldman Sachs agreed to pay a $120 million penalty to settle the CFTC's allegations that its traders, including the former head of the swap trading desk, worked to "game" the U.S. Dollar International Swaps and Derivatives Association Fix ("USD ISDAfix") rate, in an effort to benefit the bank's derivatives positions.[242]

The USD ISDAfix is the leading benchmark for interest rate swaps and for valuing cash settlement of options on interest rate swaps, as well as a valuation tool for products across financial markets.

Starting in January 2007 and continuing until March 2012, Goldman Sachs traders in New York: (i) executed transactions in interest rate swap spreads, U.S. Treasuries, and Eurodollar futures contracts at the critical 11:00 a.m. daily time slot so that their trades would be reflected in the snapshot to influence the published USD ISDAfix; and (ii) skewed Goldman Sachs' submissions in order to benefit Goldman Sachs at the expense of its derivatives counterparties and clients.

Goldman Sachs traders discussed their intent to move USD ISDAfix in whichever direction benefitted their positions. Their scheme was captured in emails and audio recordings whereby the traders stated their manipulative goals in plain language, describing the manipulated USD ISDAfix as the "jacked price," as opposed to the "fair price" and that other Goldman Sachs traders had "gamed the fix." They even strategized how best to extract the "higher value" of USD ISDAfix cash settlements against customers who lacked Goldman Sachs' view. [243]

This is the most recent of three CFTC enforcement proceedings over benchmark rigging. The CFTC fined Citibank $250 million in May 2016 [244] and fined Barclays $115 million in May 2015.[245]

241 Press Release, Commodity Futures Trading Commission, "CFTC Approves Supplemental Proposal to Automated Trading Regulation," Rel. No. PR7479-16 (Nov. 4, 2016).

242 "Goldman Pays $120M CFTC Fine For ISDAfix Rate Rigging" https://www.law360.com/articles/875455/goldman-pays-120m-cftc-fine-for-isdafix-rate-rigging (Dec. 21. 2016).

243 Press Release, Commodity Futures Trading Commission, "CFTC Orders Goldman Sachs to Pay $120 Million Penalty for Attempted Manipulation of and False Reporting of U.S. Dollar ISDAFIX Benchmark Swap Rates," Rel. No. PR7505-16 (Dec. 21. 2016).

244 Press Release, Commodity Futures Trading Commission, "CFTC Orders Citibank to Pay $250 Million for Attempted Manipulation and False Reporting of U.S. Dollar ISDAFIX Benchmark Swap Rates," Rel. No. PR 7371-16 (May, 25, 2016).

245 Press Release, 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. PR-7180 (May, 20, 2015).

CFTC Cases and Developments

Anti-Fraud Enforcement

In 2016, the CFTC has filed numerous enforcement actions against persons and entities seeking to defraud customers, commodity pool participants, and others. For example, in September 2016, as part of a settlement, the CFTC ordered Aden Rusfeldt ("Rusfeldt") to pay in total more than $3.2 million in restitution and a civil monetary penalty for fraudulent omissions in connection with his operation of ETF Trend Trading.[246] Rusfeldt was found to have fraudulently failed to disclose to prospective and current customers of his company that he was prohibited from engaging in any commodity-interest related activity under a prior court Consent Order. On top of the monetary sanctions, Rusfeldt, and his company, are permanently prohibited from engaging, directly or indirectly, in any activity related to trading in any commodity interest.

Additionally, the CFTC has continued to bring actions charging institutions and individuals for conducting trades without being registered – stating that the operation of an unregistered entity is a serious violation of the Commodity Exchange Act ("CEA") and CFTC regulations and is a threat to the integrity of the industry. For example, in November 2016, the CFTC obtained a Consent Order against Defendants IB Capital FX, LLC , Michel Geurkink ("Geurkink"), and Emad Echadi ("Echadi"), requiring them to pay, jointly and severally, $35 million in restitution to defrauded customers and a $420,000 civil monetary penalty for soliciting and accepting at least $50 million from approximately 1,850 customers in the United States and worldwide for off-exchange margined retail foreign currency trading, without being registered with the CFTC as is required under the CEA.[247] The Consent Order also imposed permanent trading and registration bans on Geurkink and Echadi.

Moreover, in September 2016, the CFTC announced that it entered an order requiring Angus Partners LLC ("Angus") to pay a $250,000 civil monetary penalty for acting as an unregistered CTA and for violating certain disclosure rules applicable to CTAs.[248] Specifically, the CFTC determined that in addition to not disclosing certain conflicts of interest, Angus, for compensation or profit, engaged in the business of advising more than 15 clients as to the value of, or advisability of, trading in over-the-counter commodity option and swap contracts, while holding itself out generally to the public as a CTA without being registered with the CFTC.

Further, the CFTC also won a successful jury verdict in a fraud proceeding against commodities pool operator, Grace Elizabeth Reisinger ("Reisinger"), demonstrating that the CFTC is willing to take fraud matters to trial. The jury determined that Reisinger was responsible for futures fraud, options fraud, and Commodity Pool Operator fraud, as well as registration violations.[249] Specifically, Reisinger operated an unregistered commodities pool called NCCN LLC via her company ROF Consulting LLC and made various misrepresentations to bring at least $2.75 million into the pool between 2005 and 2008. In October 2016, the CFTC requested that the U.S. District Court for the Northern District of Illinois issue a $3.1 million penalty against Reisinger and a roughly $1 million penalty against her

246 Press Release, Commodity Futures Trading Commission, "CFTC Orders Aden Rusfeldt to Pay in Total More than $3.2 Million in Restitution and a Civil Monetary Penalty for Fraudulent Omissions in Connection with His Operation of ETF Trend Trading," Rel. No. PR7461-16 (Sept. 29, 2016).

247 Press Release, Commodity Futures Trading Commission, "Federal Court Orders IB Capital FX, LLC, Michel Geurkink, and Emad Echadi to Pay More than $35 Million in Restitution and a Civil Penalty for Soliciting at Least $50 Million From Members of the Public to Trade Forex, Without Being Registered With the CFTC," Rel. No. PR7485-16 (Nov. 16, 2016).

248 Press Release, Commodity Futures Trading Commission, "CFTC Orders Angus Partners LLC D/B/A Angus Energy to Pay a $250,000 Civil Penalty for Acting as an Unregistered Commodity Trading Advisor and for Disclosure Violations," Rel. No. PR7462-16 (Sept. 29, 2016).

249 Press Release, Commodity Futures Trading Commission, "CFTC Wins Jury Verdict in Commodity Pool Fraud Case," Rel. No. PR7444-16 (Sept. 14, 2016).

company, plus disgorgement, restitution and a permanent injunction. Reisinger said the monetary penalty was unwarranted and constitutes a "financial life sentence."[250] Nonetheless, this case once again demonstrates the hardline stance the CFTC has taken in 2016 against fraud.

Accordingly, although some may gloss over the seriousness of failing to be in compliance with CFTC registration requirements, the CFTC has demonstrated throughout the year that enforcing its registration policies and prosecuting commodities related fraud remains a high priority.

Resignation of CFTC Chairman Timothy G. Massad

On January 3, 2017 the Chairman of the CFTC, Timothy G. Massad ("Massad"), announced that he had tendered his resignation to President Obama.[251] Massad's resignation will be effective on January 20, 2017, the day of President Trump's inauguration. Massad began his term in June 2014, which was not set to expire until 2019.[252] However, Massad had come under political pressure to leave his post before his term ended to avert an unusual situation in which the CFTC could have had a Democratic majority with a Republican in the White House.[253]

Massad has departed after working to complete stricter rules for the multitrillion swaps market.[254] He transformed the CFTC from a sleepy regulatory agency of agricultural futures to a front-line Wall Street cop after the financial crisis.[255] Massad specifically listed the following as his accomplishments during his tenure: (i) implementing the regulatory framework for uncleared swaps; (ii) harmonizing international rules for derivative markets; (iii) implementing rules to bolster protections against cyberattacks; and (iv) mitigating the risk of disruption caused by automated trading.[256] Massad has urged the incoming administration to reconsider its pledge to undo parts of the Dodd-Frank Act and the rules it has required to boost transparency to the market for over-the-counter derivatives.[257]

Massad was unable to muster support to complete a final piece of the Dodd-Frank Act regulations, which was aimed at clamping down on speculative trades that can drive up food and gasoline prices, leaving any resolution of the rule for the new administration.[258] President Trump's selection for CFTC chairman is expected to play a pivotal role in rolling back some rules dictated by the Dodd-Frank Act, which called for broad government oversight of swaps after unregulated trades helped fuel the 2008 financial crisis.[259]

250 "Commodities Pool Chief Balks At $3.1M CFTC Penalty," http://www.law360.com/articles/858824/commodities-pool-chief-balks-at-3-1m-cftc-penalty (Nov. 2, 2016).

251 Press Release, Commodity Futures Trading Commission, "CFTC Chairman Timothy Massad Announces Resignation as Chairman," Rel. No. PR7507-17 (Jan. 3. 2017).

252 "CFTC Chair Massad Is Latest Finance Regulator to Leave," http://thegardenisland.com/business/national-and-international/cftc-chair-massad-is-latest-finance-regulator-to-leave/article_7ecba433-3757-5b43-af03-8b6b3929167b.html (Jan. 3. 2017).

253 "Swaps Cop Massad to Step Down," http://www.treasuryandrisk.com/2017/01/04/swaps-cop-massad-to-step-down?t=treasury- (Jan. 4. 2017).

254 "Timothy Massad Resigning as CFTC Chairman," https://www.thestreet.com/story/13942021/1/timothy-massad-resigning-as-cftc-chairman.html (Jan. 4, 2017).

255 "Swaps Cop Massad to Step Down," http://www.treasuryandrisk.com/2017/01/04/swaps-cop-massad-to-step-down?t=treasury- (Jan. 4. 2017).

256 "Timothy Massad to Resign as CFTC Chairman," http://www.pionline.com/article/20170103/ONLINE/170109973/timothy-massad-to-resign-as-cftc-chairman (Jan. 3. 2017); Press Release, Commodity Futures Trading Commission, "CFTC Chairman Timothy Massad Announces Resignation as Chairman," Rel. No. PR7507-17 (Jan. 3. 2017).

257 "Swaps Cop Massad to Step Down," http://www.treasuryandrisk.com/2017/01/04/swaps-cop-massad-to-step-down?t=treasury- (Jan. 4. 2017).

258 "US CFTC Chairman Massad Hands In Resignation," http://www.platts.com/latest-news/electric-power/washington/us-cftc-chairman-massad-hands-in-resignation-21489939 (Jan. 3. 2017); "CFTC Chair Massad Is Latest Finance Regulator to Leave," http://thegardenisland.com/business/national-and-international/cftc-chair-massad-is-latest-finance-regulator-to-leave/article_7ecba433-3757-5b43-af03-8b6b3929167b.html (Jan. 3. 2017).

259 "Giancarlo Said to Be Trump's Leading Choice for CFTC Chair," https://www.bloomberg.com/politics/articles/2017-01-05/giancarlo-said-to-be-trump-s-leading-candidate-for-cftc-chair (Jan. 4. 2017).

CFTC Cases and Developments

Republican J. Christopher Giancarlo ("Giancarlo"), one of the two remaining CFTC Commissioners, was recently designated per seriatim as acting chairman of the commission.[260] Giancarlo is also considered to be a leading candidate to be nominated for a full term in the post, but will require U.S. Senate confirmation to officially helm the CFTC.[261] President Trump has not yet formally indicated his nomination. Giancarlo has argued that in some areas the CFTC went further than lawmakers intended, thereby contributing to a reduction in market liquidity, or the ability to quickly make trades, which may have sent trading business overseas. [262] On the other hand, he has backed broad mandates for overhauling the swaps market, including the requirement that many be processed through clearinghouses and that swaps traders and brokers must pass a competency and ethics exam.[263]

In addition to appointing the new CFTC Chairman, Trump will get to fill three open seats to bring the five-member Commissioner panel to full strength.[264] The future of the CFTC remains unseen.

260 Press Release, Commodity Futures Trading Commission, "CFTC Names J. Christopher Giancarlo Acting Chairman," Rel. No. PR7519-17 (Jan. 20. 2017).

261 "Swaps Cop Massad to Step Down," http://www.treasuryandrisk.com/2017/01/04/swaps-cop-massad-to-step-down?t=treasury- (Jan. 4. 2017); "CFTC Names Giancarlo as Acting Chairman," https://www.law360.com/securities/articles/883429/cftc-names-giancarlo-as-acting-chairman?nl_pk=d9218bbb-9765-4614-af62-1d235cd0d6c6&utm_source=newsletter&utm_medium=email&utm_campaign=securities (Jan. 20. 2017).

262 "Massad Resigns as Commodity Futures Trading Commission Chairman," http://www.nytimes.com/2017/01/03/business/dealbook/massad-resigns-as-commodity-futures-trading-commission-chairman.html (Jan. 3. 2017).

263 "CFTC Chairman Timothy Massad to Step Down Jan. 20," http://www.wsj.com/articles/cftc-chairman-timothy-massad-to-step-down-jan-20-1483477052 (Jan. 3. 2017).

264 "Giancarlo Said to Be Trump's Leading Choice for CFTC Chair," https://www.bloomberg.com/politics/articles/2017-01-05/giancarlo-said-to-be-trump-s-leading-candidate-for-cftc-chair (Jan. 4. 2017).

Securities Policy and Regulatory Developments

Securities Policy and Regulatory Developments

The SEC was quite busy in the second half of 2016, as it proposed rules to streamline disclosure requirements, adviser registration and reporting in connection with the SEC's disclosure effectiveness review – the goal of which is to review the SEC's disclosure requirements and make recommendations to update those requirements in an effort to create more meaningful, accessible, and efficient disclosure.

SEC Proposes Amendments to Disclosure Requirements as Part of Its Disclosure Effectiveness Review

On July 13, 2016, the SEC voted to propose amendments that would update and simplify its disclosure requirements.[265] The proposed amendments are intended to "eliminate redundant, overlapping, outdated, or superseded provisions," following changes to SEC disclosure requirements, U.S. GAAP, International Financial Reporting Standards ("IFRS"), and technology. The proposed amendments are part of the SEC's overall disclosure effectiveness initiative that involves a review of the requirements, presentation, and delivery of disclosures made by public companies to investors and are also part of the SEC's work to implement the Fixing America's Surface Transportation ("FAST") Act, which aims to eliminate Regulation S-K provisions that are duplicative, overlapping, outdated, or unnecessary.

While the proposed amendments apply primarily to public companies, including foreign private issuers, some requirements will apply to other SEC-regulated entities, including Regulation A issuers, investment companies, investment advisers, and broker-dealers. Specifically, the proposed amendments addressed the following:

Redundant or Duplicative Requirements: The SEC considered whether requirements that mandate substantially the same disclosures as U.S. GAAP, IFRS, or other SEC disclosure requirements should be eliminated as redundant or duplicative in order to simplify issuer compliance efforts while still providing the same information to investors.

Overlapping Requirements: The SEC identified disclosure requirements that are related to, but not exactly the same as, U.S. GAAP, IFRS, or other SEC disclosure requirements. With respect to these overlapping requirements, the SEC:

- Proposed to delete disclosure requirements that either convey reasonably similar information to, or are encompassed by, overlapping U.S. GAAP, IFRS, or SEC disclosure requirements or that require disclosures incremental to the overlapping disclosure requirements and may not be useful to investor;
- Proposed to integrate SEC disclosure requirements that overlap with, but require information incremental to, its other disclosure requirements; or
- Solicited comment on SEC disclosure requirements that overlap with, but require information incremental to, U.S. GAAP in an effort to determine whether to retain, modify, eliminate or refer them to the Financial Accounting Standards Board for incorporation into U.S. GAAP.

265 "Proposed Rule, Disclosure Update and Simplification," Securities Act Release No. 33-10110; Exchange Act Release No. 34-78310; Investment Company Release No. 32175; File No. S7-15-16 (July 13, 2016), https://www.sec.gov/rules/proposed/2016/33-10110.pdf; Press Release, United States Securities and Exchange Commission, "SEC Proposes Amendments to Update and Simplify Disclosure Requirements as Part of Overall Disclosure Effectiveness Review," Rel. No. 2016-141 (July 13, 2016), https://www.sec.gov/news/pressrelease/2016-141.html.

Outdated Requirements: The SEC identified disclosure requirements that have been rendered obsolete by time or by changes to the regulatory, business or technological landscape and will therefore need to be amended. The proposed amendments are intended to both simplify issuer compliance efforts and ensure that investors are still provided with adequate information by requiring additional disclosure of information readily available to issuers at minimal to no cost.

Superseded Requirements: Acknowledging that accounting, auditing, and disclosure requirements change over time and result in inconsistencies between newer requirements and existing disclosure requirements, the SEC proposed amendments to update its own disclosure requirements that would better reflect recent legislation or updates to its own or U.S. GAAP requirements.

These proposed amendments aim to improve disclosure requirements by simplifying investor compliance efforts while simultaneously ensuring that investors are still properly and effectively provided with pertinent information. The deadline for comments was October 3, 2016.

SEC Proposes Rules to Enhance Order Handling Information Available to Investors

Also on July 13, 2016, the SEC proposed amendments to Rule 606 of the Regulation National Market System under the Exchange Act.[266] These proposed amendments would require broker-dealers to provide order handling information for their institutional orders upon customer request and aggregated in a quarterly report. The proposed amendments would also expand existing retail customer order handling disclosure obligations.

Currently, Rule 606's order routing disclosure requirements focus only on small customer orders, require broker-dealer to disclose, upon request, customer order routing information for the preceding six months, and require the quarterly public disclosure of information regarding the routing of these orders in the aggregate. Unfortunately, institutional investors have not been armed with the same type of information and this lack of standardization has made it difficult for market participants to have the means to adequately compare broker-dealers.

The SEC's proposed amendments are intended to help resolve this issue by providing market participants with the information that will help them make informed decisions about broker-dealers based on their execution practices, the impact of conflicts of interest, and the potential for information leakage associated with the routing of large institutional orders. Specifically, the proposed amendments address the following:

New Institutional Order Disclosures (customers): Broker-dealers who receive institutional orders, (orders for national market system stock with a value of at least $200,000), must, upon customer request, provide reports that include:

- monthly data for the preceding six months;
- the number of shares sent to the broker-dealer;

266 "Proposed Rule, Disclosure of Order Handling Information," Exchange Act Release No. 34-78309; File No. S7-14-16 (July 13, 2016), https://www.sec.gov/rules/proposed/2016/34-78309.pdf; Press Release, United States Securities and Exchange Commission, "SEC Proposes Rules to Enhance Order Handling Information Available to Investors," Rel. No. 2016-140 (July 13, 2016), https://www.sec.gov/news/pressrelease/2016-140.html.

- the number of shares executed by the broker-dealer;
- information regarding institutional orders presented by the broker-dealer through actionable indications of interest, and information regarding the venues to which they were exposed; and
- information about the venues to which customer institutional orders are routed, in the aggregate and categorized as passive, neutral, and aggressive, including:
  - information regarding the routing of share orders;
  - information regarding the execution of share orders;
  - information regarding share orders that provide liquidity; and
  - information regarding the share orders that removed liquidity.

New Institutional Order Disclosures (public): Broker-dealers must also provide the public with aggregated reports regarding the handling of institutional orders quarterly.

Retail Order Disclosures: Under the proposed amendments, "customer orders" would be renamed "retail orders" and would provide for enhanced disclosure requirements with respect to the order routing information. Quarterly reports must:

- provide separate limit order reports for marketable limit orders and non-marketable limit orders;
- report routing information monthly rather than quarterly;
- be posted on a publicly accessible website for three years;
- include venue information for the 10 venues with the largest number of total non-directed orders routed for execution and for venues where 5% or greater of non-directed orders were routed for execution; and
- describe the terms of payment for order flow and profit-sharing arrangements that may have an impact on broker-dealer routing decisions.

Rule 606 did not originally account for standardized institutional order disclosure requirements because orders, at the time of the Rule's adoption, were manually and individually entered. Time and technology have allowed for the volume of orders to increase and have warranted updates to these requirements. The SEC's goal is to bring order handling disclosure in line with technology, to provide greater transparency, and to improve the monitoring of broker-dealer routing decisions. The deadline for comments was September 26, 2016.

SEC Adopts Rules to Enhance Information Reported by Investment Advisers

On August 25, 2016, the SEC adopted amendments to the investor adviser registration and reporting form, Form ADV, and several rules under the Advisers Act as part of its efforts to enhance the monitoring and regulation of the asset management industry.[267] The amendments are intended to improve the quality of information provided by investment advisers, so to ensure that investors and the SEC are armed with enough information to adequately understand the risks of

267 "Final Rule, Disclosure Update and Simplification," Investment Advisers Release No. 4509; File No. S7-09-15 (Aug. 25, 2016), https://www.sec.gov/rules/final/2016/ia-4509.pdf; Press Release, United States Securities and Exchange Commission, "SEC Adopts Rules to Enhance Information Reported by Investment Advisers," Rel. No. 2016-168 (Aug. 25, 2016), https://www.sec.gov/news/pressrelease/2016-168.html.

each investment adviser and the industry as a whole. A summary of the most significant of these amendments is below.

Information Regarding Separately Managed Accounts ("SMAs"): Advisory accounts other than investment companies, business development companies, or other pooled investment vehicles must provide additional information about their SMAs, including:

- the approximate percentage of regulatory assets under management held by SMAs in 12 broad asset categories;
- information about the use of derivatives and borrowings in the SMAs; and
- the identity of custodians accounting for at least 10% of the SMAs' regulatory assets under management and the amount of the SMAs' regulatory assets under management held at the custodian.

Additional Information Regarding Investment Advisers: Investment advisers will be required to report the following additional information regarding their business:

- Social media platform presence;
- The total number of offices in which an adviser conducts business and information about the largest 25 offices based on the number of employees;
- Whether the adviser's chief compliance officer is compensated or employed by a person other than the adviser (or a related person of the adviser). If so, the adviser must provide the name and IRS Employer Identification Number of that person, unless that other person is a registered investment company;
- Advisers with assets of $1 billion or greater must report the range of their total assets ($1-10 billion, $10-50 billion, $50 billion or greater);
- The number of clients and amount of regulatory assets under management attributable to each client;
- The number of clients to whom the adviser provides advisory services without regulatory assets under management;
- Calculations of regulatory assets under management of parallel managed accounts related to the investment company or business development company advised;
- The amount of regulatory assets under management attributable to non-U.S. persons;
- The regulatory assets under management associated with the sponsoring or portfolio management of a wrap-free program;
- Information about financial industry affiliations and private fund reporting; and
- Whether advisers of private funds limit their sales to qualified clients.

Umbrella Registration: The Form ADV amendments codify umbrella registration for private fund advisers operating a single advisory business through multiple legal entities. Though not mandatory, umbrella registration will simplify and streamline the registration process and provide consistency of information regarding these private fund advisers.

Securities Policy and Regulatory Developments

Clarifying, Technical and Other Amendments to Form ADV: The SEC's final amendments, developed in response to inquiries from advisers and service providers, will provide ease and clarity to advisers completing the form.

The SEC also adopted amendments to Advisers Act Rules:

- Rule 204-2 Books and Records Rule: Amendments to this rule will require advisers to retain all communications regarding performance calculations or rates of returns.
- Investment advisers will also be required to maintain originals of written communications received, and copies of written communications sent, regarding the performance or rate of return of any managed accounts or regarding securities recommendations as part of the SEC's efforts to protect investors from fraudulent claims.

Advisers were required to comply with these amendments as of October 1, 2016.

SEC Proposes Rule Amendment to Expedite Process for Settling Securities Transactions

On September 28, 2016, the SEC proposed an amendment to Rule 15c6-1 of the Exchange Act.[268] The proposed amendment would shorten the standard settlement cycle for most broker-dealer securities transactions from three business days after the trade date to two business days after the trade date.

Rule 15c6-1 was originally adopted in 1993 to standardize the settlement cycle for broker-dealer securities transactions, subject to exceptions articulated in the rule. Upon Rule 15c6-1's adoption, settlement cycles were shortened from five business days after the trade date to three business days after the trade date. The SEC's rationale for shortening the settlement cycle was to reduce the credit and market risk exposure associated with unsettled trades, reduce liquidity risks, encourage efficiency in the clearance and settlement process, and reduce systemic risks for U.S. markets.

If adopted, the proposed amendment would prohibit a broker-dealer from entering into securities contracts that settle later than two business days after the contract date unless otherwise expressly agreed to by the parties at the time of transaction. The SEC's proposed amendment would further its original goals and reduce risks, including credit, market, and liquidity risks faced by U.S. market participants, arising from the value and number of unsettled securities transactions prior to completion of settlement. Additionally, the proposed amendment would enhance the efficiency of the U.S. clearance and settlement system. The deadline for comments was December 5, 2016.

SEC Proposes Universal Proxy Rule in Contested Director Elections

As discussed in a previous Alert,[269] on October 26, 2016, the SEC proposed changes to the

268 "Proposed Rule, Amendment to Securities Transaction Settlement Cycle," Exchange Act Release No. 34-78962; File No. S7-22-16 (Sept. 28, 2016), https://www.sec.gov/rules/proposed/2016/34-78962.pdf; Press Release, United States Securities and Exchange Commission, "SEC Proposes Rule Amendment to Expedite Process for Settling Securities Transactions," Rel. No. 2016-200 (Sept. 28, 2016), https://www.sec.gov/news/pressrelease/2016-200.html.

269 Harrington, John J. "SEC Proposes Requirement for Universal Proxies in Contested Director Elections." Nov. 14, 2016, at https://www.bakerlaw.com/alerts/sec-proposes-requirement-for-universal-proxies-in-contested-director-elections.

proxy rules to mandate the use of universal proxy cards in contested director elections at annual meetings. These universal proxy cards will include the names of all duly nominated director candidates for whom proxies are solicited to allow shareholders to choose nominees in a way that most closely reflects the choice that could be made by voting in person at a shareholder meeting.[270] Specifically, the change allows shareholders to choose from registrant, dissident and proxy access nominees, rather than being limited to selecting a certain slate of candidates over another.[271]

Outgoing SEC Chair Mary Jo White explained that the proposal seeks to "strike the appropriate balance" between improving the proxy voting process and "treating registrants and dissidents in an equitable manner while continuing to require dissidents to independently advance their own solicitations."[272] Indeed, changes to the proxy system are a clear concern for the SEC, as it has noted that a majority of shareholders vote by proxy. Accordingly, the SEC has devoted much time and attention to improving shareholders' rights under the proxy process, including numerous rule proposals, staff reports, and comment letters.[273] This proposed rule comes on the heels of a 2-1 vote, with Commissioner Michael Piwowar dissenting.

Under the current system, in a contested director election, shareholders must choose between returning the registrant's proxy card or the dissident's proxy card.[274] The bona fide nominee rule, Rule 14a-4(d)(1), prohibits a proxy from including persons who have not consented to be named in the related proxy statement and serve if elected.[275] Typically, registrant and dissident nominees do not usually consent to be named in the other's proxy statement, so those voting by proxy are far more constrained than shareholders attending the meeting in person.[276] Moreover, state law prevents the use of two proxy cards since the most recently delivered proxy card controls. Therefore, shareholders must attend meetings in person if they wish to vote for both registrant and dissident nominees.

The so-called "short slate rule" mitigates this to a certain extent. Adopted in 1992, the SEC enacted the rule, 14a-4(d)(4), to allow dissidents with a partial slate of nominees to indicate on their proxy card that they will use their authority to vote for registrant nominees in order to elect a complete slate.[277] However, this rule applies only when the dissident is seeking to elect a minority of the board.[278]

Thus, in order to make proxy voting more similar to that of in-person voting, the SEC proposed changes to the bona fide nominee rule and the short slate rule. These changes seek to permit the use of a universal proxy card to allow a registrant or dissident the opportunity to include other

270 "SEC Proposes Amendments to Require Use of Universal Proxy Cards," Release No. 34-79164; File No. S7-24-16 (Oct. 26, 2016) (the "Proposed Rule"), p. 9, available at https://www.sec.gov/rules/proposed/2016/34-79164.pdf.

271 *See* Harrington.

272 "Statement at Open Meeting on a Universal Policy System and Exemptions to Facilitate Intrastate and Regional Securities Offerings." Oct. 26, 2016, at https://www.sec.gov/news/statement/white-statement-open-meeting-102616.html

273 Proposed Rule, pp. 6-7.

274 *See* Harrington.

275 17 CFR 240. 14a-4(d)(1)

276 The SEC notes that shareholders are "required to submit the votes on either the registrant's or the dissident's proxy card and cannot pick and choose from nominees on both cards." Proposed Rule p. 11.

277 Proposed Rule, pp. 13-14.

278 *Id.* at p. 14.

nominees on its proxy card, without consent from the other nominees. Specifically, under the amended Rule 14a-4(d)(1), a bona fide nominee would be defined as "a person who has consented to being named in a proxy statement relating to the registrant's next meeting of shareholders at which directors are to be elected."[279] By saying "a proxy statement," the SEC is signaling that it means any proxy statement, rather than what the rule currently provides—only the proxy statement of the soliciting party.

At its core, the SEC's proposal is the adoption of Rule 14a-19, which provides that soliciting director nominees other than a registrant's nominees must first meet certain requirements. Specifically, dissidents would be required to provide notice to a registrant, at least 60 days in advance of the anniversary of the previous year's annual meeting, of the names of all nominees for whom the dissident intends to solicit proxies.[280] Dissident shareholders would still need to comply with any earlier deadline under a registrant's advance notice by law provisions.[281] On the flip side, a registrant must provide, no later than 50 calendar days in advance of the anniversary of the previous year's annual meeting, a list of all names of nominees for whom the registrant intends to solicit proxies.[282] After the dissident provides notice, it would be required to solicit shareholders representing at least a majority of the voting power in the election of directors, and would be required to file a definitive proxy statement by the later of 25 days prior to the meeting date and five days after the registrant filed its definitive proxy statement.[283] This assuages concerns that a dissident is essentially getting a free ride without expending its own resources to solicit proxies.

Taken together, the proposed rule effectively eliminates the need for the short slate rule because a dissident would no longer need authority to vote for any registrant nominees to fill open seats. This can be achieved simply by using the universal proxy card.

Other proposed amendments include those that clarify voting options and effects in director elections. Rule 14a-4(b) would be amended to require "against" and "abstain" (in lieu of "withhold") voting options on proxy cards when applicable state law gives effect to those votes (i.e., when a majority vote standard applies).[284] The proxy statement disclosure requirements would also be amended to require disclosure with respect to the effect of a "withhold" vote when available (i.e., when a plurality vote standard applies).[285]

SEC Adopts New Rules for Intrastate and Regional Securities Offerings

Also on October 26, 2016, the SEC adopted amendments to modernize Rule 147 under the Securities Act, which provides a safe harbor for compliance with the Section 3(a)(11) exemption from registration for intrastate securities offerings.[286] The amendments also established a new intrastate offering exemption under the Securities Act, designated as Rule 147A, which will differ from Rule 147 because there is no restriction on offers, and issuers are allowed to be incorporated

279 *Id.* at p. 25.

280 *Id.* at p. 35.

281 *See* Harrington.

282 Proposed Rule, p. 35.

283 *Id.; see* Harrington.

284 *See* Harrington.

285 *Id.*

286 "Exemptions to Facilitate Intrastate and Regional Securities Offerings" Release Nos. 33-10238; 34-79161; File No. S7-22-15 (Oct. 26, 2016) (the "Final Rule"), p. 1, available at https://www.sec.gov/rules/final/2016/33-10238.pdf

or organized outside of the state in which the intrastate offering is conducted, under certain conditions.[287] This allows out-of-state individuals to learn of Internet-based offerings, even if they are not allowed to invest. The amendments are focused on facilitating capital formation through offerings that rely on intrastate crowdfunding provisions under state securities laws.[288]

Overall, however, the rules are substantially similar, and include the following provisions:[289]

- The issuer must satisfy at least one "doing business" requirement demonstrating the in-state nature of the issuer's business;
- A "reasonable belief" standard for issuers to rely upon in determining the residence of the purchaser at the time of the sale of securities;
- A requirement that issuers obtain a written representation from each purchaser as to his or her residency;
- The residence of a purchaser that is a non-natural person, such as a corporation, partnership, trust or other form of business organization, will be defined as the location where, at the time of the sale, the entity has its "principal place of business";
- A limit on resales to persons resident within the state or territory of the offering for a period of six months from the date of the sale by the issuer to the purchaser of a security sold pursuant to the exemption;
- An integration safe harbor that will include any prior offers or sales of securities by the issuer, as well as certain subsequent offers or sales of securities by the issuer occurring after the completion of the offering;
- Disclosure requirements, including legend requirements, to offerees and purchasers about the limits on resales.

The SEC previously proposed amendments to Rules 147 and 504 on October 30, 2015.[290] The final rule adopts the majority of the proposed amendments, with some exceptions. Specifically, the proposed rule sought to amend Rule 147 to replace the existing safe harbor with a new intrastate offering exemption.[291] However, due to developments in today's business practices and technology since Rule 147 was originally adopted, the SEC determined that it was necessary to fully update and modernize the requirements of Rule 147, rather than engage in a complete overhaul.[292] The SEC's decision was predicated on the fact that issuers would be able to continue relying on the Rule 147 safe harbor, including crowdfunding provisions pursuant to compliance with Section 3(a)(11) of the Securities Act and Rule 147.[293]

The SEC also adopted amendments to Rule 504 of Regulation D under the Securities Act in an

287 *Id.*

288 *Id.*

289 *Id.* at p. 25.

290 *Id.* at p. 4; see also SEC Rel. No. 33-9973 [80 FR 69786] (Nov. 10, 2015).

291 SEC Rel. No. 33-9973.

292 Final Rule at p. 7.

293 *Id.* at pp. 10-11.

effort to facilitate capital raising efforts and provide additional protections to investors.[294] These amendments seek to increase the aggregate amount of securities that may be offered and sold in a 12-month period from $1 million to $5 million, and disqualifies bad actors from participating in Rule 504 offerings.[295] A company can use this exemption so long as it is subject to reporting pursuant to Section 13 or 15(d) of the Exchange Act; it is an investment company; or it is not a blank check company (i.e., a development stage company that has no specific business plan or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company, entity or person).[296]

The final rules repeal Rule 505, which allows offerings of up to $5 million annually that must be sold to accredited investors or no more than 35 non-accredited investors.[297]

Department of Labor's Fiduciary Rule Goes Into Effect April 2017 – *Maybe*

On April 10, 2017, the Department of Labor is currently scheduled to enable a fiduciary regulation requiring financial advisors to provide advice in the best interests of their client via retirement accounts. The rule does not apply to brokerage accounts. While it may seem odd that such a regulation is necessary, the White House Council of Economic Advisers previously reported that conflicts of interest by investment advisers lead to $17 billion in lost income every year.[298] That is because, in reality, a prospectus's fine print may indicate steep fees and commissions that prevent everyday investors from maximizing on their returns.[299] Accordingly, this new rule rewards advisors who focus more on transparency and accountability.

In additional to higher compliance costs, the rule will require advisors to invest more in their business to perform as advertised.[300] At a minimum, advisors will have to increase their Internet presence, by building a digital platform that will increase investor interaction.[301] Indeed, some firms are already preparing for the rule implementation. Merrill Lynch recently announced that it will stop new commission-based IRA brokerage accounts through its advisors as of April 10, 2017.[302] Instead, clients will have three other options to choose from: (i) working with an advisor on a fee-basis; (ii) using commission-based, self-directed brokerage accounts; or (iii) Merrill Edge Guided Investing, a fee-based robo-advisor option that will start in early 2017.[303]

President Obama vetoed the U.S. Senate's repeal of the Department of Labor's rule, and was upheld by a party-line vote of the House of Representatives that same month.[304] It is unclear what

294 *Id.*

295 *Id.* at pp. 1-2.

296 *Id.* at p. 70.

297 *Id.* at p. 2.

298 Mercado, Darla. "How the New 'Fiduciary' Rule Will Actually Affect You." Oct. 13, 2016. CNBC. Available at http://www.cnbc.com/2016/10/13/how-the-new-fiduciary-rule-will-actually-affect-you.html.

299 Carson, Ron. "Honest Financial Advisors Should Embrace New DOL Rule." June 1, 2016. CNBC. Available at http://www.cnbc.com/2016/06/01/honest-financial-advisors-should-embrace-new-dol-rule.html.

300 *Id.*

301 *Id.*

302 *See* Mercado.

303 *Id.*

304 Shoeff Jr., Mark. "Congressional Sit-In Disrupted by Failed Attempt to Override Veto of Anti-DOL Fiduciary Rule Bill." June 23, 2016. InvestmentNews. Available at http://www.investmentnews.com/article/20160623/FREE/160629961/congressional-sit-in-disrupted-by-failed-attempt-to-override-veto-of.

may happen in the new Trump administration, but members of the House are signaling that the rule may be dismantled or delayed.[305] It is therefore expected that, at the very least, President Trump will delay the start of the Fiduciary Rule well beyond the government-wide regulatory freeze of January 20, 2017, intended to put new or pending regulations in a holding pattern.[306] This comports with former SEC Chair Mary Jo White's announcement on November 15, 2016 that she did not expect the SEC to adopt its own fiduciary rule until after January 2017, citing that there is not consensus among the SEC to move forward.[307] White did note, however, that there is a concern about "anything that results in depriving retail investors of reasonably priced, reliable advice" and noted an ongoing dialogue between the SEC and the Department of Labor to determine where the agencies may overlap in jurisdiction.[308]

At the very least, the courts can make an impact here, as litigation challenging the regulation could stop it from taking effect without much help from the Trump administration. So far, federal judges in Kansas and Washington, D.C., have found that the Department of Labor acted within its authority to undertake an adequate analysis in promulgating the rule.[309] The D.C. Circuit Court is considering an emergency appeal, however.[310] Conversely, if judges continue to uphold the regulation, the Trump administration may turn to legislation for a repeal, or may turn to the Department of Labor itself to reverse the rule, which would likely result in the reopening of a comment period.[311]

As for now, the delay provides more time for broker-dealers and others that will be affected by the Fiduciary Rule to prepare to comply with the Rule when it goes into effect.

The SEC Approves FINRA's Pay-to-Play Rule

On August 26, 2016, the SEC approved FINRA rule changes targeted at the regulation of political contributions by FINRA member firms that engage in solicitation activities with government entities on behalf of investment advisers.[312] The rule changes were originally proposed by FINRA in December 2015, and are modeled after the requirements of Rule 206(4)-5 of the Advisers Act, which regulates pay-to-play practices by investment advisers (the "SEC Pay-to-Play Rule").[313] FINRA announced on October 24, 2016, that its pay-to-play rules will take effect on August 20, 2017.[314]

The SEC Pay-to-Play Rule prohibits covered investment advisers or their associates from providing or agreeing to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of an adviser, unless that person is a "regulated

305 Waddell, Melanie. "SEC's White: No Fiduciary Rule Coming Before January." Nov. 15, 2016. National Law Journal. Available at http://www.nationallawjournal.com/id=1202772446706/SECs-White-No-SEC-Fiduciary-Rule-Coming-Before-January?slreturn=20161021130722.

306 Germaine, Carmen. "Delayed Fiduciary Rule Faces Host of Obstacles to Repeal." Jan. 23, 2017. Law360. Available at https://www.law360.com/securities/articles/883632/delayed-fiduciary-rule-faces-host-of-obstacles-to-repeal?nl_pk=d9218bbb-9765-4614-af62-1d235cd0d6c6&utm_source=newsletter&utm_medium=email&utm_campaign=securities.

307 *See* Waddell.

308 *Id.*

309 *See* Germaine.

310 *Id.*

311 *Id.*

312 Order Approving a Proposed Rule Change to Adopt FINRA Rule 2030 and FINRA Rule 4580 to Establish "Pay- To-Play" and Related Rules ("Approved Rule"), Aug. 25, 2016, p. 1, available at https://www.sec.gov/rules/sro/finra/2016/34-78683.pdf.

313 *Id.* at pp. 1, 4.

314 *See* FINRA Regulatory Notice 16-40, Oct. 24, 2016, available at: http://www.finra.org/industry/notices/16-40.

person."[315,316] Under the SEC Pay-to-Play Rule, a regulated person includes registered broker-dealers so long as: (i) FINRA rules prohibit member firms from engaging in distribution or solicitation activities if political contributions have been made to certain public officials; and (ii) the SEC orders that these rules impose substantially equivalent or more stringent restrictions on member firms than the SEC Pay-to-Play Rule on investment advisers, and that such rules are consistent with the objectives of the SEC Pay-to-Play Rule.[317] Accordingly, FINRA proposed its own rule to enable its member firms to continue to engage in government entity solicitation, while discouraging its member firms from participating in pay-to-play activities through reliance on the Advisers Act rule.[318]

The Two-Year Bar

New FINRA Rule 2030(a) prohibits a covered member from engaging in solicitation activities for compensation with a government entity on behalf of an investment adviser if that adviser provides, or is seeking to provide, investment advisory services to such government entity within two years after a contribution[319] to an official[320] of the government entity is made by the covered member or by one of its associates (including those who become a "covered associate").[321] The two-year time-out period substantially mirrors the SEC Pay-to-Play Rule, and is intended to discourage covered members from participating in pay-to-play activities by requiring a cooling-off period during which the impact of political contributions may dissipate.[322]

Rule 2030(b) also prohibits covered members or covered associates from soliciting or coordinating any person or political action committee (or "PAC") to make: (i) contributions to an official or government entity with respect to situations in which the covered member is engaging in, or seeking to engage in, distribution or solicitation activities on behalf of an investment adviser; or (ii) payment to the political party of a state or locality of a government entity in which the covered member is engaging, or seeking to engage in, distribution or prevent covered members or covered associates from circumventing the two-year time-out period.[323]

Exceptions

Much like the SEC Pay-to-Play Rule, the FINRA Rule contains three exceptions from the Rule's prohibitions:

De Minimis Contributions: Covered associates, who are natural persons, may contribute up to

315 *See* 17 CFR 275.206(4)-5(a)(2)(i)(A).

316 Approved Rule at p. 5. *See also* Michael Washburn, *BakerHostetler Panel Analyzes Shifts in Enforcement Policies and Tactics As Industry Anticipates New Administration and SEC Chair* (Part One of Two), The Hedge Fund Law Report, Jan. 5, 2017; and BakerHostetler presentation, *The Ins and Outs of the SEC Enforcement Program and Its Arsenal Against Hedge Funds, New York Yacht Club*, Nov. 16, 2016.

317 *Id.*

318 *Id.* at pp. 5-6.

319 Like its SEC Rule counterpart, the new FINRA rule distinguishes between contribution and payment, in that a payment is considered any gift, subscription, loan, advance deposit of money, or anything of value made for the purpose of influencing an election. *See Id.* at p. 13.

320 Under both the SEC and FINRA Pay-to-Play Rules, an "official" includes an incumbent, candidate or successful candidate for elected office of a government entity if that office is directly or indirectly responsible for, or may influence the outcome of the hiring of an investment adviser. *See* Approved Rule at p. 13.

321 *Id.* at pp. 7-15.

322 *Id.* at p. 7.

323 *Id.* at p. 15.

$350 per election to an official for whom that covered associate is entitled to vote, and a maximum contribution of $150 for any other official.[324]

New Covered Associates: Rule 2030(c)(2) provides an exception where a covered associate, who is a natural person, made a contribution more than six months prior to becoming a covered associate of the covered member, unless the covered associate engages in, or seeks to engage in, the distribution or solicitation activities with a government entity on behalf of the covered member.[325]

Certain Returned Contributions: A member is not barred from engaging in distribution or solicitation activities with government entities on behalf of an investment adviser if the contribution in violation of the Rule is returned to the contributor. Reliance on this exception is subject to certain conditions, however. For example, a member that has more than 150 registered persons can only rely on this exception three times in any calendar year (conversely, a member with fewer than 150 registered persons may rely on this exception twice per calendar year), and never more than once for the same covered associate.[326]

Covered Investment Pools

In addition, Rule 2030(d) provides that distribution and solicitation activities on behalf of a covered investment pool[327] in which a government entity is solicited to invest shall be treated as though the covered member was engaging or seeking to engage in distribution or solicitation activities with the government entity on behalf of the investment adviser to the covered investment pool.[328] This Rule is modeled off of similar prohibitions in the SEC Pay-to-Play Rule and applies to situations in which an investment adviser manages assets of a government entity through a hedge fund or other type of pooled investment vehicle.[329] Accordingly, this Rule is extended to public pension plans that access the services of investment advisers through investments in hedge funds.[330]

Indirect Contributions

For all prohibited contributions described above, FINRA provides that such contributions are in violation of Rule 2030 even if made indirectly.[331] In other words, covered members who make contributions through “funneling” monies via family members, friends, or other, similar parties, are also in violation of the Rule as these activities circumvent the intent and spirit of the Rule. Like the other adopted provisions of the Rule, this section is consistent with the SEC’s Pay-to-Play Rule.

During the comment period, many submissions brought up First Amendment concerns in that the proposed Rule would stifle the ability to participate in the political process through financial contributions; however, these concerns were also disbanded within the SEC Pay-to-Play context

324 *Id.* at p. 16.

325 *Id.* at 17.

326 *Id.* at 18.

327 Covered investment pools shall include any investment company registered under the Investment Company Act that is an investment option of a plan or program of a government entity, or a company that would be an investment company under Section 3(a) of the Investment Company Act but for the exclusions provided under Section 3(c)(1), (c)(7), or (c)(11), of that Act. *See Id.* at p. 19.

328 *Id.*

329 *Id.*

330 *Id.* at p. 20.

331 *Id.* at p. 21.

in 2014 when state parties filed suit against the SEC on First Amendment grounds.[332] In response, FINRA also notes that the Rule is justified by an overriding government interest to prevent fraud and unfair market practices.[333]

FINRA noted that the Rule would not apply to member firms for contributions made prior to the effective date, although the SEC Pay-to-Play Rule may still apply. Firms should review their existing internal policies and practices regarding political contributions, particularly noting their policies on distribution and solicitation of activities with government entities on behalf of investment advisers.

332 *See N.Y. Republican State Comm. v. SEC*, 799 F.3d 1126 (D.C. Cir. 2015).

333 Approved Rule at p. 25.

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