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Where White Collar Enforcement Is Heading

By **Gregory Morvillo and Amy Walsh** (March 6, 2018, 12:37 PM EST)

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The Trump administration has been in power for a little over a year, and the natural question for those who practice in the white collar space is: What kinds of investigations and cases can we expect from regulators and prosecutors in the near future? While much of this is tea-leaf reading, there have been certain significant developments in various industries, coupled with official statements by the U.S. Securities and Exchange Commission and the U.S. Department of Justice, that give us some indication of what lies ahead.

Cryptocurrencies

Amy Walsh

Cryptocurrency and the blockchain technology that undergirds it is now a major global phenomenon that is not going away anytime soon. Throughout 2017, financial regulators struggled with how to regulate this vibrant and volatile area of the market. One challenge in regulating cryptocurrency is definitional — is it currency? Is it a commodity? Or is it a security? And regardless of what it is, how should it be traded, and by what method should it be valued?

The Commodity Futures Trading Commission has declared cryptocurrencies to be commodities, subject to the CFTC's oversight under the Commodity Exchange Act and allowing for direct regulation of futures and derivatives tied to them. On the other hand, the SEC has taken the position that initial coin offerings that offer digital tokens should be registered with the SEC (or qualify for an exemption) if the digital tokens being offered function like securities. SEC Chairman Jay Clayton acknowledged to the Senate Banking Committee that billions of dollars have been raised through ICOs, and none of the ICOs has been registered with the SEC. Moreover, both SEC Chairman Clayton and CFTC Chairman Christopher Giancarlo told members of the Senate Banking Committee that all the financial regulators need to come up with a unified approach to regulating virtual currency, and implied that new legislation may be necessary.

On the enforcement side, both the CFTC and the SEC have brought several enforcement actions to halt the fraudulent sale of cryptocurrencies. However, putting aside blatantly fraudulent schemes, the

questions going forward for white collar practitioners will be what are the rules governing transactions involving cryptocurrencies, who will be in charge of enforcing those rules, and what types of behavior fall outside the rules, thereby creating a risk of enforcement action or criminal prosecution. Without clear regulations in place, it is difficult to answer those questions. For example, although the SEC's view may be inferred from some of its enforcement actions, it has not issued any guidance on what is or is not a security in the context of ICOs, nor has it issued any guidance to assist good faith actors as to whether a particular ICO is exempt from the registration requirements.

One might ask how a regulatory enforcement action or a criminal prosecution can be premised on such a murky and unchartered area of the law. And yet, Chairman Clayton recently rattled his saber regarding the gatekeepers who advise clients on whether to register the product being offered in an ICO. Chairman Clayton said on Jan. 22, 2018, that with regard to this issue, he has instructed the SEC staff "to be on high alert for approaches to ICOs that may be contrary to the spirit of our securities laws and the professional obligations of the U.S. securities bar."

There is no question that we will see a marked increase in enforcement activity relating to cryptocurrencies over the course of 2018. What remains to be seen is what the precise focus of the regulators and prosecutors will be — whether it will be limited to traditional fraud, or whether it will extend to trading behavior, valuation, and the role of the gatekeepers in advising on the registration requirements of an ICO.

Gatekeepers

Beyond the world of cryptocurrency, it appears that gatekeeper liability in other areas will feature prominently in 2018. For example, in January of this year, federal prosecutors in New York charged three former members of the Public Company Accounting Oversight Board and three former high-ranking partners at KPMG with an alleged scheme to use stolen confidential information to help the firm obtain better results during PCAOB inspections of the firm's audits. Specifically, the government has alleged that the three former PCAOB employees passed along information they learned while at the PCAOB (and later, through others still at the PCAOB) to the accounting firm's partners related to upcoming PCAOB inspections of the firm's audits. Thus, this case implicates not only the conduct of the auditors, but also the watchdog of the auditors.

Apart from criminal prosecutions, federal financial regulators have recently sent strong signals that the board positions of directors of large financial institutions will be jeopardized if significant misconduct occurs on their watch. For example, the Federal Reserve recently restricted Wells Fargo's growth until it sufficiently improves its governance and risk management processes, including strengthening the effectiveness of oversight by its board of directors. In the same announcement, the Federal Reserve noted that the bank will replace four directors by the end of the year. Although the change in board membership was not mandated under the consent order relating to the bank's growth, there was significant pressure on the bank to make changes in the board room. Moreover, the current chair of the Fed has made it clear that the Fed expects much more from board members than ever before in terms of risk management, even if at the expense of generating revenue.

Within the last few years, regulators and prosecutors have focused intently on gatekeepers' liability and have not hesitated to bring enforcement and criminal actions against those players in the financial markets. There is no reason to think that this trend will not continue through 2018 and beyond, given these recent developments and the heightened rhetoric surrounding the duties of board members in general.

Spoofing

Spoofing is a practice used by unscrupulous traders to trick other investors into buying and selling at artificial prices. To effect a spoofing scheme, a trader places an order and quickly cancels it. The idea is that the market will notice buy and sell orders and be fooled into thinking the stock price is moving in a certain direction. Spoofing creates the appearance of market depth where it does not exist, produces false price movements, delays unsuspecting market participants from executing orders and more. As with everything in the digital age, computer programs can execute these schemes faster than any human being. High-frequency traders can program computers to place and cancel orders within milliseconds of each other and can do so hundreds of times per day.

If the placement and cancellation of an order is done solely to drive the price up or down, it violates the anti-spoofing laws. Not only are criminal and regulatory entities paying close attention to it, but this practice and the government's focus on it has the attention of both big and small investment firms. There is good reason for Wall Street to pay heed to the practice and the regulatory environment surrounding it. There have already been a handful of criminal and regulatory spoofing cases. The CFTC has charged several cases against entities involved in spoofing and the Department of Justice has charged multiple individuals criminally.

At is simplest form, spoofing is a new form of an old crime — market manipulation. While manipulation is not, by any means, new ground for law enforcement, spoofing cases may provide fresh land to till. We think with the ubiquitous nature of high frequency trading programs, the government will have to scramble to keep up with spoofing. But, as it usually does, the government will find a way to keep pace, and more cases will follow.

Omissions

It is axiomatic that federal securities laws prohibit affirmative misrepresentations as well as material omissions in connection with the sales of securities. A material omission can range from silence about a data breach, to a failure to disclose expected financial difficulties, to undisclosed government investigations and more. The question companies have to answer is whether and when to disclose bad news to the market. Fast disclosure often results in sharp stock price decreases, which all public companies want to avoid. However, the alternative is remaining quiet and hoping that the information does not surface.

This latter option is fraught with peril and often results in shareholder actions, as well as scrutiny by

regulators and prosecutors. A perfect example of this litigation and investigations stemming from the accusation that Apple material omission that it intentionally slowed down older iPhones. Apple is being sued in 30 different class actions over this alleged course of conduct. Unsurprisingly, at the end of January 2018, it came to light that both the Department of Justice and the Securities and Exchange Commission are investigating these claims as well. The reverse can also be true, as in Vodafone's case, where the failure to disclose the existence of an investigation becomes as the basis for securities fraud claims. Plaintiffs suing Vodafone have alleged 10(b) claims against the company and several of its officers for not disclosing an investigation by the Australian Communications and Media Authority into Vodafone's prepaid phone practices in that country and the resulting ADR price drop when the Australian Communications and Media Authority announced its investigation findings earlier this month.

We think omission cases, which have been in the government's wheelhouse for years, will be on the rise. Regulators all over the world are watching public companies to see how they are handling the dissemination of negative news, and they are taking full advantage of any and all leads developed by plaintiffs lawyers in securities class actions. Companies that don't disclose material information and developments in a reasonable time will increase the risk of regulatory and criminal scrutiny.

Opioids

In late 2017, the current administration made opioid manufacturing and abuse a major priority for the Department of Justice. In so doing, the attorney general announced the establishment of a new Drug Enforcement Administrationfield division and directed all United States attorneys to designate an opioid coordinator in each office. But unlike the drug epidemic of the 1980s, it is not just street level pushers and drug traffickers that are in the opioid supply chain. Opioids are manufactured by major drug companies, prescribed by licensed physicians, and distributed by nationwide retail pharmacies. These actors are all potentially in the sights of prosecutors, state attorneys general, as well as private plaintiffs.

For example, the New York state attorney general recently brought an action against Insys Therapeutics Inc. for allegedly misrepresenting that a spray version of the opioid fentanyl is safe for noncancer patients and appropriate for mild pain. Insys has been sued in by attorneys general in New Jersey and Arizona based on similar allegations. In addition, Purdue Pharma and other drug manufacturers, as well as large drug distributors, are fending off over 100 lawsuits filed by local governments alleging, in essence, that the drug manufacturers improperly marketed opioids to doctors by overstating the drugs' benefits and downplaying their risks, and the drug distributors failed to monitor and report suspicious drug orders.

While these allegations are limited to civil lawsuits at this point, these types of cases often yield information and witnesses that if shared with law enforcement, can lead to criminal investigations of the same alleged conduct . In a run-of-the-mill drug case, prosecutors typically prosecute low-level drug dealers and move up the distribution chain to those at the top who stand to profit the most. There is no reason that prosecutors won't take the same approach, using the same prosecutorial tools, in the context of the current opioid crisis.

Marijuana

Turning to a different drug, marijuana dispensaries have grown like weeds all over the United States since the time individual states began legalizing its use. As many as 30 states have legalized the sale of recreational or medicinal marijuana. For the past several years, the Department of Justice turned a blind eye to this blatant violation of federal law under clearly delineated federal statutes. However, the federal government's tolerance may be about to evaporate in a proverbial puff of smoke. On Jan. 4, 2018, Attorney General Jeff Sessions issued the following unequivocal statement: "Given the Department's well-established general principles, previous nationwide guidance specific to marijuana enforcement is unnecessary and is rescinded, effective immediately."

Does this mean that the Department of Justice will start a task force and run the marijuana business into the ground? It is unlikely. The money flowing into the states that have legalized recreational use of marijuana is staggering. Those states that now permit the medicinal use of the drug are aiding people who have real needs. Thus, attacking those businesses would be time-consuming and very unpopular in many places.

That said, because the revenue numbers for the dispensaries are in the hundreds of millions per year, and there is little doubt that selling cannabis still violates federal law, criminal cases (that would be accompanied by hefty fines and forfeiture) could be in the offing. The hook to prosecute these companies is through the money laundering statutes. How do the dispensaries in states like New York handle the money? Many banks will not take the proceeds of the sale of marijuana. And thus, dispensaries are left to come up with creative solutions for handling the proceeds of sales, which will likely get close scrutiny.

While the Department of Justice has not come out and said its policy change will definitively increase the number of marijuana dispensary-related investigations, one would have to have partaken in a vast amount of the product to not see the possibilities. To be blunt: You're stoned if you think the feds aren't going to at least look at this industry in 2018. Whether they bring a rash of cases is yet to be seen, but money laundering and federal drug law violations are ripe for investigating.

Conclusion

While it is always a challenge to predict what lies ahead, we believe that the areas outlined above will provide fertile ground for regulators and prosecutors to make cases in industries that are beginning to generate enormous amounts of new revenue, while using the same investigative tools they've used over multiple decades of law enforcement.

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