Highlights from SEC Speaks 2019 - Litigation and Enforcement Trends

Friday, April 12, 2019

The U.S. Securities and Exchange Commission (the “SEC” or the “Commission”) held its annual SEC Speaks conference in Washington, DC on April 8 and 9, 2019. The conference featured remarks from the Chairman and commissioners, discussions regarding current enforcement initiatives and enforcement priorities for the upcoming year, and an update on litigation, judicial and legislative developments.

Highlights from this year’s conference included the Division of Enforcement’s (the “Division”) views on the recent ruling in Lorenzo v. SEC, a more detailed look at how the Division utilizes data analysis in support of its investigations, discussion of efforts related to protecting retail investors, explanation of non-fraud enforcement priorities of the Division’s Cyber Unit, and comments on key cases and priorities for various units within the Division.

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Chairman’s Speech and Commissioners’ Remarks

Chairman Clayton

Chairman Jay Clayton kicked off the conference by providing an overview of the SEC’s work within the past year. He presented his speech from the “eyes of management,” similar to the way public companies offer a “Management’s Discussion and Analysis” section in their SEC filings. Chairman Clayton began by emphasizing the SEC’s three-part mission: (1) protecting investors, (2) maintaining fair and efficient markets and (3) facilitating capital formation.

Chairman Clayton discussed a number of factors and trends impacting the SEC’s operations, including its ability to continue investing in technology, respond to major events such as changes in the regulatory landscape, and prepare for Brexit. In discussing the SEC’s financials, Chairman Clayton stated that unsurprisingly, the Commission’s largest expenditure in fiscal year 2018 was employee pay, which he expects to also be the largest expenditure for fiscal year 2019. He further noted that Congress provided the SEC with enough resources for fiscal year 2019 to lift their hiring freeze and add 100 new positions, which will allow the SEC to return to the staffing levels that existed five years ago.

In highlighting the SEC’s most noteworthy accomplishments over the past year, Chairman Clayton declared that the Division of Enforcement had a successful year vigorously policing fraud, resulting in the return of $794 million to harmed investors. He expressed the view that the SEC’s recent victory in Lorenzo v. SEC will have a “significant impact” on the Commission’s ability to enforce securities laws, including by going after disseminators of misstatements.

Chairman Clayton also lauded the SEC’s enhanced mandated disclosures for broker-dealers and investment advisers. He stated that standards of conduct for such professionals should reflect what investors would reasonably expect, while preserving investors’ choices regarding (1) the types of professionals with whom they would like to work, (2) the nature and scope of services and (3) how they want to pay for those services.

In a Q&A session with Co-Director of the Division of Enforcement Stephanie Avakian, Chairman Clayton was asked how he thought about risk. He stated that he generally worries about when expectations are out of step with reality. On a micro level, he offered the example of how investors’ liquidity expectations may be inconsistent with reality given the expansion of leveraged loans that do not settle quickly. On a macro level, he said that he worries about when markets are out of step with each other. He opined that the United States is a country with high transparency and relatively tight fiscal policies, in contrast to other countries that may be more accommodative and less transparent.

Chairman Clayton concluded his remarks by thanking those whom he called the SEC’s most important resource: the 4,500 staff members who make all the SEC’s accomplishments possible and who continue to work to protect “Main Street” investors.

Commissioner Jackson

Commissioner Robert J. Jackson Jr.’s remarks focused on a number of areas that the Commission has been working on during the 15 months since he was sworn in as a commissioner, including Regulation Best Interest, market structure, shareholder voting and cybersecurity. He also stated that the Commission needs to reevaluate and possibly update regulations surrounding areas such as insider trading, Form 8-K, and compensation disclosures.

He first addressed Regulation Best Interest, which he called an “interesting proposal.” He stated that he thinks the Commission has an important leadership role to play in this area and acknowledged that while he voted for the proposal because he thinks that it is a “good step for the agency to take,” significant changes should be made before the proposal goes forward. He advocated for clarifying the standard with respect to exactly what obligations a broker-dealer owes a customer, and he emphasized that the proposal can and should simply state that a broker’s obligation is to put the client’s interest first. He noted that people in the marketplace are going to do what they are paid to do, so it is important to limit or ban compensation practices that lead brokers to engage in conflicted activities. He stated that Regulation Best Interest should be the product of a bipartisan effort at the Commission, especially considering that it will likely be the subject of extensive litigation going forward. He remains hopeful that the Commission will find a way to come to a good resolution.

Commissioner Jackson also addressed market structure and shareholder voting. With regard to market structure, he stated that he is very proud of the work the Commission is doing with the Transaction Fee Pilot, which the Commission announced on December 19, 2018, and feels very good about the path forward for 2019. He believes that there is work to be done in the shareholder voting area, as investors who cast votes in a corporate election ...
are not presently entitled to a confirmation as to when and how their votes were counted. He is hopeful for action in this area.

Commissioner Jackson stated that the issue he hears the most about when he visits boards is cybersecurity. In 2017, a Form 8-K was not filed in 97% of instances of identity theft that affected a public company. That figure fell to 90% in 2018, but Commissioner Jackson believes that there need to be firmer disclosure rules in this area, and he plans to continue to follow up on the data. He acknowledged that writing a rule regarding such data breach disclosures would not be easy, but he has heard from the marketplace that more guidance is needed, and he urged people to follow up regarding guidance that might be helpful.

Commissioner Jackson then gave an overview of what he hopes to accomplish in the coming years. First, he stated that the Commission has not looked in-depth at the landscape surrounding insider trading law in a long time. The Commission is therefore unable to accurately assess the degree to which the laws governing insider trading fit the current market. He believes that common law has served well, but he believes that it is time to think through the existing regulations. Commissioner Jackson spoke briefly about the need to evaluate the degree to which Form 8-K disclosure rules, and particularly those regarding cyber issues, are still working in the current market landscape. Finally, he believes that the Commission should take a look at compensation disclosure rules because a lot has changed since the last time the Commission touched those in 2006.

Finally, in response to a question from the audience, Commissioner Jackson addressed the issue of robo-advisers. He expressed that he is in favor of robo-advisers to the extent that they can move American investors toward a lower-cost way to participate in the growth of the economy. But, he stated, they are not a solution for everything. The algorithms for robo advisers are written by people who have all of the same flaws that the Commission is ordinarily worried about, and most investors want to speak to a person face-to-face about their investment decisions.

Commissioner Jackson concluded his remarks by stating that while he does not always agree with everything the Division of Enforcement is doing, he believes the Division is working to get the right results for investors.

**Commissioner Peirce**

Commissioner Hester M. Peirce focused her remarks on the downsides to market participants when staff-level guidance is not disclosed to the public, thereby creating a body of secret law. Analogizing the complex regulatory framework governing the markets to the “secret garden” from Frances Hodgson Burnett’s classic children’s novel, Commissioner Peirce explained that this complexity can create a compliance minefield for market participants. While the Commission has some tools at its disposal to help provide clarity for participants, many of these tools are unwieldy and may cause unwelcome delays. To this end, staff-level guidance can provide valuable assistance to participants trying to navigate the markets. One tool in particular that can be helpful to market participants is the no-action letter. Historically, these letters were not made public, but current rules generally provide for their disclosure. Public disclosure leads to several benefits, including enhancing consistency in staff-level guidance, shedding light on ambiguous rules, allowing for the provision of expressly tailored relief that helps preserve market integrity, providing accountability and transparency, and ensuring that the views of the staff do not fall out of sync with the Commission and the markets.

Despite these positive developments, Commissioner Peirce believes the line can sometimes be crossed into secret law, such as when staff will not accept applications for certain products or businesses for reasons that are not articulated anywhere in the rules, or when staff decide that certain rules do not matter in practice because participants operate under a series of public and nonpublic directives instead. These nonpublic directives operate like duly enacted laws to bind participants, but they are not subject to effective oversight or review. When this happens, market participants begin to wonder if they have the same insight as their competitors into this “secret garden” and whether they are being held to the same standards. In these situations, participants may feel that they cannot effectively push back, even where publicly available materials do not support the staff’s decision. According to Commissioner Peirce, the patchwork of public and nonpublic directives leading to these results raises legitimate questions about fairness and transparency. The question then is whether the Commission is regulating the market and market participants in a way that promulgates long-term trust in the market. Because the public places its trust in the Commission to regulate the markets, fairness and transparency are essential to maintaining that trust. To that end, Commissioner Peirce believes that, absent concerns about confidentiality, the “secret garden” should be open to the public.

**Commissioner Roisman**

Commissioner Elad L. Roisman’s remarks focused on the importance of capital formation for small companies and the challenges such companies face in conducting an initial public offering (“IPO”). Commissioner Roisman began his speech by noting the significance of allowing retail investors to participate in the capital formation of small
companies, as this allows investors to build wealth for the purpose of retirement, education and emergency funds. Commissioner Roisman spoke of the challenges small companies face in conducting IPOs and how these challenges often lead companies to stay private, which reduces retail investment opportunities. Specific challenges cited by Commissioner Roisman include the high financial costs of conducting an IPO, affording D&O insurance, and the potential for future shareholder litigation. He also cited the challenges of low secondary market liquidity and noted that low trading volumes in the stock of a small company can contribute to an array of problems.

Commissioner Roisman then turned to the recent efforts of the Commission in trying to alleviate these challenges and facilitate the IPO process for small companies. He first spoke of the December 2018 request for comment in which the SEC solicited public input on how the Commission can reduce quarterly earnings burdens for reporting companies. Commissioner Roisman also noted the recent February 2019 proposal to expand the “test-the-waters” accommodation, which would allow all prospective issuers, not just emerging-growth companies, to gauge market interest in a possible IPO by permitting discussions with certain investors prior to the filing of a registration statement. Finally, he pointed to the Commission’s March 2019 vote to adopt amendments to modernize and simplify disclosure requirements for public companies pursuant to the Fixing America’s Surface Transportation (“FAST”) Act. Commissioner Roisman expressed hope that these recent FAST Act amendments will reduce the time and expenses public companies face with respect to their disclosure reporting requirements. Commissioner Roisman concluded his remarks by stating that he is hopeful these initiatives will encourage more small companies to engage in the IPO process, which will in turn provide retail investors with an array of options for investment opportunities.

**Enforcement Presentation Themes**

The SEC’s enforcement panels at this year’s conference took on a slightly different format than in years past. Rather than having leaders of various units within the Division of Enforcement speak in a siloed manner about key cases from the past year and priorities going forward, the panels were framed by larger themes within which the units’ representatives described their specific work. This provided insight not only into the unit-specific work being done in the Division of Enforcement, but also into higher-level themes that are key drivers of enforcement activity. These themes included (1) protection of retail investors, (2) use of data analytics and (3) cooperation.

**Enforcement Trends and Priorities Relating to Retail Investors**

Charu Chandrasekhar, head of the Division of Enforcement’s Retail Strategy Task Force, stated that the Task Force is currently “very” focused on the widespread problem of affinity fraud. Affinity fraud is a type of securities fraud that targets members of identifiable groups such as religious, racial or age groups. Ms. Chandrasekhar noted that vulnerable segments of retail populations such as seniors and minorities are often targeted by affinity fraud, and she stated that the Task Force is particularly focused on combating offering frauds, Ponzi schemes and market manipulation schemes.

Kurt L. Gottschall, Regional Director of the SEC’s Denver Regional Office, then spoke about the Division of Enforcement’s Share Class Selection Disclosure Initiative (“SCSDI”). Announced in February 2018 with a self-report deadline of June 2018, the SCSDI offered standardized settlement terms (including no civil money penalties) to entities that self-reported deficiencies regarding share class selection disclosures. Mr. Gottschall declared the initiative a success, noting that the first group of settled cases was announced in early March 2019, which involved 79 advisers self-distributing over $125 million to harmed investors. Mr. Gottschall stated that the Division of Enforcement remains “very” focused on registered investment advisers’ conflicts of interest. Examples of areas of focus include revenue sharing agreements with clearing firms, undisclosed commissions, and expense avoidance practices (e.g., avoiding ticket charges in wrap fee accounts). Further, both the SEC’s exam program and the Division of Enforcement are looking at investment adviser revenue streams to identify conflicts of interest. If conflicts exist, the Division of Enforcement will examine whether they are both readily disclosed to, and understandable by, retail investors.

LeeAnn G. Gaunt, Chief of the Public Finance Abuse Unit, spoke about the relationship between muni bonds and retail investors, noting that most muni bonds are held by retail investors either directly or indirectly. For many years, the demand for muni bonds has outpaced the supply, resulting in bond offerings that are often oversubscribed. Because offerors tend to prefer that retail investors hold their bonds, retail investor preferences are frequently built into the bond offerings. This combination of retail investor preferences plus oversized demand for muni bonds has led to situations in which the bonds are improperly diverted away from retail investors. In 2018, the Division of Enforcement brought actions against nearly two dozen parties for diverting bonds from retail investors to broker-dealers. This included cases in which broker-dealers posed as retail investors to obtain priority access to muni bonds and then sold those bonds to retail investors for a profit, as well as cases in which parties on the offering side of the bonds engaged in misconduct (e.g., an underwriter taking kickbacks from a trader for allocating bonds to the trader).
Daniel Michael, Chief of the Complex Financial Instruments Unit, spoke about how his unit is especially focused on protecting retail investors in light of the proliferation of complex products, heightened efforts to sell such products to retail investors, and the increasing ease with which retail investors access such products through expanding technologies. Specifically, Mr. Michael identified leveraged ETFs, ETFs with inverse returns, ETFs tracking esoteric indices, and market-linked notes as products that are generally beyond the knowledge and sophistication of the average retail investor. While these products can offer benefits to investors under the right circumstances, the obligation of broker-dealers and registered investment advisers to have a reasonable basis for recommending an investment are more important now than ever.

Mr. Michael then identified three specific areas of focus for the Complex Financial Instruments Unit. First, he discussed cases in which a broker-dealer or registered investment adviser had no reasonable basis for recommending a complex product to retail investors. As an example, Mr. Michael referred to In the Matter of Cadaret, Grant & Co., Inc. (September 11, 2018), in which a dual-registered broker-dealer/investment adviser failed to supervise its registered representatives who were recommending complex, triple-leveraged exchange-traded notes to retail investors. Second, he discussed cases in which the complex product at issue could be appropriate, but an improper strategy was recommended. As an example, Mr. Michael referred to In the Matter of Wells Fargo Advisors, LLC (June 25, 2018), in which investors purchased market-linked investments that should have been held to maturity, but the investors were advised to actively trade them, resulting in significant fees for Wells Fargo while wiping out investor returns. Third, he discussed cases in which complex, risky products were sold to unsophisticated investors. As an example, Mr. Michael referred to In the Matter of UBS Financial Services Inc. (September 28, 2016), in which a dual-registered broker-dealer/investment adviser failed to supervise its registered representatives who sold hundreds of millions of dollars of reverse convertible notes to relatively inexperienced and unsophisticated investors.

Use of Data Analytics by the Division of Enforcement

Daniel Michael, Chief of the Complex Financial Instruments Unit, discussed with some specificity his unit’s use of technology. For example, in investigating the sale of complex products to unsophisticated investors, the Complex Financial Instruments Unit has created a custom dashboard to facilitate filtering through tremendous amounts of data. The dashboard might, for example, allow the unit to filter through an investment adviser’s data to identify clients over a certain age and with certain investment objectives who were sold complex investment products. This process is aided by the use of a data analytics specialist who works exclusively with the unit for the purpose of identifying misconduct. Additionally, the unit has launched an ETF initiative through which it blue-sheeted dozens of leveraged inverse ETFs, analyzed the resulting millions of rows of data, identified broker-dealers and registered investment advisers with clusters of unsuitable recommendations, and served them with targeted document requests. The Complex Financial Instruments Unit also uses data analysis tools to monitor the swaps market and continues to work with the Market Abuse Unit to adapt those tools and develop new codes to identify suspicious trading patterns.

Joseph Sansone, Chief of the Market Abuse Unit, also weighed in on the use of data analytics at the Division of Enforcement. He noted that the Market Abuse Unit has relied on data analytics for years to review trading patterns for suspicious activity, to monitor serial securities law violators, to aid in development of theories early in the investigation stage and to identify sources of information in insider trading cases. Mr. Sansone noted that the Division of Enforcement’s data analysis tools are sufficiently flexible to be applied to any type of case being brought, and he provided two examples of cases in which data analysis was used effectively. First, he highlighted the case of SEC v. Jung, 1:18-cv-04811 (S.D.N.Y.), in which data analysis identified a pattern of successful trades in advance of mergers. While none of the trades were very large individually, there was an unmistakable pattern of trading in front of acquisitions advised by the defendant’s employer. Second, he highlighted SEC v. Ieremenko, 2:19-cv-00505 (D.N.J.), the recent case in which the SEC’s EDGAR system was hacked and information obtained therefrom was used to trade. In that case, the SEC used data analysis to identify traders who participated in this scheme.

Kelly Gibson, Associate Regional Director of the Philadelphia Regional Office, provided additional discussion of blue sheets and their importance in detecting violations of the securities laws. In addition, she noted that the obligation of broker-dealers to provide accurate blue-sheet data to SEC can itself give rise to enforcement actions. By way of example, Ms. Gibson pointed to the cases of In the Matter of Convergex Execution Solutions (September 13, 2018) and In the Matter of Citadel Securities LLC (December 10, 2018). In Convergex, a broker-dealer paid a $2.75 million civil money penalty to resolve claims that it provided the SEC with incomplete and deficient blue-sheet data. In Citadel, a broker-dealer paid a $3.5 million civil money penalty to resolve similar claims. Ms. Gibson stated that despite these enforcement actions (and other similar actions in 2018), many firms are not getting the message, and more blue-sheet cases will be brought in 2019. She also stated that independent compliance consultants may be required as a remedial measure in blue-sheet cases, in addition to the imposition of millions of dollars in penalties. Even in situations in which a broker-dealer utilizes a third-party vendor for blue-sheet services, the SEC may still hold the broker-dealer liable for deficiencies. When firms
become aware of such deficiencies, Ms. Gibson stated, they must promptly self-report to the SEC and FINRA.

Charu Chandrasekhar, head of the Division of Enforcement’s Retail Strategy Task Force, added that the Task Force uses data analytics to understand patterns within certain demographic groups (such as senior citizens) and to study how such groups are impacted by specific types of fraud. The Task Force sorts trading data by variables such as product, investor location, investor type, etc., to identify these patterns.

**Cooperation**

Another theme that was discussed at length during the conference was cooperation. Stephanie Avakian, Co-Director of the Division of Enforcement, began the discussion by emphasizing the importance of cooperation, which she noted is sometimes referred to as “affirmative assistance” in SEC settlement orders. Ms. Avakian provided a reminder that “high quality” cooperation is critical to advancing the SEC’s investigations in meaningful ways, allows the SEC to preserve its resources, and assists with getting money back into the pockets of harmed investors. She noted that the full range of options remains available for cooperation credit, from reduced penalties to no charges being brought, as long as the cooperation actually advances the Commission’s investigation. Additionally, Ms. Avakian stated that self-policing, remediation and self-reporting all remain important.

Bridget Fitzpatrick, Chief Litigation Counsel, added that there are numerous ways to earn cooperation credit, including by assisting with scheduling issues, helping with service of subpoenas on employees and providing authentication affidavits for key documents. Marc Berger, Regional Director of the New York Regional Office, also noted that collaborating with the SEC on search terms pursuant to responding to document requests could warrant cooperation credit. Mr. Berger further stated that the SEC has been attempting to include language in its orders that emphasizes the type of cooperation that the government deemed significant in order to encourage future cooperation. Mr. Berger cited to In the Matter of Gladius Network LLC (February 20, 2019) as an example of an order that describes what high-level cooperation looked like, in a matter that ultimately resulted in the SEC not imposing any penalties upon the company. Lastly, Mr. Berger opined that he appreciated proactive defense counsel and noted that there was no time too early for defense counsel to seek a meeting with the SEC to discuss key issues and assist with attempting to streamline the SEC’s investigation.

Anita Bandy, Associate Director in the SEC’s Home Office, was asked about how privilege waivers may impact the amount of cooperation credit a company can earn. Ms. Bandy stated that the SEC generally avoids asking for privilege waivers, and that the waiver of any legal right is not necessary for cooperation. However, she noted that if a company declines to provide certain information to the SEC for fear of waiving a privilege and the SEC spends significant resources on fact finding, the company probably cannot reasonably expect the same amount of cooperation credit as a similarly situated company that found a way to provide information to the SEC. Ms. Bandy was also asked about the use of independent compliance consultants as a remedial action. Ms. Bandy stated that this was an important tool and that the SEC looks at a variety of factors in determining whether such a consultant would be appropriate, including how high up the misconduct went within the organization, how long the misconduct persisted and what remediation improvements have already been made. She emphasized that there was no cookie-cutter approach to determining whether an independent compliance consultant would be required.

Melissa Hodgman, also an Associate Director in the SEC’s Home Office, stated that the Division of Enforcement tries to use its cases—including related press releases and public statements—to send messages about the benefits of cooperation. By way of example, she noted that the SEC announced the cases of In the Matter of Walgreens Boots Alliance, Inc. (September 28, 2018) and SEC v. Salix Pharmaceuticals, Ltd., 1:18-cv-00886 (S.D.N.Y.), on the same day to provide a side-by-side comparison of cases in which there was and was not cooperation. Both cases involved financial fraud relating to earnings, yet the outcomes were very different. Salix self-reported, provided substantial assistance during the SEC’s investigation and self-remediated (including replacing its CEO and other culpable individuals). Walgreens, on the other hand, did not self-report, and its cooperation was not on a comparable level with Salix’s. The result was that Salix was not assessed a civil money penalty, while Walgreens was ordered to pay almost $35 million in penalties.

Daniel Michael, Chief of the Complex Financial Instruments Unit, cited to In the Matter of LendingClub Asset Management, LLC (September 28, 2018) as an example of cooperation credit afforded by his unit. In the press release accompanying that case, the SEC specifically noted that it did not charge the parent company because the parent company promptly self-reported the issue, thoroughly and promptly remediated, and provided assistance to the SEC throughout the investigation. Mr. Michael noted that the Division of Enforcement can tell the difference between cooperation and “fauxoperation,” and that the former can involve making witnesses available and making efforts to provide documents in a timely manner. He noted that the cooperation afforded by the parent company in the LendingClub matter gave the SEC tremendous flexibility in determining the nature of the cooperation credit, and also provided the Complex Financial Instruments Unit with the ability to advocate for the
disclosed its clients' confidential dark pool trading information despite representing that such information would not leak. Mr. Sansone pointed to this issue, explaining that if trades are routed and executed in unaffiliated dark pools or exchanges that do not offer the same premium features as the affiliated dark pool, customers want to know where their trades are taking place. In reality, nearly half of the trades were occurring in an affiliated dark pool, which contradicts Mr. Sansone's representation.

Joseph Sansone, Chief of the Market Abuse Unit, stated that this is an important issue because customers want to know where their trades are taking place. He emphasized two types of cases brought by the Market Abuse Unit within the last year: routing cases and information leakage cases. The Division of Enforcement brought two routing cases last year, including In the Matter of Brian Sweet, CPA and In the Matter of Cynthia Holder, CPA, et al. (January 22, 2018), which involved misleading analysts about flooding distribution channel to create short-term revenue bump at potential expense of future sales.

Financial Fraud Cases

Melissa Hodgman, Associate Director in the SEC's Home Office, noted that public-company financial fraud cases are still a significant issue, evidenced by the number, types, and scale of cases brought within the last year. The Division of Enforcement's Financial Reporting and Audit (FRAud) Group leads the charge in this area, including developing in-house technologies to assist with investigations. These technologies, plus cross-staffing and utilizing SEC accountants, help to offset human-resources challenges faced in this area. Additionally, the FRAud group leverages the resources of other regulators, including criminal authorities. Ms. Hodgman noted that both the SEC and the criminal authorities they work with are focused on bringing more cases in this space, including more cases along the lines of SEC v. Keith Borge, 19-cv-02787 (S.D.N.Y.) (misleading representations about risk of missing financial target); SEC v. Salix Pharmaceuticals, Ltd., 1:18-cv-08886 (S.D.N.Y.) (misleading analysts about stock value); and In the Matter of Brian Sweet, CPA and In the Matter of Cynthia Holder, CPA, et al. (January 22, 2018) (misappropriation of confidential PCAOB information by KPMG personnel). Finally, Ms. Hodgman noted that the Division of Enforcement is not afraid to litigate public-company financial fraud cases if necessary.

Foreign Corrupt Practices Act

Charles E. Cain, Chief of the FCPA Unit, spoke briefly about the common theme of weak control environments and poor corporate culture in the SEC's FCPA-related enforcement actions. Such weaknesses, Mr. Cain stated, create an environment conducive to widespread misconduct. To highlight this point, Mr. Cain identified two cases from 2018 in which control environment and corporate culture weaknesses led to charges beyond bribery-based FCPA violations. In In the Matter of Panasonic Corporation (April 30, 2018), Panasonic was charged with accounting fraud on top of its FCPA violations. In In the Matter of Centrais Elétricas Brasileiras S.A. (December 26, 2018), Electrobras was charged with violations of the internal accounting controls provisions of the FCPA in addition to the anti-bribery provisions. It was the years-long material weaknesses in internal controls over financial reporting that allowed the bribery scheme to flourish. More recently, In the Matter of Fresenius Medical Care AG & Co. KGaA (March 29, 2019) represented a situation in which poor culture and internal controls allowed bribery to become a part of the company's business model for nearly ten years.

Market Abuse

Joseph Sansone, Chief of the Market Abuse Unit, stated that his unit is focused on assessing the accuracy of representations made in the areas of exchanges, alternative trading systems and dark pools. He emphasized two types of cases brought by the Market Abuse Unit within the last year: routing cases and information leakage cases. The Division of Enforcement brought two routing cases last year, including In the Matter of Citigroup Global Markets, Inc. (September 14, 2018), in which a broker-dealer—among other things—misrepresented to its customers that trades were taking place in an affiliated dark pool, when in reality nearly half of the trades were routed to unaffiliated dark pools or exchanges that did not offer the same premium features as the affiliated dark pool. Mr. Sansone stated that this is an important issue because customers want to know where their trades are being routed and executed, and they must not be deprived of that information. With respect to information leakage, Mr. Sansone pointed to In the Matter of ITG Inc. (November 7, 2018), in which a broker-dealer improperly disclosed its clients' confidential dark pool trading information despite representing that such information would not leak.
be kept confidential.

**Cyber Unit**

Robert A. Cohen, Chief of the Cyber Unit, expressed his belief that long-standing securities laws and SEC rules are being applied very effectively to new cyber-related areas such as initial coin offerings (“ICOs”). While the Cyber Unit’s first priority is protecting retail investors from fraud, Mr. Cohen discussed four types of non-fraud cases that were brought within the last year: (1) coin registration, (2) exchange registration, (3) broker-dealer registration and (4) crypto fund registration. With respect to coin registration, Mr. Cohen stated that offerings must be registered if the underlying tokens are securities. He pointed to In the Matter of Paragon Coin, Inc. and In the Matter of CarrierEQ, Inc., d/b/a Airfox—brought on the same day (November 16, 2018) with identical remedies for the purposes of sending a strong and clear message—wherein companies conducted ICOs without first registering the underlying tokens. These two cases represented the SEC’s first in which civil penalties were assessed in the ICO context solely for registration violations. In both cases, the companies agreed to two-part undertakings: (1) a claims process by which the companies gave investors the option of asserting their private rights of rescission and (2) registering securities under the Securities Exchange Act of 1934, which resulted in information flowing to investors to facilitate the decision of whether to seek rescission or stay in the investment, and which also caused the companies to incur reporting obligations going forward. With respect to exchange registration, Mr. Cohen discussed In the Matter of Zachary Coburn (November 8, 2018), which was the SEC’s first enforcement action against a digital token trading platform for operating as an unregistered national securities exchange. The key takeaway from that case, according to Mr. Cohen, was that if an exchange is trading securities, it needs to comply with securities laws. With respect to broker-dealer registration, Mr. Cohen pointed to In the Matter of TokenLot LLC as the first SEC enforcement action alleging failure to register as a broker-dealer in the context of digital token sales. Finally, with respect to crypto funds, Mr. Cohen noted that the SEC brought several cases in the last year alleging violations of Section 5 of the Securities Act of 1933 and Section 7 of the Investment Company Act of 1940 where crypto-asset-based funds were offered without being registered.

Finally, Mr. Cohen noted that due to a shortage of personnel in the Cyber Unit, his team often works together with other units, including the Market Abuse Unit.

**Coordination with Criminal Authorities**

Charles E. Cain, Chief of the FCPA Unit, emphasized his unit’s continued commitment to coordinating with both domestic and international law enforcement partners while also seeking to avoid overlapping relief. Mr. Cain pointed to In the Matter of Panasonic Corporation (April 30, 2018) as an example of cooperation without overlapping relief. In that case, Panasonic paid a $137 million criminal penalty to the Department of Justice and consequently was ordered by the SEC to pay $143 million in disgorgement and prejudgment interest but was not assessed a civil penalty.

Melissa Hodgman, Associate Director of the SEC’s Home Office, noted that there is generally less coordination with criminal authorities in the public fraud space. An exception, however, often occurs in gatekeeper cases because such cases involve protection of financial systems at their most basic level. By way of example, Ms. Hodgman pointed to In the Matter of Brian Sweet, CPA and In the Matter of Cynthia Holder, CPA, et al. (January 22, 2018), wherein KPMG personnel misappropriated confidential PCAOB information. The SEC’s enforcement actions in that matter are currently stayed pending resolution of the related criminal cases.

Kelly Gibson, Associate Regional Director of the Philadelphia Regional Office, discussed parallel investigation situations in which it makes sense for the SEC to proceed before criminal authorities. She noted that the SEC is better equipped to seek a temporary restraining order, seize assets and seek appointment of a receiver in cases of ongoing fraud. There may also be cases in which the SEC does not stay its proceedings pending resolution of criminal proceedings because the SEC is pursuing different targets than the criminal authorities or because the criminal authorities are not yet ready to bring charges but the SEC needs to act quickly to obtain a temporary restraining order.

**Cross-Border Matters**

A panel consisting of Kurt G. Gresenz (Senior Assistant Director, Enforcement Cooperation), Magdalena Camillo (Senior Special Counsel, Regulatory Policy), Thomas Swiers (Branch Chief, Enforcement Cooperation) and Natasha Kaden (Senior Special Counsel, Supervisory Cooperation) discussed cross-border enforcement cooperation and cross-border supervisory cooperation. They noted that approximately one-third of enforcement cases involve an international component, and cooperation is of great importance to the SEC in these matters. A prime example of international cooperation is through the International Organization of Securities Commissions, through which the SEC obtains referrals from its foreign partners and refers out cases and alerts its foreign partners of potential wrongdoing.
The panel also discussed the impact of the GDPR and Brexit on international cooperation. The SEC does not believe that the GDPR will limit or stymie international cooperation. The SEC has entered into an administrative arrangement with the European Commission and its staff to allow and continue international cooperation, while also safekeeping personal and private information. When the SEC is requesting financial or other identifying information protected under the GDPR, most EU countries have used a public-interest exception to continue cooperating with the SEC to provide information needed to conduct the investigations. This was the first administrative arrangement reached under the GDPR, and it may serve as a basis for future arrangements. To ensure continued cooperation, the SEC is also asking foreign registrants about their ability to comply with the books and records provisions of the Investment Advisers Act of 1940, and it is requesting a certification that such advisers will make their books and records available for inspection as required by law. In connection with Brexit, the SEC has not seen, and does not expect, any real impact concerning cross-border cooperation or enforcement. The SEC has maintained close contact with UK authorities about necessary updates and how to continue their cooperation.

The panel also discussed the importance of the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information ("MMoU"). The panel noted that this is one of the more important tools for international cooperation among member nations. The panel also discussed the Enhanced MMoU ("EMMoU"). The EMMoU would address difficulties currently faced by the SEC such as (1) the ability to get foreign audit workpapers, (2) compelling testimony from foreign witnesses, (3) providing assistance on asset freezes, and (4) obtaining information from internet service providers and telephone records (though not the content of underlying communications).

Lastly, the panel discussed double jeopardy in connection with foreign actions. The panel noted that simultaneous actions can affect the type of remedy that may be obtained if relief was already obtained in another jurisdiction, but was unaware of double jeopardy barring actions on the basis of other actions pending in foreign jurisdictions.

During a separate accounting-themed panel, personnel from the SEC’s Office of Chief Accountant referenced a joint statement issued by the PCAOB and the SEC on December 7, 2018 regarding the lack of access to audit workpapers in various jurisdictions (e.g., China). The SEC and the PCAOB recognize the importance of auditors as gatekeepers and the “public watchdog,” but they are cognizant of the limitations of that function when there is limited ability to access information outside the United States.

**Judicial Developments**

**Lorenzo v. SEC**

Michael Conley, Solicitor for the Office of General Counsel ("OGC"), explained that Lorenzo provided an opportunity for the OGC to revisit the Supreme Court’s decision in *Janus Capital Group v. First Derivative Traders*. The OGC believes that the Supreme Court was attempting to establish a bright-line test in *Janus*, but lower courts have found it difficult to apply, due in part to the fact that *Janus* addressed only Rule 10b-5(b) and not 10b-5(a) or (c) or Section 17(a). The Commission’s position after *Janus* was that the various anti-fraud subparts in Rule 10b-5 and Section 17(a) are not mutually exclusive. While the Commission recognized that merely drafting or disseminating a misstatement was not enough to trigger fraud under 10b-5(b), it believed that such conduct could provide a basis for liability under 10b-5(a) or 10b-5(c). The Commission took this position for many years after *Janus*, and *Lorenzo* was its first opportunity to test this theory. Although Lorenzo sent the misleading e-mails at the direction of his boss, he signed the e-mails and told prospective investors they could contact him directly. He also knew that the information in the e-mails was false when he sent them. The Commission’s position was that this conduct violated Rule 10b-5(a), (b) and (c). While the Supreme Court in *Lorenzo* found that the language of 10b-5(a) and (c) is expansive and broad enough to capture a wide range of conduct, the Commission appreciates that it still needs to establish deceptive conduct and scienter for primary liability.

Former Commissioner Roberta Karmel asked the panel whether *Lorenzo* essentially reverses *Janus*. The OGC does not think Lorenzo reverses *Janus*, but rather it teaches us the appropriate reading of *Janus*. It reinforces the view that Janus was tied to the notion of reliance in private actions, in which litigants need to allege that they relied on the allegedly false statements. It also demonstrates that 10b-5(a) and (c) are much more viable and cover more ground than some courts previously considered.

Joseph Brenner, Chief Counsel, opined that the decision was a significant one and resolved most of the issues revolving around subsections (a) and (c) of Rule 10b-5 that had been the subject of many discussions in the Wells process over the years. Further, Mr. Brenner asserted that the *Lorenzo* decision was not a narrow one and that the SEC will be skeptical of arguments from defense counsel which suggest that under Lorenzo, other types of deceptive conduct in connection with misstatements do not fall under subsections (a) or (c) of Rule 10b-5. Bridget Fitzpatrick, Chief Litigation Counsel, also expressed the view that the Supreme Court case along with pre-Lorenzo case law holding that a variety of deceptive conduct fall within subsections (a) and (c) bode well for the SEC’s
ability to police a wide variety of frauds using Rule 10b-5. Ms. Fitzpatrick stated that under her reading of Lorenzo, if conduct is clearly fraudulent, it falls within subsections (a) and (c).

**Insider Trading**

The SEC’s Judicial and Legislative Developments panel discussed developments in insider trading law, focusing on last year’s decision in United States v. Martoma and the prior case law that provides context for the Martoma ruling. Martoma addressed the definition of “personal benefit” for purposes of insider trading liability. Dirks v. SEC set forth the standard that an initial tipper did not breach a duty unless he or she obtained a personal benefit as a result of the tip. This personal benefit could be via either a quid pro quo transaction or a gift. The point of the request was to help distinguish between permissible and impermissible disclosures of nonpublic information. Then, in United States v. Newman in 2014, the Second Circuit eliminated the gift theory of personal benefit and added the requirement that there had to be a meaningfully close relationship between the tipper and the tippee. The Supreme Court restored the gift theory in 2016 in Salman v. United States, but it did not address the Second Circuit’s requirement of a meaningfully close relationship.

In Martoma, the Second Circuit originally found that there was liability based on a quid pro quo deal as well as the gift theory, and that Salman had abrogated the requirement of a meaningfully close relationship. A passionate dissent from Judge Pooler arguing that Newman’s close-relationship standard survived Salman, and that the gift theory should be limited to gifts to relatives and friends, led to a review of the decision and an amended opinion from the Second Circuit that affirmed Martoma’s conviction under a quid pro quo theory but it did not decide whether the Newman close-relationship standard is consistent with Salman. It also affirmed on an “intention to benefit” theory in which the tipper intends to benefit the tippee. Judge Pooler again dissented, arguing that intention to benefit as an independent theory of liability is inconsistent with Newman and unnecessary given the quid pro quo theory. Martoma has filed a petition for a writ of certiorari to the Supreme Court on these issues. Opposition to that petition is due April 26, 2019.

There were also developments in the law regarding civil penalties for insider trading. In SEC v. Rajaratnam, the Commission obtained a civil penalty against Rajaratnam in excess of $92 million after he was convicted of illegally trading on confidential information. These illegal trades were done in Rajaratnam’s personal account as well as in accounts belonging to clients of his fund. Rajaratnam argued that the court improperly considered his wealth and that the civil penalty imposed after his conviction should have been limited to his personal gains on the illegal trades and not included gains made for others. The Commission’s position is that Section 21A of the Securities Exchange Act of 1934 does not limit civil penalties to personal profits but can include all trading profits made as a result of unlawful trades or tips. These profits can then be trebled as part of the penalty. The United States Court of Appeals for the Second Circuit held that there was no issue with consideration of Rajaratnam’s wealth as long as the court was not hostile because of his wealth. The Second Circuit further held that civil penalties under Section 21A may be imposed in addition to criminal penalties, so no offset was required for the criminal monetary penalties also imposed against Rajaratnam.

**Kokesh v. SEC**

The panel also discussed the impact of Kokesh v. SEC. In that case, the Supreme Court held that the five-year statute of limitations set forth in 28 U.S.C. § 2462 applies to claims seeking disgorgement because disgorgement is a penalty in that it is imposed as a consequence of violating the law, it is meant to deter others from violating the law, and it is not compensatory because there is no requirement that disgorged funds be returned to investors. Claims for disgorgement are now limited to five years, and the Commission estimates that it has already lost $800 million as a result of this statute of limitations.

An additional consequence of Kokesh that the SEC has seen is a series of arguments from defendants that the penalty analysis applies beyond Section 2462 and the Commission lacks authority to seek disgorgement at all because disgorgement is a penalty (and therefore not within the equitable powers of the courts). However, the panel noted that Kokesh expressly stated in a footnote that it was not deciding whether the Commission could properly seek disgorgement, and every court that has ruled on this issue since then has found that courts may order disgorgement. Some defendants have gone even further to argue that injunctive relief is also subject to a five-year statute of limitations. The OGC noted the fundamental difference between these two types of remedies, as injunctions are meant to protect the public going forward from future violations of the law by defendants the court finds are likely to violate the law again and so is not a penalty for past conduct. In SEC v. Genteel, the Commission was seeking injunctive relief only. The district court held that the injunctive was a penalty under Section 2462 because the injunctions would not compensate the victims and would not restore the status quo ante. The decision was appealed to the United States Court of Appeals for the Third Circuit, which held that the injunctions were not penalties because preventing harm from happening is not a penalty.

The issue of industry bars was raised in a similar context in Saad v. SEC. In that case, FINRA imposed a bar, which
the defendant challenged as impermissibly punitive. The case was remanded to the Commission to determine the impact of *Kokesh* on industry bars. The OGC expressed its concerns about the effects these arguments will have on its enforcement program, but there may be hope in the form of a bipartisan bill introduced in Congress last month called the Securities Fraud Enforcement and Investor Compensation Act of 2019. This legislation provides that disgorgement is available if there was any unjust enrichment by the defendants, and it would authorize a separate remedy of restitution in certain cases and allow the Commission to order certain entities to pay restitution to victims. The bill would also establish limitations periods for those remedies. Disgorgement would remain at five years, but equitable remedies would have a ten-year limitations period. The OGC is cautiously optimistic that this bipartisan bill will pass.

**Rule 30e-3**

The Legislative and Judicial Developments panel also discussed new challenges to SEC rules in the past year. The United States Court of Appeals for the D.C. Circuit heard oral arguments in a petition for review of the Commission’s Rule 30e-3 brought by Twin Rivers Paper Company and a number of business and consumer organizations (collectively, “Twin Rivers”). The rule permits qualified mutual funds to distribute most shareholder reports online, but investors may opt to continue to receive paper copies of the reports. Twin Rivers challenged the rule on a number of grounds, including that it is arbitrary and capricious and inappropriately prioritizes cost savings to funds over benefits to investors, and that the Commission failed to adequately respond to recommendations from the Investor Advisory Committee. Twin Rivers does not believe there was a remedy here because investors already had the ability to elect to receive electronic delivery of reports. The OGC explained that the rule was not adopted to remedy any perceived misalignment, but rather it was intended to modernize fund disclosure and minimize costs to investors. In response to the petition, the Commission raised issues of standing with respect to the petitioners and the availability of a cause of action. Twin Rivers argued that it had prudential standing and that the cause of action derived from the Commission’s attempts to regulate Twin Rivers’ competitor—the Internet—an argument the OGC believes has no merit because the interests of paper companies and the Internet are not aligned. These issues were recently argued, and a ruling has yet to be handed down.

**Administrative Law Judges**

Finally, the Legislative and Judicial Developments panel addressed the topic of administrative law judges. Following successful challenges by defendants to appointments of administrative law judges by the Commission, which were found by the Supreme Court to require appointment by the executive branch of the federal government, the Commission ratified all of its administrative law judge appointments. The Commission also remanded all pending cases to the Office of Administrative Law Judges consistent with the directive from the Supreme Court. The Commission instructed that these cases should be started from scratch and that no consideration should be given to prior decisions reached in the cases.

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