2016 YEAR-END SECURITIES ENFORCEMENT UPDATE

To Our Clients and Friends:

I. Overview

   A. Looking Back, Looking Forward

Any attempt to assess the past six months is undeniably going to be overshadowed by what lies ahead. The change in administration is likely to be as tumultuous and unpredictable for the SEC as for any other federal agency, and the differences between the enforcement priorities under Chair Mary Jo White and Enforcement Division Director Andrew Ceresney and those of their successors may be more stark than other SEC transitions in recent years.

The final six months of the current administration (Ceresney departed at year-end, and Chair White will be stepping down upon the inauguration of the new President) were in some ways a perfect encapsulation of the past few years. The SEC closed out the fiscal year by touting yet another record number of new enforcement actions and the $4 billion in disgorgement and penalties it had imposed on defendants.[1] The Division of Enforcement continued to focus a significant amount of attention on investment advisers and investment funds, with such cases constituting the largest component of new actions in the latter half of 2016. At the same time, although the SEC continued to emphasize its prioritization of public company financial reporting frauds, recent months saw a relatively small number of new filings in this area, and few marquee cases, though the Enforcement Division did drive home its scrutiny of gatekeepers by bringing a significant number of cases against auditors.

Other touchstones of the White/Ceresney era (and the aftermath of Dodd-Frank) were also present. The Enforcement Division continued to grow its caseload through an increasing reliance on whistleblowers. The SEC announced a number of multi-million dollar pay-outs to individuals who brought matters to the staff's attention, while expanding the protection for whistleblowers through an expansive reading of common employment agreements deemed to "impede" potential whistleblowers from coming forward. Another innovation of recent years, the requirement that settling parties admit to misconduct in select cases, also continued to crop up, while remaining a relative rarity.

The Division also furthered its "broken windows" approach of bringing large enforcement sweeps targeting non-fraud violations, settling with dozens of municipal issuers who had self-reported disclosure deficiencies in connection with municipal securities offerings.

And as has been the case throughout recent years, the SEC's post-Dodd-Frank use of its administrative forum for litigated actions remained controversial; while the SEC has both pulled back somewhat on litigated administrative proceedings (APs) and finalized rules aimed at providing greater procedural
safeguards to parties, the legality of APs is still a hot-button issue. Federal courts of appeals for the first time weighed in on the constitutionality of the method by which the SEC appoints administrative law judges – with dramatically different outcomes.

The looming question, of course, is how many of the policies and approaches implemented by the past administration will remain in place under the new regime. Upon White's departure in late January, the SEC will be down to just two Commissioners, Republican appointee Michael Piwowar and Democratic appointee Kara Stein (two vacancies from early 2016 were never filled by Congress). Piwowar will likely serve as interim Chair. As of this writing, the President-elect had named Sullivan & Cromwell mergers and acquisitions partner Jay Clayton as his pick for new Chairman.[2] However, it will take some time before the selection is confirmed by the Senate and the SEC is back to its full complement of five Commissioners.

The President-elect himself said little about his plans for the SEC during the campaign or since the election, though one might suspect there is little love lost between Mr. Trump and the agency which once sued his hotel and casino company (but not him personally) for securities fraud. Trump's public comments have been limited largely to criticism of Dodd-Frank, though such statements were directed primarily at the law's bank regulatory provisions rather than the aspects of Dodd-Frank impacting the SEC's enforcement program. In identifying his pick as new SEC Chair, the President-elect stated, "We need to undo many regulations which have stifled investment in American businesses, and restore oversight to the financial industry in a way that does not harm American workers" – again emphasizing a likely rollback in Dodd-Frank with little insight into the direction of the Enforcement Division.[3]

In contrast, Commissioner Piwowar is on record as opposing some of the more aggressive aspects of the SEC under Chair White. While the Commission's divisions during the White era were most apparent in regulatory matters, certain enforcement issues drew objections as well, giving some insight into the likely direction of the enforcement program during the interim period and potentially longer-term.

For example, in a 2014 speech Commissioner Piwowar voiced concerns about the impact that corporate penalties have on shareholders, suggesting that the SEC establish a more rigorous analytical framework for the imposition of such penalties.[4] During the same speech, he questioned the "broken windows" approach of penalizing lower-level non-fraud regulatory infractions championed by Chair White, stating that a "broken windows' approach to enforcement may not achieve the desired result. If every rule is a priority, then no rule is a priority." In addition, Piwowar has questioned the more aggressive use of APs in litigated cases, requesting that the SEC implement guidelines for determining whether to pursue litigation in an AP or in federal court.[5] (The Division of Enforcement subsequently issued some general guidance to the public, albeit such guidance still leaves such decisions solely at the discretion of the SEC.[6])

Additional cues as to the likely direction of the enforcement program can be seen in the President-elect's selection of former SEC Commissioner Paul Atkins as a key member of his transition team on financial regulatory matters. Atkins has been a frequent critic of some of the SEC's more aggressive stances, including the assessment of large corporate penalties, both during his tenure as a Commissioner and in the years since.[7] Atkins has long urged the Enforcement Division to focus more resources on "retail"
fraud, such as Ponzi schemes and penny stock pump-and-dump schemes, rather than more novel regulatory initiatives.[8]

Finally, with a Republican Congress in Washington, a dramatic roll-back of Dodd-Frank is all but assured. While most of the criticism of the law is aimed at its regulatory reach, Dodd-Frank also includes several provisions which play an important role in the SEC's enforcement program, and thus the scope of any revision or repeal of the law could have a significant impact on enforcement priorities and policies in the years ahead. For example, under Dodd-Frank, private equity and hedge funds managers became subject to SEC examinations, a number of which resulted in enforcement referrals. The revision of provisions relating to the regulation of private funds could take the wind out of recent enforcement efforts to sanction inadequate disclosures of fees and expenses by these funds. Similarly, the increasing use of litigated administrative proceedings rather than federal court trials in the wake of Dodd-Frank may be curtailed, with more contested actions being brought in court. Further, the expanding importance of paid whistleblowers on the shape of the SEC's enforcement program (discussed below) is a creature of Dodd-Frank, and thus changes in that aspect of the law could have an impact on the intake and handling of complaints.[9]

Of course, it is important not to overstate the impact of a new administration on the SEC's enforcement program. The vast majority of enforcement actions are apolitical and relatively noncontroversial. While the SEC Chair and Enforcement Division Director may set priorities, investigations are initiated and conducted by the staff, and clear violations of the federal securities laws will be pursued. Ongoing investigations remain full steam ahead. Nonetheless, a new SEC may be open to a more wholesale evaluation of the manner in which the Division investigates and litigates cases, the types of investigations it chooses to pursue, and the remedies it seeks, undoubtedly with an eye towards curbing some of the Division's more aggressive impulses.[10]

As a final introductory note, one court decision from recent months serves as a pointed example of the Enforcement Division's potential for overreach. In SEC v. Schooler, the perpetrator of a real estate investment scheme had been ordered to pay nearly $150 million in disgorgement and penalties in the wake of a 2012 enforcement action. Following the defendant's death, the SEC subpoenaed his wife (from whom he had been legally separated but not divorced) seeking extensive financial information. The wife challenged the scope of the subpoena, which sought some fifty categories of documents; in response to a request to narrow the subpoena, the SEC attorney responded, "you are mistaken about the subpoena being overly broad. Please produce all documents requested in our subpoena." After the wife filed a motion to quash, the SEC agreed to a court-ordered meet and confer process and agreed to narrow the requests. In its November 2016 order, the court quashed the subpoena in part, and ordered the SEC to pay monetary sanctions, explaining: "The court cannot countenance the SEC's conduct here--drafting an overly broad subpoena; making absolutely no effort to narrow the requested documents when confronted by objections and a charge of over breadth by opposing counsel; and then agreeing to narrow the requests when faced with a hearing on a motion to quash the subpoena and order to meet and confer."[11]
B. Whistleblowers

The past six months have seen an ever-increasing volume of cash payouts to whistleblowers, as well as expanded efforts by the SEC to crack down on what it views as restrictive employment agreements which may improperly impede potential whistleblowers from reporting information to the SEC staff.

According to the agency's Fiscal 2016 annual whistleblower report to Congress, the SEC received over 4,200 whistleblowing tips in fiscal year 2016, up more than 40% since the whistleblower program's first full year in 2012.[12] The SEC awarded more than $57 million to 13 claimants, more than the payments from all prior years of the program combined, including six of the ten highest whistleblower awards to date. Since the program's inception in 2011 and through the end of fiscal year 2016, the SEC has made 34 total awards exceeding $111 million. As in past years, the single largest category of tips fell under the category "Corporate Disclosures and Financials," although technically, a larger number of tips fell into the category "Other." The largest number of tips came from California, New York, Florida, Ohio, and Texas, each with over 100. The SEC also received whistleblower tips from individuals in 67 foreign countries during fiscal year 2016.

Over the past six months, the SEC announced a number of multi-million-dollar awards, including four of the largest individual payments to date:

- On August 30, 2016, the SEC announced its second-biggest award, $22 million, to a whistleblower whose "detailed tip and extensive assistance" helped to stop a "well-hidden fraud" that existed at the whistleblower's company.[13]

- On September 20, 2016, the SEC announced a $4 million award for a whistleblower whose "original information alerted the agency to a fraud."[14]

- On November 14, 2016, the third-largest award--$20 million--was announced for 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."[15]

- On December 5, 2016, the SEC announced a $3.5 million award for a whistleblower whose information led to an enforcement action.[16]

- On December 9, 2016, the SEC announced an award of nearly $1 million for a whistleblower whose tip led to multiple enforcement actions.[17]

Because of legal confidentiality requirements, the SEC's award orders give very little information about the nature of the whistleblowers or the cases resulting from their tips, and thus it is unclear how many, if any, of the tips were received from insiders of public companies or securities firms.

Beyond such awards themselves, the SEC has broadened its efforts to penalize companies whose employment agreements incorporate provisions deemed to dissuade potential whistleblowers from coming forward. In the second half of 2016, the SEC brought multiple settled enforcement actions.
against companies under Exchange Act Rule 21F-17, which prohibits impeding an individual's ability to communicate with the SEC about possible securities law violations, "including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications."

The language and circumstances varied across the different actions, but according to the SEC, the employment agreements all restricted former employees in their ability to report potential violations to the SEC. Two of the companies' severance agreements had specifically required outgoing employees to waive their rights to any monetary recovery they might receive from filing a charge or complaint with the SEC or other federal agencies.[18] Another company had a broad non-disparagement clause in its agreements prohibiting former employees from engaging "in any communication that disparages, denigrates, maligns or impugns" the company, including in communications with the SEC or other regulators, which the SEC found to impede potential whistleblowers from coming forward.[19] And another company sued by the SEC used language that prohibited outgoing employees from "voluntarily contact[ing] or participat[ing] with any governmental agency in connection with any complaint or investigation pertaining to the Company."[20]

The companies paid penalties ranging from $130,000 to $1.4 million and agreed to make reasonable efforts to contact former employees and confirm that the agreements they had signed did not prohibit them from providing information to the SEC or receiving whistleblower awards. The companies also agreed to make the necessary changes to ensure that their agreements were in compliance with Rule 21F-17. Notably, all of these actions were settled (without admissions of wrongdoing), and the SEC's expansive reading of Rule 21F-17's prohibition on employment agreements which impede whistleblowers has yet to be tested in court.

While most of these cases have only found that the contractual language could potentially have deterred whistleblowers, in one case the SEC contended that a confidentiality clause had actually caused an employee who had been voluntarily communicating with the SEC staff to stop doing so out of fear that, under a recently executed separation agreement, he could be compelled to pay liquidated damages to the company.[21] The company paid a total of $6 million to settle the case, but the SEC order does not provide a breakdown of which portion of the penalty relates to the Rule 21F-17 violation as opposed to the underlying violation of the Foreign Corrupt Practices Act with which the company was also charged.

Finally, the SEC has continued to periodically penalize companies for retaliating against whistleblowers, another power granted to the agency under Dodd-Frank. In September, the SEC announced a settled administrative proceeding against a casino-gaming company for allegedly retaliating against an employee who raised concerns about the company's cost accounting model and reported to senior management and the SEC that the company's financial statements might be inaccurate.[22] Within weeks of raising concerns, the employee was allegedly removed from significant work assignments and then terminated a few months later. The company agreed to pay a $500,000 penalty, without admitting or denying the SEC's findings.

And in December, in a case described above challenging an improper confidentiality clause, the SEC also alleged that an oil and gas company had allegedly retaliated against an employee who raised concerns to senior management about the company's process with respect to calculating oil and gas
reserves reported in the company's periodic reports.[23] According to the press release, this was the first time the SEC charged a company with retaliating against an employee who reported potential violations internally, rather than to the SEC.

C. Administrative Proceedings

A consistent theme of the SEC's enforcement program throughout the past few years has been the agency's growing use of its in-house administrative forum rather than federal court for litigated proceedings. The expanded ability of the SEC to obtain remedies in administrative proceedings under Dodd-Frank led the SEC to increasingly turn to APs rather than federal trials, raising questions about the fairness and legality of such proceedings. Notably, analyses of recent trends show that the Division of Enforcement, presumably in response to some of the controversy, has reversed course. According to one such analysis, the SEC brought fewer total contested administrative proceedings in 2016 than 2015, with the vast majority of litigated fraud cases filed in federal court.[24] At the same time, while 2016 saw fewer litigated administrative proceedings, the dollar amounts of penalties assessed by administrative law judges (ALJs) in the agency's tribunal have increased, with more penalties over $2 million in 2016 than in the previous three years.[25]

Of course, the SEC has long had the ability to pursue litigated cases in its administrative forum, particularly against regulated persons and entities such as brokers and investment advisers, and that is unlikely to change. In response to some of the concerns raised about the fairness of these proceedings to litigants, the SEC announced in July that it had adopted amendments, first proposed in 2015,[26] to its Rules of Practice governing APs.[27] Key provisions of the amendments allow parties to conduct depositions (three per side for single-respondent cases or five per side in multiple-respondent cases) and extend the potential length of the prehearing period for complex cases from four months to ten months. The amendments also streamline the process for appeals, clarify the types of dispositive motions that may be filed, and tighten up admissibility of evidence rules to exclude evidence that is "unreliable."

Notwithstanding these changes, a number of parties to SEC administrative proceedings have filed suits in federal court challenging the constitutionality of such proceedings. Most of these challenges focus on the manner in which SEC ALJs are appointed, contending that because the ALJs are not appointed by the President or a Department Head (but rather hired through a process set up by the Office of Personnel Management), such appointments violate the Appointments Clause of the U.S. Constitution.

In most cases to date, respondents in SEC APs have filed federal injunctive actions seeking to enjoin the proceedings, rather than undergoing an administrative trial on the merits and pursuing the constitutional question on appeal. In December, a panel of the Fourth Circuit concluded that a district court lacked jurisdiction to hear a constitutional challenge before the underlying AP had been litigated, joining several other federal courts of appeals which had reached the same conclusion.[28]

However, over the past six months, the first two challenges to the constitutionality of the ALJ appointment process have reached the federal courts on the merits after first going through the SEC's tribunal--with the courts reaching diametrically opposing conclusions. In August, the D.C. Circuit
upheld the constitutionality of the SEC's use of administrative proceedings, ruling that it did not violate the Constitution's Appointments Clause because ALJs do not have the authority to issue final decisions, and are thus not "inferior officers" whose appointments are governed by the Appointments Clause.\[29\] The D.C. Circuit explained that the initial decision by an ALJ in an SEC administrative proceeding becomes final "when, and only when, the Commission issues the finality order, and not before then." The plaintiffs have petitioned for rehearing en banc, and that petition remained pending when this update went to press.

But in December, the Tenth Circuit explicitly disagreed with the D.C. Circuit and found the SEC's use of administrative proceedings unconstitutional.\[30\] The Tenth Circuit explained, "This past August, the D.C. Circuit addressed the same question we face here. . . . [The D.C. Circuit's] holding was based on the court's conclusion that SEC ALJs cannot render final decisions. . . . We disagree with the SEC . . . and its argument that final decision-making power is dispositive to the question at hand." The Tenth Circuit concluded that SEC ALJs were not mere employees, but inferior officers requiring appointment by the President or an agency head.

These cases set up a circuit split, suggesting the issue may be headed for the Supreme Court.

II. Public Company Reporting and Accounting Cases

Since 2013, the Division of Enforcement has repeatedly extolled its renewed focus on financial reporting cases by public companies. Task forces were created, and resources previously dedicated to matters arising out of the late 2000s financial crisis were redirected. While the number of financial reporting cases has definitely seen an increase, returning these matters to their place of prominence in the SEC enforcement docket, it is fair to say that few cases over the past six months were of serious size or significance. While there is a steady stream of earnings management and revenue recognition matters coming from the SEC, the absence of noteworthy cases suggests either that companies are on much better behavior than in the days of Enron and Worldcom, or the SEC has yet to ferret out significant frauds.

That said, the SEC continues to identify smaller-scale financial fraud, as well as internal controls deficiencies. The number of enforcement actions targeting auditors also continues to see steady growth.

A. Financial Fraud

In September, the SEC charged two former accounting executives with overstating the financial performance of a large publicly-traded real estate investment trust (REIT).\[31\] The officers allegedly inflated a key metric--adjusted funds from operations (AFFO)--used by analysts and investors to assess the company. AFFO is a non-GAAP financial metric and the primary measure by which the REIT provided earnings guidance. According to the SEC, the REIT's then-CFO manipulated the REIT's AFFO calculation in order to meet earnings estimates, and the then-chief accounting officer was present for the falsification on at least one occasion. The matter was filed as a litigated action in federal district court. In a parallel action, the U.S. Attorney's Office of the Southern District of New York filed criminal charges against both executives.
In another September action, the SEC filed one of its larger financial reporting cases of the year, alleging that an oil services company used deceptive income tax accounting to inflate its earnings in order to meet analyst expectations.[32] The company allegedly inflated its earnings by over $900 million between 2007 and 2012. According to the SEC, executives made numerous post-closing adjustments to meet the company's previously disclosed effective tax rate (ETR)--that is, the average tax rate on pre-tax profits. In 2011 and 2012, the company restated its financial statements on at least three separate occasions. Without admitting wrongdoing, the company agreed to pay a $140 million penalty, and two of its former accounting executives agreed to enter settlements which included suspensions from practicing before the SEC as accountants. In a separate action announced a month later, the company's audit firm and two partners also entered into settlements with the SEC.[33]

In October, the SEC charged an energy services provider and four executives for their roles in a revenue recognition scheme.[34] The SEC alleged that the company improperly recognized $20 million in revenue from at least 2010 to 2012. According to the SEC, company executives recognized revenue before required documentation had been received and directed internal accountants to book revenue on non-existent jobs, and entered improper transactions into the company's financial reporting system after year-end in order to mitigate a revenue shortfall. To settle the charges, the company agreed to pay a $1 million penalty, and four now-former executives also agreed to individual settlements which included monetary penalties and bars from serving as corporate officers or directors.

Also in October, the SEC charged Credit Suisse AG and the chief operating officer of the firm's private banking division, with misstating net new assets, a key performance metric of the firm's wealth management business.[35] The SEC contended that this metric is valued by investors in financial institutions as a measure of success in attracting new business. The bank agreed to pay a penalty of $90 million and to admit wrongdoing, and the executive agreed to pay a penalty of $80,000 without admitting or denying the allegations.

Finally, the SEC pursued cases against public companies whose entire operations appeared to be illusory. For example, in August, the SEC charged a purported West Palm Beach cyber arms manufacturing and security technology solutions company, along with its former CEO and CFO, with defrauding investors by issuing false and misleading press releases regarding its operations, revenue projections, and acquisition of other companies.[36] The press releases and corporate filings projected that the company's annual revenue would be from $60 million to $75 million and that it had made a bid to acquire one of the nation's largest arms manufacturers for over $1 billion. However, according to the SEC, the company had no customers and had never manufactured any cyber arms. The matter is being litigated.

B. Internal Controls

In addition to more serious fraud cases, the SEC continued to pursue a number of stand-alone cases alleging deficient internal controls and other books and records violations. In September, the SEC instituted settled cease-and-desist proceedings against a Portuguese telecom company with registered American Depositary Shares on the New York Stock Exchange.[37] The company agreed, without admitting or denying liability, to pay a $1.25 million penalty to settle charges for its alleged failure to
disclose the extent of its credit risks involved in its investment in certain debt instruments as well as its insufficient internal accounting controls.

In October, the SEC charged a Houston-based technology solutions company and two executives with overstating the company's financial performance by artificially reducing the value of a 2013 liability the company had recorded for employee paid time off.[38] The adjustments caused the company to overstate pre-tax operating profits by $800,000, enabling an internal target to be met. The executives were also alleged to have corrected a 2012 accounting error that increased the operating results by $730,000, despite signing management representation letters confirming that no out-of-period adjustments over $250,000 were recorded in that period. Without admitting or denying the allegations, the company agreed to pay a $2.5 million penalty, and the individual officers agreed to pay penalties and to be suspended from practicing before the SEC as accountants.

In November, the SEC settled cease-and-desist proceedings against a North Carolina-based energy management company alleging the company failed to accurately identify and report is segments in accordance with GAAP.[39] Among other things, the SEC alleged that the company had concluded that segment reporting was unnecessary because the CEO did not regularly review operating results below the consolidated level, when in fact the CEO, CFO and board of directors engaged in quarterly reviews of each business unit. The company agreed to pay a civil money penalty of $470,000 to settle the charges.

In December, the SEC instituted settled administrative proceedings against an airline company, which agreed to pay a $2.4 million dollar penalty without admitting the allegations.[40] According to the SEC, the company violated the books and records provisions of the securities laws by instituting a flight route that was projected from the start to lose money, allegedly for the benefit of the head of an agency who could have jeopardized the airline's business interests.

And finally, shortly before year-end, the Commission announced that a Kentucky-based cable company agreed to pay $6.5 million to settle accounting-related claims (in addition to more than $75 million paid to resolve SEC and DOJ claims alleging FCPA violations).[41] The SEC alleged that, for over four years, the company materially overstated its net income (by as much as 30%) due to improper accounting at one of its subsidiaries, including the reporting of false inventory value to cover up for missing copper inventory. According to the SEC, the improprieties went undetected because the company's accounting systems were highly manual and decentralized and lacked the necessary controls. The SEC further alleged that executives at the subsidiary concealed the issues from the parent company's executive management even after an internal accountant reported the wrongdoing, doing so only after she threatened to report the matter directly. The SEC noted that the company self-reported the issues to the SEC promptly after retaining outside counsel to conduct an internal investigation and undertook extensive remedial actions.

C. CEO and CFO Clawbacks

In a significant legal development for the Division of Enforcement, a federal court of appeals recently affirmed the authority of the SEC to obtain clawbacks of incentive-based compensation from CEOs and
CFOs even where such executives are not themselves charged with misconduct. Under Sarbanes-Oxley, the SEC can compel these executives to return incentive-based compensation in the event of a restatement of the company financials due to corporate misconduct. While in the years following the 2002 passage of Sarbanes-Oxley the SEC typically sought clawbacks only from executives who were also charged with participating in the wrongdoing, the agency has increasingly brought stand-alone clawback actions against CFOs and CEOs even where it did not allege that the officer had him- or herself broken the law.

Several district courts have rejected legal challenges to the SEC's use of stand-alone clawback actions. In August, a panel of the Ninth Circuit agreed, becoming the first appellate court to hold that the SEC could seek clawbacks "regardless of whether a restatement was caused by the personal misconduct of an issuer's CEO and CFO or by other issuer misconduct."[42] The majority reasoned that the SEC could seek repayment because the statutory text refers to "the material noncompliance of the issuer," not the misconduct of the CEO or CFO. The panel did not define the meaning of "misconduct," although Judge Bea wrote a concurring opinion that would have defined "misconduct" as "an intentional violation of a law or standard (such as GAAP) on the part of the issuer."

Notably, recent months saw several examples of cases in which the SEC declined to file a clawback action, but included language in its press releases highlighting that the agency only did so because the executives had already voluntarily paid back cash bonuses and stock awards to the company.[43]

**D. Auditor Cases**

While there were a limited number of financial fraud cases in recent months, the SEC’s scrutiny of independent auditors appears to be ratcheting up. In September, then-Enforcement Division Director Ceresney gave a keynote address at the American Law Institute Conference on Accountants' Liability in Washington, D.C.[44] Among other things, Ceresney admonished auditors to ensure the firm and its personnel have the capacity and competence to handle the issuers they audit, exercise professional skepticism in evaluating management representations (particularly where red flags are present), evaluate management estimates, consult internally when troublesome issues arise, hold the line against the client when concerns are not addressed, and pay special attention to independence requirements.

The general trends recognized by Ceresney and the SEC are evident in the types of proceedings brought by the SEC in the latter half of 2016. In July, the SEC settled charges against a New York-based accounting firm and one of its partners for failing to properly audit a public company that was later charged by the SEC for improper revenue recognition practices.[45] The SEC alleged that the auditor was on notice of potential irregularities, and failed to perform sufficient procedures to detect illegal acts. Without admitting the allegations, the firm agreed to pay a penalty of $100,000 and to not accept new public company clients until an independent consultant certifies that the firm took remedial action; the partner paid a penalty of $25,000 and was barred from appearing before the SEC.

In a second case, the SEC brought a settled action against the engagement partner who had audited a company found by the SEC to have engaged in fraudulent financial reporting.[46] The SEC alleged that the auditor failed to exercise appropriate skepticism or obtain sufficient audit evidence during the
audits. Without admitting wrongdoing, the audit partner agreed to be barred from appearing before the SEC for three years.

In September, as described earlier, the SEC also settled charges against the audit firm and two partners who audited an oil and gas company found to have used deceptive income tax accounting to inflate its earnings. The SEC alleged that the audit team relied on the company's explanations of its post-closing accounting adjustments and did not take measures to address known recurring problems in its tax accounting audits. Without admitting wrongdoing, the firm agreed to pay more than $11.8 million to settle the charges.

The SEC also pursued actions against auditors outside the public company context. In an October action involving the issuance of municipal securities, the SEC alleged that an accounting firm and its partner allowed the town of Ramapo, New York to record a receivable for a property sale that the partner knew had not occurred. The SEC also alleged that the partner ignored red flags in representations made by Ramapo officials about other receivables, interfund transfers, and liabilities. According to the SEC, even after becoming aware that Ramapo's financial statements were being investigated by law enforcement and the partner received complaints about possible fraud, the firm did not mitigate the risk of material misstatements. Without admitting the allegations, the firm agreed to forfeit $380,000 in audit fees and interest and paid an additional $100,000 in penalties. The senior partner paid a $75,000 penalty, and both agreed to other remedial measures.

In addition, the SEC filed a number of enforcement actions alleging violations of the Commission's auditor independence rules. In one interesting matter, the SEC in September instituted settled proceedings against two accounting firm partners for allegedly causing violations of the independence rules by developing personal relationships with personnel at their respective audit clients. One case involved a partner who had become friends with an executive at the audit client, and the other involved a partner who allegedly maintained a romantic relationship with a financial executive of an audit client.

The SEC also brought charges for breaching independence obligations against a firm whose two founding partners failed to comply with audit partner rotation requirements. Both partners failed to rotate off of audit engagements in which they had served as the lead audit partner for five consecutive fiscal years.

Finally, in a split decision by the SEC which may give some insights into the application of remedies in future cases involving accountants, Commissioner Piwowar issued a dissent on the issue of sanctions in a proceeding against two audit partners under Rule 102(e). Chair White and Commissioner Stein voted to bar both respondents from appearing or practicing before the SEC, with one respondent allowed to apply for reinstatement in three years and the other in two years. Commissioner Piwowar dissented in relevant part because he considered the sanction to be "a punitive sanction that goes far beyond what the Division [of Enforcement] requested." He explained that a permanent bar with the right to reapply through a lengthy and costly process was harsher than either a temporary suspension (which automatically ends) or a permanent bar (which can be ended at any time by the commissioners). The case is under review by the Eighth Circuit, where the petitioners have raised challenges to the severity of the sanction and the constitutionality of the ALJ under the Appointments Clause (discussed
above). Given the change in SEC administration, it is an open question whether the Commission may move towards time-limited suspensions under Rule 102(e) rather than bars with a right to petition for reinstatement.

III. Investment Advisers and Funds

A. Conflicts of Interest

While the issue of conflicts of interest by advisers has been a long-time priority for the Enforcement Division, cases alleging undisclosed conflicts seemed to dominate the investment adviser docket over the past six month.

In July, the SEC announced settlements with two investment advisors in a pair of unrelated cases involving undisclosed loan arrangements with broker-dealers.[52] In the first, the SEC alleged that an Iowa-based adviser failed to disclose that it had entered into an agreement with a third-party broker-dealer under which the broker-dealer would become the firm's primary broker in exchange for an over $3 million forgivable loan to the adviser. The SEC found that the adviser's failure to disclose to its clients and in its Form ADV the receipt of revenue from the broker-dealer and the conflict of interest created by the loan was a breach of its fiduciary duties. Without admitting or denying the SEC's findings, the firm agreed to pay a $60,000 penalty. On the same day, the SEC announced a settlement with a San Diego, California adviser for its failure to disclose its receipt of more than $1.8 million in multiple loans from a broker-dealer in exchange for the broker-dealer providing services to the firm's clients. Without admitting or denying the SEC's findings, the adviser paid a $50,000 penalty.

In August, the SEC brought a settled action against a Salt Lake City investment adviser as well as its chief investment officer and a former member alleging that they mismanaged the assets of certain trust entities and failed to disclose conflicts of interests.[53] The SEC found that the firm had invested more than $800,000 of the entities' assets in unsuitable, illiquid investments in which the fund and the two principals each had an undisclosed financial interest. The SEC also found that the former member had misappropriated approximately $137,000 from the entities' accounts and that the CIO failed to adopt and implement policies and procedures reasonably designed to prevent his misconduct. Without admitting or denying the findings of the SEC's order, the firm and its principals agreed to pay financial penalties, with the former member agreeing to an industry bar.

In September, the SEC instituted settled proceedings against the two principals of a Southern California investment adviser for their alleged failures to adequately disclose material conflicts of interest to clients whose money they invested in an affiliated mutual fund.[54] Without admitting or denying the allegations, the principals agreed to pay a total of $104,000 in disgorgement and a $40,000 penalty.

In October, the SEC charged the principal of a Northern California adviser with failing to disclose a conflict of interest in recommending that his clients sell shares of a managed futures fund for which he could not receive commissions and buy shares of another fund for which he would be compensated.[55] The SEC further alleged that he misrepresented the reason that his firm had changed custodians, informing them that he did so after a lengthy independent search to benefit clients when in fact the custodian had terminated the relationship as the result of a prior SEC proceeding against the
firm. Without admitting or denying the allegations, the principal agreed to be barred from the securities industry for two years and to pay a penalty of $140,000.

Also in October, the SEC charged a Hawaii-based investment adviser and its principal with "cherry-picking" profitable trades for the principal's personal account, purchasing securities in an omnibus account and allocating them between the principal and the adviser's clients after seeing their performance.[56] The SEC also alleged that the adviser misled clients about fees being charged to them, and made trades for an affiliated mutual fund that deviated from the fund's fundamental investment limitations. The matter is being litigated.

And in December, the SEC announced a settled action against a New York private equity fund manager alleged to have failed to obtain the consent of the advisory boards of certain funds it managed before making co-investments with a fund affiliated with the firm's CEO.[57] The fund limited partnership agreements required the consent of the funds' advisory boards before making any co-investment with persons or entities affiliated with the firm, but the SEC alleged that the firm negligently failed to obtain such consent prior to co-investing over $250 million in four portfolio companies in which another private equity fund managed by the firm's CEO had also invested. Without admitting or denying the allegations, the adviser agreed to pay a $275,000 penalty.

B. Fees and Expenses

The SEC continued to focus its attention on the adequacy of fee and expense disclosures by investment advisers and fund managers. In July, the SEC filed an enforcement action against an investment advisory firm for failing to properly disclose to clients the additional transaction costs beyond the "wrap fees" clients paid for the cost of bundled services.[58] According to the SEC, the firm's Form ADV misrepresented that its client trades were typically executed through its wrap program's sponsoring broker so the client's wrap fee covered the transaction costs. Instead, the SEC alleges the firm used brokers outside the wrap program for the majority of its wrap trades, resulting in additional costs to clients for those transactions. Without admitting or denying the findings, the firm agreed to pay a $300,000 penalty, and further agreed to post on its website on a quarterly basis the volume of trades by market value executed away from sponsoring brokers and the associated transaction costs passed on to clients.

In other matters involving similar wrap fee disclosures, the SEC announced in September a pair of actions against two different advisory firms alleging failures to establish policies and procedures necessary to determine the amount of commissions firm clients were being charged when sub-advisers "traded away" with a broker-dealer outside the wrap fee programs.[59] The SEC's press release noted that the SEC's National Exam Program has included wrap fee programs among its annual examination priorities, with a focus on whether advisers are fulfilling fiduciary and contractual obligations to clients. Without admitting or denying the charges, the firms agreed to pay penalties of $600,000 and $250,000.

In August, the SEC announced litigated administrative proceedings against an Oregon investment adviser and its principal for allegedly steering clients toward more expensive mutual fund investments
in order to receive payments from the mutual fund companies for winning the business. The adviser allegedly failed to disclose to clients that a substantial portion of the fees charged to investors by the mutual fund companies were paid back to him, increasing his business revenue at the clients' expense. The SEC further alleged that the adviser failed to produce books and records during an SEC examination of the firm.

Also in August, the SEC filed a settled action against four advisers affiliated with a Manhattan-based private equity fund, alleging that they failed to adequately disclose the benefits they received by accelerating the payment of future monitoring fees owed by the funds' portfolio companies upon the sale or IPO of those companies. In addition, the SEC alleged that the private equity fund failed to supervise and take appropriate remedial actions against a senior partner who was caught improperly charging personal expenses to fund clients. The SEC credited the fund's cooperation, finding it was "extremely prompt and responsive in addressing staff inquiries." The fund agreed to pay $50 million in disgorgement and penalties.

And in a third August action, the SEC brought a settled action against another New York private equity fund adviser regarding its management fee allocation practices. The adviser allocated a percentage of the transaction fees it received from portfolio companies to the private equity funds it advised in order to offset the funds' quarterly management fees. The SEC alleged that the firm failed to disclose it allocated a significant amount of those transaction fees for itself, resulting in the funds paying $10.4 million in management fees that should have been offset. According to the SEC, the firm uncovered this fee allocation issue while under examination by the SEC's Office of Compliance Inspections and Examinations (OCIE). The SEC noted the firm's significant remedial measures, including self-reporting this issue to OCIE, conducting an internal review, adopting and disclosing a new fee allocation methodology, and voluntarily reimbursing the funds for the entire $10.4 million in excess fees plus $1.4 million in interest. Without admitting or denying the findings, the firm agreed to pay a $2.3 million penalty.

In September, the SEC instituted a settled proceeding against private equity fund firm First Reserve Management, L.P., alleging the firm allocated advisory expenses and insurance premiums to its fund clients without making appropriate disclosures or receiving effective consent. In addition, the SEC found First Reserve improperly negotiated a legal fee discount from a law firm based on the large volume of work the law firm performed for First Reserve's clients, without negotiating a similar discount for its clients. After an examination conducted by the SEC's Office of Compliance Inspections and Examinations ("OCIE") raised concerns about the expenses allocated to clients, but prior to any contact by SEC investigative staff, First Reserve voluntarily reimbursed expenses and agreed to pass on any future discounts to its clients from the law firm. Without admitting or denying the allegations, First Reserve agreed to pay a $3.5 million penalty.

C. Disclosure Issues

In July, the SEC filed litigated administrative proceedings against RD Legal Capital and its founder alleging they marketed their investment funds as opportunities to invest in low-risk legal settlements but instead invested the funds' money "however they saw fit," including in unsettled cases and cases in which
collection was still subject to litigation risk. According to the SEC, the firm invested a substantial percentage of its funds' assets in a judgment related to litigation associated with the 1983 Iranian terrorist bombing of the United States Marines barracks in Beirut, a legal receivable the SEC alleged to be high risk. The SEC also alleged RD Capital unreasonably inflated the value of assets in the funds' portfolio in order to drain the funds of liquidity at investors' expense.

In August, the SEC announced settlements with 13 investment advisory firms for allegedly advertising the overstated performance track record of a third-party entity's investment strategy used by each adviser. The SEC alleged the firms offered the strategy to their own investors without verifying the performance claims. Without admitting or denying the allegations, the advisers agreed to pay penalties ranging from $100,000 to $500,000 based upon the fees each firm earned from the strategy.

Also in August, the SEC instituted litigated administrative proceedings against a New York hedge fund manager and his firm, alleging they paid at least 60 terminally ill individuals to use their names on purported joint brokerage accounts in order to purchase investments on behalf of his hedge fund and redeem them early by invoking a survivor's option. This scheme allegedly caused issuers of the securities to pay out more than $100 million in early redemptions to the fund, which would otherwise have been ineligible for survivorship rights. The SEC further alleged that the hedge fund manager violated the custody rule by placing hedge fund client assets at risk, keeping them in accounts in his and the terminally ill individuals' names.

In October, the SEC charged a Massachusetts-based investment company, which managed funds invested in tollway bonds, with valuing the bonds based on an incorrect net asset value. The SEC further alleged that, after discovering the error, the firm failed to precisely calculate remediation payments and failed to disclose the initial remediation process to investors. Without admitting or denying the allegations, the investment company agreed to recalculate the net asset value of the toll road bonds and make distributions based on the recalculation, and to pay a penalty of $3,900,000.

And in December, the SEC charged Pacific Investment Management Company LLC ("PIMCO") with misleading investors about the performance of one of the firm's actively managed exchange-traded funds and failing to accurately value certain of the fund's securities. Without admitting or denying the allegations, PIMCO agreed to retain an independent compliance consultant and to pay approximately $1,530,000 in disgorgement and prejudgment interest and a penalty of just over $18 million.

D. Fraud & Misappropriation

In July, the SEC charged a Georgia manager of two unregistered advisory firms and his son with defrauding investors in a $10.7 million hedge fund. The SEC alleged that, over a four-year period, the manager directed preferential redemptions and other distributions out of the hedge fund and feeder funds to himself, his family, and favored investors, while misrepresenting to other investors that redemptions were suspended. The SEC further alleged that the manager increased his compensation by appointing himself as sub-manager of a feeder fund but failing to disclose this conflict of interest to investors. Also according to the SEC, the manager failed to disclose this disciplinary history to
prospective investors, which included an industry bar and revocation of his broker-dealer registration as a result of a 1971 administrative proceeding. The matter is being litigated.

Later in July, a San Jose, California investment adviser, its parent company, one of its principals, and its former CFO settled charges that they solicited investments in an unregistered offering using materially misleading private placement memoranda.[71] According to the SEC, the adviser raised approximately $2.2 million from investors while significantly overstating the firm's assets under management and financial performance, and misrepresented or failed to disclose conflicts of interest arising from the use of offering proceeds to pay affiliated entities. The SEC further alleged that the adviser failed to implement adequate policies and procedures to ensure possible conflicts of interest were adequately disclosed. Without admitting or denying the allegations, the entities agreed to pay a $120,000 penalty on a joint-and-several-liability basis and the principal agreed to pay a $60,000 penalty.

In October, the SEC charged a Los Angeles investment adviser and its owner with fraudulently overbilling clients approximately $643,000 and stealing approximately $865,000 from clients' trusts.[72] According to the SEC, the fund owner overbilled clients and concealed it by altering statements provided to investors. The SEC also alleged that the fund owner failed to disclose conflicts of interest created by the fund's investment misled advisory clients about conflicts of interests caused by investments in privately-held companies with which he was affiliated. In a parallel action, the U.S. Attorney's Office for the Eastern District of New York filed criminal charges against the firm's owner.

In November, the SEC charged the two managing directors of a Washington, DC investment fund with looting the fund and a software company that was its sole investment.[73] The SEC alleged that the individuals took almost a million dollars in interest-free loans from the fund and nearly $500,000 in authorized and undisclosed transfers from the fund and the software company. The matter is being litigated.

And in December, the SEC charged the founder of a New York hedge fund company, two of the fund's advisory firms, and several officers and employees with improperly inflating asset values and illicitly moving investor money to cover losses and liquidity problems.[74] The SEC alleged that the advisers overstated the value of an oil company that was among their largest assets, and concealed a liquidity crisis by transferring money between the funds, making preferential redemptions to favored investors, and using misrepresentations to attract new investors. In a parallel action, the U.S. Attorney's Office for the Eastern District of New York announced criminal charges.

E. Compliance Deficiencies

In September, the SEC charged a Missouri investment adviser and its president and chief investment officer with failing to properly conduct principal transactions and failing to adequately implement policies and procedures regarding principal transactions and best execution.[75] The SEC noted that the firm had received deficiency letters in 2006, 2009 and 2012 related to various compliance failures related to principal transactions. Without admitting or denying the allegations, the firm agreed to retain an independent compliance consultant and to pay a penalty of $34,000 and its president agreed to pay a penalty of $7,500.
In October, the SEC charged a Lexington, Kentucky investment adviser with failing to conduct annual compliance reviews from 2010 to 2014.[76] Without admitting or denying the allegations, the firm agreed to be censured and to pay a penalty of $25,000.

IV. Brokers and Financial Institutions

A. Fees, Expenses and Other Disclosures

In the second half of 2016, the SEC brought a variety of cases involving disclosure, registration, and internal system failures by broker-dealers and other large financial institutions. The SEC repeatedly signaled to broker-dealers and financial institutions that it would not tolerate the failure to disclose material information—such as markups, fees, the firms' own purchase prices, and investing risks—to customers.

In July 2016, State Street Bank and Trust Company settled claims that it allegedly misled mutual funds and other custody clients by applying hidden markups to indirect foreign currency exchange trades.[77] The SEC claimed that State Street told clients it guaranteed the most competitive rates available on their indirect foreign currency exchange trades, provided "best execution," or charged "market rates" on the transactions, but instead set prices largely driven by predetermined markups. State Street admitted some wrongdoing and agreed to pay $167.4 million in disgorgement and penalties to the SEC, a $155 million penalty to the Department of Justice, and at least $60 million to ERISA plan clients in an agreement with the Department of Labor.

The next month, the SEC charged three individuals and the now-defunct firms Global Transition Solutions, Inc. and Global Transition Solutions, LLC with fraud for allegedly misleading their current and prospective customers about the fees they charged in connection with securities transactions.[78] The SEC alleged that the individuals told many of their customers—largely public pension funds— that the firm would receive only explicitly disclosed commissions charged on customers' trades, but the company also received additional revenue from mark-ups and mark-downs taken by other brokers and shared with the company, resulting in at least $13 million in undisclosed payments. The matter is being litigated.

In August 2016, the SEC announced a settlement with a former trader in residential mortgage-backed securities (RMBS), who allegedly had generated extra revenue for the firm by concealing the prices at which various RMBS had been purchased, then re-selling them at higher prices to the buying customer with the firm retaining the difference.[79] On other occasions, the trader allegedly misled purchasers by suggesting he was actively negotiating a transaction between customers when he was merely selling RMBS out of the firm's inventory. Without admitting or denying the allegations, the trader agreed to be banned from the securities industry and to pay $400,000 to settle the charges.

At the end of 2016, a St. Louis brokerage firm and a former senior vice president agreed to settle SEC charges for allegedly selling $200 million in unsuitably risky and complex synthetic collateralized debt obligations ("CDOs") to five Wisconsin school districts.[80] The SEC alleged that the firm overstated the safety and downplayed the risks of investing in CDOs, failed to disclose certain material facts, and did not independently perform any meaningful suitability analysis with respect to the CDO
investments. Ultimately, the synthetic CDOs failed and the school districts suffered a complete loss of their cash investment. The former executive admitted the SEC's allegations against him. The firm and the former executive were ordered to jointly pay disgorgement and prejudgment interest of $2.44 million and to pay civil penalties of $22.5 million and $100,000, respectively.

B. Registration Violations

The SEC also charged numerous companies with violations of various registration requirements during the second half of 2016.

In one pair of cases, the SEC entered into settlement agreements with foreign brokers participating in the U.S. securities markets without the requisite registrations. In the first case, an Israel-based bank which managed hundreds of U.S. accounts with over $500 million in securities assets, agreed to settle SEC charges that it had engaged in U.S. cross-border transactions without being registered as an investment adviser or broker-dealer.[81] The bank, which had disgorged $3.3 million in profits in a deferred prosecution agreement with the DOJ in 2014 for the same conduct, tried to correct the problem beginning in 2008 by telling its managers to close U.S. accounts and banning direct communication with U.S. customers. However, many accounts remained open years later and employee contact with customers continued. The bank agreed to disgorge an additional $65,700 and to pay a $1.5 million penalty.

In the second foreign broker case, another Israeli firm, which had voluntarily withdrawn from the U.S. market in 2013, settled with the SEC in November to resolve allegations that it had misled investors into trading highly risky binary options through its two online trading platforms, failed to register as a broker-dealer, and failed to register the binary options, which constituted securities under the federal securities laws.[82] According to the SEC, despite the firm's touting of the options trading platform as "highly profitable," only about 3% of U.S. investors who opened accounts with the firm made any profits. Without admitting or denying any wrongdoing, the firm agreed to disgorge $1.5 million in U.S. revenue, pay a $200,000 penalty for its failure to register as a broker, and be barred from selling binary options in the United States. In conjunction with the settlement, the SEC issued an investor alert warning investors about binary options fraud.[83]

Another pair of cases settled in late 2016 involved unregistered domestic brokers offering derivative products. In the first matter, a company that ran "fantasy sports for stocks"--mobile phone games in which players predicted the order in which ten securities would perform relative to one another--settled with the SEC in October, agreeing to pay a $50,000 penalty for allegedly illegally offering complex derivatives products to retail investors.[84] The SEC claimed that the company's agreements with players constituted security-based swap offerings because they provided for a payment that was dependent on an event associated with a potential financial, economic, or commercial consequence and based on the value of individual securities. The SEC also concluded that the company failed to file a registration statement and failed to sell the contracts through a national securities exchange, both of which are required under the Dodd-Frank Act.
In the second action, San Francisco-based company settled charges in December that it failed to register security-based swaps that were offered and sold online—rather than through a national securities exchange, as required under the Dodd-Frank Act—to shareholders in pre-IPO companies.[85] The company's platform matched shareholders holding restricted shares of stock with investors seeking to invest in the potential economic return on those shares. The firm's subsidiary entered contracts with the shareholders and investors, and payment provisions were triggered by such events as a merger, acquisition, IPO, or dividend distribution at the underlying company. The SEC contended that these contracts constituted security-based swaps that must be registered and sold through a national securities exchange. Without admitting the allegations, the company agreed to pay an $80,000 penalty.

C. Supervisory Controls and Internal Systems Deficiencies

The SEC brought a number of cases involving brokers' supervisory controls and other oversight systems, as well as efforts by individual brokers to override such safeguards.

In September, a large financial services firm agreed to settle allegations that it failed to adequately train and educate its sales team about the risks associated with reverse convertible notes, which are derivatives whose value is based on the performance of an underlying stock.[86] Between 2011 and 2014, the firm's registered representatives sold $548 million in reverse convertible notes to more than 8,700 retail customers, including some with little relevant investing experience and modest income and net worth. Without admitting any of the allegations, the firm agreed to pay $9 million in disgorgement and a $6 million penalty. The SEC used the action to emphasize its ability to use "sophisticated coding techniques" to analyze trading records and "build platform wide cases rather than cases built investor by investor."

In August 2016, a trader in commercial mortgage backed securities (CMBS) settled SEC allegations that he mismarked loans tied to the CMBS to boost his profits, and provided inaccurate information to his employer to prevent it from detecting the inaccurate valuations.[87] After the firm raised questions about the authenticity of documents the trader had provided to the bank's internal valuation department, he admitted his wrongdoing to his supervisor and resigned. The bank self-reported the matter to the SEC after conducting an internal investigation. Without admitting or denying wrongdoing, the trader agreed to pay a fine of $50,000 and to be barred from the industry for three years.

In October, a large brokerage firm agreed to settle SEC allegations that it failed to properly safeguard material non-public information generated by its analysts.[88] The firm allegedly encouraged its analysts to communicate with customers and traders during morning calls, trading day "squawks," "idea dinners," and non-deal road shows. The SEC alleged that the firm lacked adequate policies and procedures to prevent analysts from disclosing yet-to-be-published views and analyses, changes in estimates, and short-term trade recommendations during those conversations. Without admitting wrongdoing, the firm agreed to pay a $9.5 million penalty.

In a different action, the same firm agreed to settle allegations that it told clients that it would use ongoing automatic data analysis to rank the dark pools, or private exchanges for trading securities, that were best suited for customer orders, but allegedly did not in fact perform the analysis.[89] Due to a coding error,
the firm updated the automated system just once during a two-year period, causing orders to be misrouted. The firm agreed to pay $18.5 million in penalties to the SEC.

D. Other Compliance Issues

Finally, in the latter half of the year, the SEC pursued actions against broker-dealers and financial institutions related to reporting violations, Regulation SHO, the Market Access Rule, and the Customer Protection Rule.

In August 2016, a large global investment bank settled SEC charges that it caused a company to include false and misleading statements in its proxy statement.[90] In 2011, the bank drafted a fairness opinion relating to a private equity firm's bid to purchase an ambulance company. The SEC alleged that the bank's opinion letter made the bid appear more attractive than it actually was. Without admitting any wrongdoing, the bank agreed to pay $500,000 in disgorgement and a $2 million penalty.

In December 2016, the SEC filed settled cease-and-desist proceedings against the CEO of a Utah-based broker-dealer and two other employees for allegedly causing the firm's violations of SEC market structure rules.[91] The SEC charged that the firm improperly relied on Regulation SHO's bona-fide market making exception and engaged in numerous short sales in over-the-counter equity securities, violating Regulation SHO and resulting in improper trading profits. In addition, the SEC charged the CEO with violating the CEO certification requirement of the Market Access Rule. This was the first time the SEC charged a broker-dealer's CEO with a certification violation. The three individuals agreed to pay a total of approximately $750,000 in penalties, disgorgement, and prejudgment interest.

Also in December 2016, a brokerage firm agreed to pay $7.5 million to settle charges it used trades involving customer cash to lower the firm's borrowing costs in violation of the SEC's Customer Protection Rule, which limits the use of customer funds by broker-dealers.[92] The SEC alleged that the firm's transactions with an affiliate reduced the amount of cash deposited in its customer reserve account. The SEC noted that the firm, which did not admit the allegations, provided substantial cooperation during the SEC's investigation and agreed to review its compliance with the Customer Protection Rule and to take remedial steps to improve its calculation process.

V. Insider Trading

A. The Supreme Court's Salman Decision

As discussed in our Client Alert on December 7, 2016[93], the Supreme Court in Salman v. United States laid to rest some of the uncertainty that had arisen after the Second Circuit's decision in United States v. Newman. The Court in Salman clarified the meaning of the "personal benefit" test, holding that an insider-tippee receives a personal benefit where the tipper makes a gift of inside information to a trading relative or friend.[94] The Court rejected Newman insofar as Newman required prosecutors to prove that the insider disclosed information for a personal monetary or tangible benefit.

In its immediate aftermath, Salman is likely to reenergize prosecutors to bring tipping cases involving family members and friends that they might otherwise not have brought after Newman.
The Court in *Salman* did not address *Newman*’s other significant holding, imposing a high burden on criminal prosecutors in insider trading cases to prove a downstream tippee’s scienter. Therefore, for cases where there is little to no evidence that the downstream tippee, who is multiple levels removed from the original tipper, knew that the information was obtained from an insider in violation of a fiduciary duty, or that the insider received a personal benefit in exchange for the information, the government continues to shoulder a difficult burden to prove the defendant's scienter.

### B. Cases Involving Securities Industry Personnel and Other Professionals

A recurring theme in recent years has been the SEC’s enhanced scrutiny of securities industry participants and outside professionals such as lawyers and accountants for improper tipping and trading activity.

In July, the SEC brought charges against a lawyer and his stockbroker, alleging that the lawyer, who did M&A due diligence for a large accounting firm, obtained confidential information about impending acquisitions of three different companies, and subsequently alerted his stockbroker about the deals.[95] According to the SEC, the stockbroker shared the information with a long-time friend and colleague, who traded in the securities of each of the three companies. The tips from the lawyer and stockbroker are alleged to have resulted in the friend and his family making over $111,000 in trading profits. The matter is being litigated.

In August, the SEC charged a stockbroker and his friend for participating in an insider trading scheme to profit in advance of two major announcements.[96] According to the SEC, an IT executive at a pharmaceutical company tipped his brother-in-law, a stockbroker, ahead of the company’s announcement of its agreement to license a cancer drug, and also tipped him in advance of the company’s acquisition by another company. This information was then relayed to another broker and a mutual friend, who allegedly made nearly $90,000 in illicit profits. According to the SEC, the traders attempted to evade detection by trading call options through a different brokerage firm. The U.S. Attorney's office for the Southern District of California filed parallel criminal charges.

The SEC filed charges in September against a hedge fund manager and his firm for insider trading based on material nonpublic information he learned from a corporate executive.[97] According to the SEC, the fund manager used his status as a large shareholder of this company to befriend the executive and learn confidential details about the sale of a large company asset. The SEC alleged that, despite agreeing not to trade on this information, the hedge fund manager and his firm purchased securities in the company, and after news of the asset sale went public, benefitted from a 31% increase in the stock price. The SEC further alleges that the hedge fund manager, after receiving the subpoena from the SEC, contacted the executive and tried to fabricate a story to recount if the executive were questioned. The matter is being litigated.

And in October, a hedge fund advisory firm and senior research analyst agreed to settle SEC charges related to their alleged failures to detect insider trading by a firm employee.[98] The employee and his friend were criminally charged and have since received prison sentences. The SEC alleged that the hedge fund manager failed to implement adequate policies and procedures to prevent insider trading at the firm, and the employee's supervisor failed to respond to red flags that should have alerted him. The firm agreed
to settle the SEC's charges by disgorging approximately $6.3 million in profits and paying a penalty of about $2.5 million. Neither the firm nor the supervisor admitted or denied any of the SEC's findings.

C. Corporate Officers and Directors

In July, the SEC instituted settled proceedings against the former corporate controller of an optical networking company who purchased shares of her company after learning the company was about to be purchased.[99] According to the SEC, she secretly purchased several thousand shares of stock in two brokerage accounts held in the names of her relatives, and later sold the stock for nearly $35,000 in profits. Without admitting the allegations, the trader agreed to pay disgorgement and a matching penalty, and to be barred from practicing as an accountant before the SEC for five years.

In September, the SEC charged a former director of regulatory affairs of a biotech company for trading ahead of the company's announcement of its new drug to treat breast cancer.[100] The trader is alleged to have made more than $1.1 million by purchasing options based on nonpublic information he learned during the drug's clinical trials. The SEC's complaint further alleges that the individual altered his trading records when confronted by the company about his trading activities. The U.S. Attorney's Office for the District of Massachusetts filed parallel criminal charges.

The SEC filed a litigated action in October against an attorney who served on the board of directors of a bank holding company for trading on material nonpublic information regarding an impending merger discussed during a board meeting.[101] According to the complaint, the attorney learned of this merger and then placed his first trade while the board meeting was still in progress. He then placed four more orders within an hour after the meeting concluded. The SEC alleges that he made more than $56,000 in trading profits. The U.S. Attorney's Office for the Middle District of Tennessee filed parallel criminal charges, to which he pled guilty.[102]

D. Other Trading and Misappropriation Cases

In August, a cardiologist was charged with trading based on confidential developments regarding a clinical drug trial.[103] The SEC alleged that the cardiologist sold all of his stock in the company prior to negative announcements that patient enrollment was being suspended due to allergic reactions suffered by patients. The cardiologist, who was a principal investigator of the drug trial, received advance notice of the news and sold all of his stock to avoid approximately $160,000 in losses. When the cardiologist received advance notice that enrollment would be permanently halted after a patient died, he made additional option trades. The U.S. Attorney's Office for the District of Connecticut filed parallel criminal charges.

In an international case of insider trading, three Peruvian defendants were charged with insider trading prior to the merger of a Canadian and U.S. mining company.[104] One of the defendants, a Peruvian lawyer at the Canadian-based company, told a friend and fellow lawyer nonpublic information about a tender offer his company had submitted to acquire shares in the U.S. company. The lawyers purchased shares in a brokerage account through a shell company in the British Virgin Islands in an attempt to avoid having the trades traced back to them. After one of the Canadian company's in-house attorneys confronted the lawyer who tipped his friend, both lawyers tried to cover up the insider trading by...
pretending the account's $100,000 transfer represented the repayment of a previous loan. The SEC alleged the lawyers made more than $112,000 in illegal profits. The first lawyer also illegally tipped an acquaintance at a brokerage firm, who used the insider information to obtain $73,000 in alleged profits.

In December, the SEC filed charges against a company's IT support technician who allegedly hacked into and stole confidential information relating to the company's earnings and upcoming agreements.[105] The employee, who had been entrusted with IT administrative access privileges such as usernames and passwords, used these credentials to access electronic documents maintained by the CFO and Head of Investor Relations. According to the SEC, the employee purchased company stock in advance of seven earnings announcements, resulting in trading profits of almost $350,000. The employee agreed to settle the SEC's charges by disgorging all profits. The U.S. Attorney's Office for the Western District of Washington filed parallel criminal charges.

Finally, the SEC announced that a Spanish banker was criminally indicted for insider trading in a case in which the SEC's prior civil action had been previously dismissed.[106] In 2011, the SEC's civil action against the banker had been dismissed on summary judgment for insufficient evidence on the issue of whether he had access to nonpublic information. In 2014, however, the SEC discovered a secret bank account in Zurich, Switzerland which had received a transfer of 100,000 Euros from a friend who had also profited from the purchase of call options. The banker also allegedly lied under oath several times during his deposition from the civil action. The indictment states that the banker made nearly $500,000 in illegal profits.

VI. Municipal Securities and Public Pensions Cases

The Municipalities Continuing Disclosure Cooperation (MCDC) Initiative was announced in March 2014.[107] The MCDC Initiative offered favorable settlement terms to municipal underwriters and issuers willing to self-report violations of continuing disclosure obligations. To date, the SEC has settled with seventy-two underwriters as part of the ongoing sweep, and has more recently turned its attention to the issuers themselves. In August 2016, the SEC announced enforcement actions against seventy-one issuers and related persons for alleged continuing disclosure deficiencies.[108] The issuers implicated included a wide-range of entities from forty-four states including Colorado, Illinois, and New York, among them more than a dozen cities, along with counties, towns, universities, school districts, and hospitals. The SEC found that the issuers "sold municipal bonds using offering documents that contained materially false statements or omissions about their compliance with continuing disclosure obligations" from 2011-2014. Without admitting the allegations, the municipal issuers agreed to establish appropriate policies, procedures and training regarding continuing disclosure obligations.

In September, the SEC brought charges against an Oklahoma-based bank alleging that the bank, primarily through the failures of its former senior vice president, concealed a number of problems and red flags from investors in municipal bond offerings in connection with the purchase and renovation of senior living facilities managed by an Atlanta-based businessman.[109] According to the SEC, the bank failed in its gatekeeper role as indenture trustee and dissemination agent for the bond offerings. Without admitting the allegations, the bank settled with the SEC, agreeing to pay disgorgement of the fees collected, interest, and penalties totaling $1.6 million. The SEC credited the bank with terminating the
senior vice president following an internal investigation and self-reporting to the SEC. The SEC's case against the former bank official is being litigated.

And in December, the SEC filed a complaint in the Southern District of New York against a former official of the nation's third largest public pension fund, along with two brokers, who were accused of "orchestrating a pay-to-play scheme."[110] During the course of his two-year employment from 2014-2016, the former director is alleged to have used his position to direct as much as $2.5 billion in state business to the brokers, which netted each millions of dollars in commissions. In exchange, the brokers are alleged to have given the former director thousands of dollars in benefits, including luxury gifts and lavish vacations. According to the SEC, the former director was required to disclose his solicitation and receipt of the benefits he received from the brokers, but not only did he fail to do that, the complaint alleges that the director and the brokers took steps to conceal their exchange. The matter is being litigated. The U.S. Attorney for the Southern District of New York simultaneously announced criminal charges against the three.

As a final note, in September 2016, the SEC obtained a favorable jury verdict in a case it had filed in 2013 against the city of Miami and the city's former budget director.[111] The SEC had alleged that city officials transferred approximately $38 million in cash from certain funds to mask shortfalls in the city's general fund, concealing the city's financial health while selling more than $150 million in municipal bonds. Following the verdict, the city agreed to pay a $1 million penalty to resolve the litigation.[112] This was the SEC's first federal jury trial against a municipality.


SEC Administrative Proceeding Releases File Nos. 3-17348, 3-17349, SEC Charges Investment Advisers For Failing to Disclose Conflicts of Interest Arising from Receipt of Forgivable Loans (July 18, 2016), available at www.sec.gov/litigation/admin/2016/ia-4455-s.pdf.

SEC Administrative Proceeding Release File No. 3-17385, SEC Charges Salt Lake City-Based Investment Advisor, Its Founder, and a Former Member For Unsuitable Investments and Failing to Disclose Conflicts of Interest (Aug. 15 2016), available at www.sec.gov/litigation/admin/2016/ia-4483-s.pdf.


The following Gibson Dunn lawyers assisted in the preparation of this client update: Marc Fagel, Emily Aldridge, Lori Arakaki, Sara Ciccolari-Micaldi, Matt Coe-Odess, Mary Kay Dunning, Ashley Evans, Melissa Goldstein, Alexandra Leigh Grossbaum, David Kusnetz, Christopher Lang, Brian Lipshutz, Renee Lizarraga, Jaclyn Neely, Caitlin Walgamuth and Jessica Wright.

Gibson Dunn is one of the nation's leading law firms in representing companies and individuals who face enforcement investigations by the Securities and Exchange Commission, the Department of Justice, the Commodities Futures Trading Commission, the New York and other state attorneys general and regulators, the Public Company Accounting Oversight Board (PCAOB), the Financial Industry Regulatory Authority (FINRA), the New York Stock Exchange, and federal and state banking regulators.
Our Securities Enforcement Group offers broad and deep experience. Our partners include the former Directors of the SEC’s New York and San Francisco Regional Offices, the former head of FINRA’s Department of Enforcement, the former United States Attorneys for the Central and Eastern Districts of California, and former Assistant United States Attorneys from federal prosecutors' offices in New York, Los Angeles, San Francisco and Washington, D.C., including the Securities and Commodities Fraud Task Force.

Securities enforcement investigations are often one aspect of a problem facing our clients. Our securities enforcement lawyers work closely with lawyers from our Securities Regulation and Corporate Governance Group to provide expertise regarding parallel corporate governance, securities regulation, and securities trading issues, our Securities Litigation Group, and our White Collar Defense Group.

Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work or any of the following:

**New York**
- Reed Brodsky (+1 212-351-5334, rbrodsky@gibsondunn.com)
- Joel M. Cohen (+1 212-351-2664, jcohen@gibsondunn.com)
- Mary Kay Dunning (+1 212-351-2307, mkdunning@gibsondunn.com)
- Lee G. Dunst (+1 212-351-3824, ldunst@gibsondunn.com)
- Barry R. Goldsmith (+1 212-351-2440, bgoldsmith@gibsondunn.com)
- Mark K. Schonfeld (+1 212-351-2433, mschonfeld@gibsondunn.com)
- Alexander H. Southwell (+1 212-351-3981, asouthwell@gibsondunn.com)
- Avi Weitzman (+1 212-351-2465, aweitzman@gibsondunn.com)
- Lawrence J. Zweifach (+1 212-351-2625, lzweifach@gibsondunn.com)

**Washington, D.C.**
- Stephanie L. Brooker (+1 202-887-3502, sbrooker@gibsondunn.com)
- David P. Burns (+1 202-887-3786, dburns@gibsondunn.com)
- Daniel P. Chung (+1 202-887-3729, dchung@gibsondunn.com)
- Stuart F. Delery (+1 202-887-3650, sdelery@gibsondunn.com)
- Richard W. Grime (+1 202-955-8219, rgrime@gibsondunn.com)
- Patrick F. Stokes (+1 202-955-8504, pstokes@gibsondunn.com)
- F. Joseph Warin (+1 202-887-3609, fwarin@gibsondunn.com)

**San Francisco**
- Winston Y. Chan (+1 415-393-8362, wchan@gibsondunn.com)
- Thad A. Davis (+1 415-393-8251, tadavis@gibsondunn.com)
- Marc J. Fagel (+1 415-393-8332, mfagel@gibsondunn.com)
- Charles J. Stevens (+1 415-393-8391, cstevens@gibsondunn.com)
- Michael Li-Ming Wong (+1 415-393-8234, mwong@gibsondunn.com)
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