January 10, 2018

2017 YEAR-END SECURITIES ENFORCEMENT UPDATE

To Our Clients and Friends:

2017 was the prototypical transition year for the SEC. In contrast to many other federal agencies under the current administration, the new SEC leadership did not promise a wholesale rethinking of the agency's mandate. Rather, they seemed to signal minor changes around the edges, at least for the Division of Enforcement. That said, the new Chair and new Division Co-Directors focused their public statements on "Main Street" fraud – crooked brokers, Ponzi schemes, pump & dumps – while at times downplaying the more complex securities industry-focused cases favored by the prior SEC administration.

Indeed, a quick scan of some of the headlines that peppered the SEC's news feed in the closing weeks of 2017 provides insight into the Enforcement Division's general direction:

> *"SEC Charges Operators of $1.2 Billion Ponzi Scheme Targeting Main Street Investors"*
>
> *"SEC Continues Crackdown on Brokers Defrauding Customers"*
>
> *"SEC Charges Florida Penny Stock Operators with Defrauding Elderly Investors"*

None of which is to say that the SEC has lost interest in public company accounting, fund managers' fee and expense disclosures, and the highly complex trading practices of large financial institutions. Such cases continue to be part of the enforcement landscape, albeit coming with a little less fanfare than in recent years. The open question heading into 2018, as the Enforcement Division exhausts its existing docket and begins pursuing more recently initiated investigations, is whether we will see a real transformation in the types of cases being prioritized by the agency.

I. Significant Developments

A. Meet the New Boss…

As discussed in our 2017 Mid-Year Securities Enforcement Update, new SEC Chairman Jay Clayton assumed his position in May 2017, and shortly thereafter appointed new Enforcement Division Co-Directors Stephanie Avakian (who had served as Deputy Division Director in the prior administration) and Steven Peiken (a law firm partner of Clayton's and a former federal prosecutor).[1] And just days before 2017 came to a close, the Senate confirmed two new Commissioners: Republican Hester Peirce (an outspoken critic of Dodd-Frank who has served on the Senate Banking Committee staff) and Democrat Robert Jackson (a Columbia professor who has advocated for broadened corporate disclosure requirements).[2] For the first time in over two years, the photo displays in SEC office lobbies will have no empty frames. And while it is too soon to know the two newest Commissioners' views on thorny enforcement issues (in contrast to their widely divergent views on government regulation), both expressed a commitment at their Senate confirmation hearing to holding executives accountable for corporate misconduct.[3]

As a typical SEC investigation can take years from opening to filing, it will be months before we see the priorities of the Commission and the Enforcement Division leadership manifested in new case filings. But the SEC's leadership has made no bones about focusing greater attention on "retail" fraud, while continuing to cover the waterfront of the agency's broad enforcement mandate. The agency has likewise signaled its intention to prioritize matters relating to cybersecurity.

In an October 26, 2017 speech, Co-Director of the Enforcement Division Stephanie Avakian stated:

> At a high level, our greatest priorities and where we allocate our limited resources do not really change over time, and nor should they. We are always going to be focused on retail investors. These are often the most vulnerable market participants who are most in need of our protection. We are also always going to be focused on cyber-related issues, which are only continuing to increase in number and impact. Finally, we are always going to be focused on issues raised by the conduct of investment advisers, broker-dealers, and other registrants, on financial fraud and disclosure issues involving public companies, and on insider trading.[4]

Avakian's speech detailed the roll-out of the Enforcement Division's "Retail Strategy Task Force" and the creation of a new "Cyber Unit" to focus on its "retail and cyber" priorities. (Contrast this with the first comparable announcement from the prior administration, which heralded the creation of the "Financial Reporting and Audit Task Force" and touted the SEC's focus on public company accounting and disclosure fraud.[5])

One major determinant of the Enforcement Division's activity level will be its budget and staffing. Like other federal agencies, the SEC has been under a hiring freeze since the onset of the new presidential administration. And while the SEC has not been reported to be facing the same significant race for the exits as is occurring at certain other federal agencies, a protracted hiring freeze will necessarily reduce the number of enforcement attorneys and accountants simply through natural staff attrition. The Chairman has requested a 2018 budget essentially flat with 2017, and a slight 2019 increase earmarked for IT improvements, further signaling that the growth in the size of the enforcement staff over recent years will not be continuing.[6]

Judged simply by the numbers, the SEC's current enforcement activity level appears relatively static, depending on how one sifts the data. In November, the SEC reported a marked decline in the number of new enforcement actions filed in the fiscal year ended September 30.[7] The Enforcement Division filed 446 standalone cases in fiscal 2017 (i.e. excluding follow-on sanctions orders and actions to deregister public companies with delinquent filings), a nearly 20% decline from the prior year's high of 548 new standalone cases. However, as the Division noted in its defense, over 80 separate FY 2016 cases originated from the Division's Municipalities Continuing Disclosure Cooperation Initiative, under which muni bond issuers and underwriters self-reported deficiencies in their continuing disclosures; carve out those muni sweeps from 2017's results, and the decline in new enforcement actions was somewhat less dramatic.[8]

Per the Enforcement Division's Annual Report, there was no significant change in the proportion of enforcement actions described as Issuer Reporting/Audit & Accounting, while cases involving investment advisers, broker dealers, and violations of the FCPA appeared to be slightly down. Numbers aside, as described further below, there were few public company financial reporting cases that could reasonably be viewed as significant or groundbreaking. And while the SEC did institute proceedings against several prominent private fund managers and large financial institutions, the SEC's pronouncement of such actions sometimes appeared muted, often being posted on the SEC's website without an accompanying press release, leaving some to wonder whether these actions were simply hold-over investigations which might be less enthusiastically pursued under the new administration.

One clear change in the direction of the SEC's enforcement program has been a promised pull-back on "broken windows" investigations favored by prior Chair Mary Jo White. In recent years, the SEC has pursued a number of broad sweeps against multiple individuals and entities targeting largely technical, non-fraud violations (from late Form 4 filings by public company insiders to certain short sale violations). At an October conference, Co-Director Peikin suggested that he was not supportive of the broken windows approach, stating that "it may be the case that we have to be selective and bring a few cases to send a broader message rather than sweep the entire field."[9] At the same conference, Peikin also seemed less inclined to require admissions of wrongdoing as a condition of settlement, a policy implemented (albeit somewhat sparingly) for selected settlements under the prior administration.

B. <u>Whither ALJ's… and Other Significant Legal Developments</u>

One of the most hard-fought legal issues the SEC has faced in recent years – the seemingly arcane question of whether the method of appointment of the agency's administrative law judges (ALJs) comports with the Appointments Clause of the US Constitution – came one step closer to resolution in the waning days of 2017. As detailed in our Mid-Year Update, several cases are winding their way to the Supreme Court, which may rule on the issue in 2018. Since mid-year, a cert petition was filed in *Lucia v. SEC*, in which the D.C. Circuit upheld the SEC's ALJ appointments, as well as in *Bandimere v. SEC*, a Tenth Circuit case reaching the opposite conclusion.

In a surprising development, the US Solicitor General in November filed a brief on behalf of the SEC in *Lucia* stating that the government would no longer defend the SEC's previous position that ALJ's were constitutionally appointed. Rather, the Solicitor General now agreed with the petitioner in *Lucia* that ALJs are inferior officers of the United States and their appointment must be in compliance with the Appointments Clause.[10] The following day, the SEC issued an order "ratif[ying] the agency's prior appointment of" all of its ALJs, and ordering the ALJs to reconsider the record in all pending proceedings in which an initial decision has not yet been rendered, or in which the initial decision was issued but not yet considered on appeal by the Commission.[11] While the SEC's pronouncement deemed that the order had "resolved any concerns," the core issue of whether the ALJs had been constitutionally appointed in the first place, and whether there are any repercussions for past or pending cases, remains open, and the Supreme Court may nonetheless opt to grant certiorari in *Lucia* and/or *Bandimere*.

A second legal development of note impacting SEC enforcement practice arose in the Southern District of Florida, where a magistrate judge held that a law firm waived work product protection for its witness interview memoranda after counsel provided oral summaries of the interviews to the SEC staff.[12] The magistrate held that there was "little to no substantive distinction" for purposes of work product protection between providing actual interview memoranda and simply reading or summarizing the memoranda for the government, and that the oral summary was the "functional equivalent" of the original memos. The court noted, however, the possibility that work product protection could be maintained if counsel had only provided "vague references," "detail-free conclusions," or "general impressions" to the SEC Staff. (The court left open, pending *in camera* review, whether the original notes that the memoranda were based on were discoverable as well).

While just a single district court decision, the case could have significant ramifications. The SEC, among other agencies, routinely asks counsel for information developed during internal investigations, and expects counsel to provide summaries of witness interviews in order for companies to receive cooperation credit from the SEC staff. Notably, both the SEC and DOJ have stated that they do not require privilege waivers in order to obtain cooperation credit, so it is likely that both counsel and agency personnel will be feeling their way through this ruling in 2018, hoping to craft a solution amenable to all sides.[13]

Interestingly, the same decision also found that the provision of attorney work product to the client's accounting firm did *not* constitute a waiver, concluding that the firms had a common interest "for *other* purposes" since the accounting firm was not yet a target of the SEC—and thus not an adversary—of the company.

A third legal issue of note is the continuing fallout from the Supreme Court's June ruling in *Kokesh v. SEC*. In *Kokesh* (as described at length in our Mid-Year Update), the Court held that the five year statute of limitations applicable to government actions for civil penalties also applied to SEC demands for disgorgement, finding disgorgement to be penal in nature.[14] *Kokesh* left open whether the statute would likewise apply to injunctions, industry bars, and other non-monetary relief. In December, a federal district court In New Jersey held that, under the reasoning in *Kokesh*, an SEC proceeding seeking a permanent injunctions and penny stock bar was time-barred.[15] The Court concluded that these remedies would not compensate injured investors or merely restore the status quo; rather, they had the effect of punishing the defendant. Note, however, that some pre-*Kokesh* decisions found that such remedies were not penal and thus not subject to the five-year statute, and thus this is clearly not the final word on the subject.

Meanwhile, the Enforcement Division is cognizant of the time pressures created by *Kokesh*, with Co-Director Peikin remarking in a recent speech that *Kokesh* "is a very significant decision that has already had an impact across many parts of our enforcement program," particularly in resource-intensive FCPA investigations. As Peikin emphasized, "we have no choice but to respond by redoubling our efforts to bring cases as quickly as possible."[16]

Finally, the Supreme Court in November heard oral arguments in *Digital Realty Trust v. Somers*, which raised the question of whether whistleblowers are required to report potential securities law violations to the SEC in order to be protected from retaliation under Dodd-Frank. In *Digital Realty*, the Ninth Circuit held that, consistent with SEC guidance, reporting the violation to one's employer was sufficient; in contrast, the Fifth Circuit had held that protection from retaliation under Dodd-Frank arose only if a complaint had been filed with the SEC. A decision is expected by June 2018.[17]

C. You Can Hear the Whistle Blow…

The past year has seen continuing growth in both the number of whistleblower tips provided to the SEC, and the amount of money awarded to whistleblowers whose tips result in successful enforcement actions. According to the agency's 2017 annual whistleblower report to Congress, the SEC received more than 4,400 tips in fiscal 2017—a nearly 50 percent increase since the whistleblower program's first full year in 2012.[18] The SEC awarded nearly $50 million, including three of the ten largest whistleblower awards to date, to twelve individuals in 2017. As in previous years, whistleblower tips were most commonly categorized as "Corporate Disclosures and Financials," "Offering Fraud," and "Manipulation." The largest number of tips originated from California, New York, Texas, Florida and New Jersey, with each state yielding more than 100 tips. The SEC also received whistleblower submissions from individuals in 72 foreign countries.

Over the last six months, the SEC has ordered a number of multi-million dollar awards to whistleblowers, including:

- In July, the SEC announced an award of nearly $2.5 million to an employee of a domestic government agency whose tip led to an investigation and whose "continued assistance" helped to uncover a company's misconduct.[19] Notably, the SEC explained in the award order that a government employee is generally eligible for an award under the whistleblower program, subject to two statutory exceptions.[20] The first exception prohibits a whistleblower award to an employee of "an appropriate regulatory agency," defined as the SEC and various banking agencies, including the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. The second exception prohibits an award to an employee of "a law enforcement organization," interpreted to mean an agency involved in the detection, investigation, or prosecution of potential violations of law. Neither exception applied to this case.

- Two days later, the SEC announced an award of more than $1.7 million to a company insider who provided "critical" information that allowed the SEC to uncover a fraud that "would have otherwise been difficult to detect."[21] The SEC noted in the award order that the reward was reduced to reflect an unreasonable delay in reporting and some culpability of the whistleblower.[22]

- In October, the SEC announced a $1 million award to a whistleblower who provided "new information and substantial corroborating documentation of a securities law violation by a registered entity."[23]

- In November, the SEC announced an $8 million award to two whistleblowers whose "critical information and continuing assistance" helped the SEC bring a successful enforcement action.[24] In the award order, the SEC denied a reward to two experts who had been retained by one of the whistleblowers, concluding that retained experts cannot claim to be an original source of information if such information was previously provided to the SEC by the original whistleblower.[25] The SEC noted that permitting the experts to claim a reward could incentivize retained experts to abandon their obligations to whistleblowers and could discourage whistleblowers from retaining professionals to supplement and refine their tips.

- And in December, the SEC announced a $4.1 million award to a company insider who "alerted the agency to a widespread, multi-year securities law violation" and continued to assist the SEC throughout the investigation.[26] The SEC noted in the award order that the whistleblower's delay in reporting was excused in part due to the existence of several mitigating factors, including: 1) the delay occurred before the whistleblower reward program was established, and 2) the whistleblower was a foreign national working outside the U.S. and therefore may not have been afforded employment anti-retaliation protections.[27]

Notably, the new SEC administration did seem to signal one area where it might be softening its aggressive pro-whistleblower stance. One of the more impactful (and controversial) developments of recent years has been the Enforcement Division's clampdown on companies' use of employee confidentiality agreements viewed by the SEC as impeding potential whistleblowers from coming forward. Beginning in 2015 and continuing through January 2017 (as detailed in our Mid-Year Update), the SEC brought multiple enforcement actions alleging violations of Rule 21F-17 of the Securities Exchange Act, promulgated pursuant to Dodd-Frank, which prohibits individuals and companies from taking actions to impede whistleblowers from communicating with the SEC. Yet since January 2017, the SEC has brought no further cases of this nature – suggesting that either the newly constituted Commission has deprioritized Rule 21F-17 actions, or companies have gotten the message and corrected the ostensibly objectionable language in employment agreements.

D. <u>Everything's Coming up Cyber</u>

Upon their appointment as Co-Directors of the SEC's Enforcement Division in June 2017, Steven Peiken and Stephanie Avakian touted cybersecurity as a major enforcement priority.[28] As noted above, the SEC followed up on this goal with the creation of a dedicated Cyber Unit aimed at investigating and prosecuting cyber-related threats, which it declares "among the greatest risks facing our securities markets."[29] This Unit consolidates the agency's existing cyber-related expertise and focuses on a variety of areas from data breaches and cybersecurity, to the use of digital currencies and Initial Coin Offerings ("ICOs").[30]

Regarding cybersecurity, in October the SEC charged a day trader with accessing the brokerage accounts of more than 100 victims and making unauthorized trades to artificially affect the stock prices of various companies.[31] Avakian noted that "[a]ccount takeovers are . . . exactly the type of fraud our new Cyber Unit is focusing on." Chairman Clayton also issued a statement in September emphasizing the importance of cybersecurity to the SEC as both a regulatory body and, somewhat ironically, as an organization facing its own data security threats.[32] He simultaneously disclosed that a 2016 intrusion into the agency's own EDGAR database may have allowed hackers to gain access to and trade on the basis of nonpublic information. In the wake of this and other high profile data breaches this year, the SEC announced in November that it will likely issue new guidance regarding disclosure and reporting of cybersecurity incidents.[33] William Hinman, director of the SEC's Division of Corporation Finance, stated that while the agency's 2011 Cybersecurity Disclosure Guidance[34] remains valid, certain aspects need to be revisited in light of emerging issues, such as trading by corporate insiders following a breach.

The new Cyber Unit also focused on the proliferation of digital (or "crypto") currencies. The recent price spike in cryptocurrencies—such as Bitcoin, Ethereum, and Litecoin—in 2017 has led to a surge of interest from investors and traders alike, and what used to be considered a niche asset is becoming a mainstream investment. As such, the SEC and other regulators are beginning to take notice and issue guidance to investors.

In July, the SEC warned that virtual tokens sold in ICOs may be securities, and that those who offer and sell securities in the United States "must comply with the federal securities laws," which apply "without regard to the form of the organization or technology used to effectuate a particular offer or sale."[35] Then, in November, the SEC warned investors about increasingly popular celebrity endorsements of ICOs, cautioning investors "to be wary of investment opportunities that sound too good to be true" and stressing that such endorsements may be unlawful if they do not disclose the nature, source, and amount of any compensation received in exchange for the endorsement.[36]

The SEC's most significant statement on cryptocurrencies came in mid-December, when Chairman Clayton warned investors to proceed with "extreme caution" when investing in cryptocurrencies and ICOs, which he said offer "substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation."[37] He emphasized that not a single initial coin offering has registered with the SEC, nor has the SEC approved any exchange-traded products holding cryptocurrencies.

In addition to its cautionary statements, the SEC brought a handful of ICO-related enforcement actions in the latter part of 2017. In September, the SEC filed an action against two companies and their sole owner for engaging in an allegedly fraudulent ICO that sold unregistered securities and "lured investors with false promises of sizeable returns."[38] The SEC obtained an emergency asset freeze in December to halt another ICO that had raised $15 million from thousands of investors by falsely promising a 13-fold profit in less than a month.[39] Robert Cohen, Chief of the Cyber Unit, described that this case "hits all of the characteristics of a full-fledged cyber scam and is exactly the kind of misconduct the unit will be pursuing."

Later in December, in the first SEC enforcement action that did not appear to allege an outright fraud, food review app Munchee halted its ICO and refunded money to investors after being contacted by the SEC, and agreed to an order finding that its conduct constituted an unregistered securities offering.[40] A week later, the SEC temporarily suspended trading in the securities of The Crypto Company, whose shares rose more than 2700% after signing a deal to buy a cryptocurrency data platform, due to concerns about the "accuracy and adequacy of information" available to investors and "potentially manipulative transactions in the company's stock."[41]

II. Public Company Reporting and Accounting Cases

A. Accounting Fraud and Other Misleading Disclosures

In August, the SEC instituted proceedings against a Florida-based franchisor of children's educational programs and several of its officers and directors.[42] In its complaint, the SEC alleged that the CEO made false statements and misleading omissions, including a failure to disclose related party payments, a failure to disclose the CEO's prior bankruptcies, and false claims that the CEO had reviewed internal controls when he had not done so. The SEC also alleged that the CEO failed to timely report his securities holdings or file required proxy materials in connection with his effort to regain control over the company following his ouster. The company and two individuals agreed to settle, with the individuals agreeing to ten-year officer and director bars and monetary penalties; the SEC's case against the CEO is being litigated.

In September, the SEC announced a settled fraud action against a Massachusetts-based biopharmaceutical company.[43] The SEC alleged that the company provided misleading information to investors regarding the number of unfilled prescriptions for the company's primary drug, representing that the "vast majority" of patients prescribed the drug ultimately purchased it, when only about half the prescriptions were actually filled. Without admitting or denying the allegations, the company agreed to pay a $4.1 million penalty to settle the charges. The SEC did not charge any individuals, but reported that its investigation is ongoing.

The same month, the SEC settled charges of accounting fraud against a Massachusetts-based medical manufacturer whose foreign subsidiaries allegedly inflated revenues, failed to maintain adequate internal controls, and inaccurately recorded improper payments made to government officials.[44] According to the SEC, the company reported revenue for products that were sitting in warehouses, were subject to sales contingencies, or where shipment to the customer had been postponed. Without admitting or denying the SEC's allegations, the company agreed to pay approximately $13 million in disgorgement, interest, and penalties.

In October, the SEC filed a complaint against a mining company and two of its former executives, alleging that the defendants concealed the decline in value of coal assets purchased in 2012 from investors, among others.[45] The case is being litigated and the SEC is seeking disgorgement and civil penalties among other remedies.

In November, the SEC filed a complaint against a Maryland-based biotech company and four of its former executives.[46] The complaint alleged that the company routinely overstated its financial performance, by, among other things, backdating documents to recognize revenue in earlier periods. While the SEC settled its case against the company upon the company's payment (without admitting or denying the allegations) of a $1.5 million penalty, it is litigating against the executives.

B. Personal Enrichment

One theme of SEC enforcement actions in the latter half of the year was the personal enrichment of corporate executives, whether from undisclosed perks or straight-out embezzlement.

In August, the SEC filed a fraud complaint against the former assistant treasurer of an Ohio-based restaurant chain.[47] The SEC alleged that the defendant diverted $3.9 million from payroll funds to his own accounts and then covered up his theft by falsifying accounting records and making false certifications. After pleading guilty in parallel criminal action to charges of wire fraud and filing a false tax return, the defendant was sentenced to 60 months in prison and restitution. In settling the SEC action, the individual agreed to be barred from serving as an officer or director of a public company or appearing before the SEC as an accountant.

In a similar action filed in November, the SEC initiated settled proceedings against the former Vice President and Controller of a Virginia-based information technology company.[48] Here, too, the SEC alleged that the respondent made unauthorized transfers from the company's payroll accounts to his personal accounts and falsified records to conceal his misappropriation. According to the SEC, the unauthorized transfers totaled $19 million over 10 years. The respondent had previously pleaded guilty to a wire fraud charge and was ordered to pay full restitution of the misappropriated funds. The SEC's settlement included a permanent officer and director bar and a bar from appearing before the SEC as an accountant.

Finally, in December, the SEC charged a biopharmaceutical company, along with its former CEO and CFO, with accounting and disclosure failures stemming from undisclosed perks.[49] According to the SEC, the former CEO and CFO improperly received and then concealed cash advances, reimbursements for expenses never incurred, and various other payments for personal expenses. The company, which fired the executives and took steps to remedy its controls, settled without penalty. Without admitting or denying the allegations, the former CFO agreed to pay over $150,000 in disgorgement and penalties. The SEC is litigating against the former CEO in federal court.

C. Corporate Control Cases

In September, the SEC filed a complaint against a co-founder of an acquired cloud-computing company.[50] The complaint described a scheme in which, after his company was acquired, the co-founder bribed a third-party to enter into contracts designed to allow the acquired company to meet an earn-out target and receive contingent consideration from the acquirer. The contingent consideration totaled $98 million, $30 million of which was paid to the defendant co-founder. The co-founder is litigating both the case brought by the SEC and a parallel criminal proceeding.

And in December, the SEC instituted settled proceedings against the founder and former chairman and CEO of a homebuilding company.[51] The SEC alleged that the respondent failed to disclose in his Schedule 13D his plans to have a proxy appointed to the company's board of directors with the intention of ousting the company's then-CEO. Without admitting or denying the SEC's allegations, the respondent agreed to pay a $33,000 civil penalty.

D. Auditor Cases

The SEC also pursued several cases against audit firms and individual accountants for alleged audit failures. In August, the SEC announced settled proceedings against an accounting firm and the relevant engagement partner based on allegations that their oil and gas company client had significantly overstated the value of its assets.[52] The SEC alleged that the auditors did not adequately consider facts that should have raised doubts as to the company's valuations. Without admitting the allegations, the firm agreed to pay about $6.2 million in disgorgement and penalties, and the engagement partner paid a $25,000 penalty and agreed to be barred from appearing before the SEC as an accountant for two years.

In December, the SEC charged a California-based audit firm, its co-owners, a former partner, and a former audit manager with securities violations relating to audits of multiple penny stock companies.[53] The SEC alleges that the firm and its members ignored indications of fraudulent reporting by three of their audit clients (all penny stock companies) and facilitating the clients' fraud as a result. While two of the firm's partners settled with the SEC and agreed to barred from appearing before the SEC for two to three years, the SEC is continuing to litigate against the remaining parties.

In addition to bringing new auditor cases, the SEC also took measures to enforce previously ordered sanctions. In August, the SEC announced that a Washington-based accountant improperly helped public companies prepare financial statements filed with the SEC despite having been barred, pursuant to Rule 102(e) of the Commission's Rules of Practice, from appearing or practicing before the Commission. The accountant had received a five-year bar in 1999, but remained ineligible to practice because he had never applied for reinstatement. The SEC obtained a court order requiring him to comply with the SEC's earlier order and to disgorge approximately $30,000 in profits from his unlawful engagements.

III. Investment Advisers and Funds

A. Fees and Expenses

The SEC continued to prioritize cases involving inadequate disclosures of advisory fees and expenses, with a particular focus on mutual fund distribution fees, known as 12b-1 fees. In early September, the SEC brought a settled administrative proceeding against a Colorado Springs-based investment adviser serving small to medium-sized non-profit, faith-based organizations that sponsor ERISA Section 403(b) retirement plans for the benefit of their employees.[54] According to the SEC, for more than four years, the adviser recommended, and plan participants and IRA holders held, Class A mutual fund shares when less expensive institutional share classes of the same mutual funds were available. Class A shares may charge investors marketing and distribution fees, typically 25 basis points per year, which went to adviser's affiliated broker-dealer. The SEC alleged that the adviser did not adequately inform its clients of the conflict of interest presented by its recommendations to purchase Class A mutual fund shares, and failed to implement written compliance policies and procedures governing mutual fund share class selection. The adviser agreed to pay total disgorgement of about $25,000.

Less than a week later, the SEC filed a second settled case also involving 12b-1 fees. The SEC charged the Atlanta-based investment services subsidiary of a large bank with improperly collecting more than

$1.1 million in 12b-1 fees from clients by recommending more expensive share classes of various mutual funds when cheaper shares of the same funds were available.[55] The bank agreed to pay a penalty of nearly $1.15 million, and to disgorge any 12b-1 fees it had not yet refunded to clients.

And in a third case relating to 12b-1 fees, the SEC in December sued a dually registered investment adviser and broker-dealer as well as its principal, alleging that they defrauded advisory clients by investing client funds in risky securities that generated hidden mark-ups, in addition to receiving improper 12b-1 fees.[56] The SEC alleges that, over the course of several years, the investment advisory firm purchased securities from underwriters at a markdown from the public offering price. Acting as a principal for its own account, the firm would then mark up and re-sell those securities to its advisory clients. This scheme generated significant amounts of undisclosed compensation. The action is being litigated in federal court.

In October, the SEC sued a former private equity fund partner, alleging that he had secretly billed fund client for nearly $300,000 in personal expenditures, family vacations, hair salon visits, designer clothing, and high-end electronics.[57] According to the SEC, the defendant submitted false expense reports to obtain reimbursement for claimed business expenses that were, in fact, personal expenses; when the firm confronted him about his practices, he agreed to repay the personal expenses but allegedly continued to charge thousands of dollars to the funds he advised. The case is being litigated in federal court.

Finally, in late December, the SEC brought settled charges against a Fort Worth, Texas private equity firm alleging that it inadequately disclosed that upon either the private sale or an initial public offering of a portfolio company, the firm terminated certain portfolio company monitoring agreements and accelerated the payment of future monitoring fees pursuant to the agreements.[58] The SEC acknowledged that the firm did disclose that it may receive monitoring fees from portfolio companies held by the funds it advised, and disclosed the amount of monitoring fees that had been accelerated following the acceleration; but according to the SEC, the firm should have disclosed to the funds' limited partners prior to their commitment of capital that it may accelerate future monitoring fees upon termination of the monitoring agreements. The SEC contended that the after-the-fact disclosure did not cure the conflict of interest resulting from the fee payments. Without admitting the allegations, the firm agreed to pay disgorgement and prejudgment interest of nearly $10 million.

B. <u>Conflicts of Interest</u>

As is typical, many (if not most) adviser cases alleged improper conflicts of interest. In July, the SEC brought settled negligence-based charges against a New York private equity fund adviser.[59] According to the SEC, the adviser, which advises two funds and has an equity stake in each, caused one fund to sell a parking garage to the second fund, and, as part of the transaction, the selling fund was to be reimbursed for $4.5 million worth of expenses incurred in trying to get the parking garage re-zoned ahead of the sale. However, the adviser failed to secure such a reimbursement arrangement from the purchasing fund or to obtain a waiver of payment of the expenses by the selling fund. Without admitting the allegations, the adviser agreed to pay a penalty of $250,000.

Later in July, the SEC announced settled charges against a Seattle-based investment adviser for the firm's failure to disclose the receipt of revenue from a third-party broker-dealer and the resulting conflict of interest.[60] Since at least 2002, the SEC alleged, the adviser participated in an undisclosed revenue-sharing agreement with the broker which created a financial incentive for the adviser to favor mutual funds which made payments to the broker. The SEC also alleged that the adviser negotiated a $1 per trade reduction in clearance and execution costs with its clearing broker yet continued to charge advisory clients the same overall brokerage commission without passing on to them the cost reduction. The SEC noted that the investment adviser did not take into account whether advisory clients continued to receive best execution in light of the increased portion of the charges that the adviser retained. Without admitting the allegations, the firm consented to pay disgorgement of about $380,000 and a $100,000 penalty.

On the same day in October, the SEC brought two unrelated conflict of interest cases. The SEC instituted a settled administrative proceeding against a Newport Beach, California, individual, alleging that while employed by a large registered investment adviser, he cherry-picked profitable trades for his personal accounts.[61] According to the SEC, the adviser purchased and sold securities through an omnibus trading account, and, if the trades made a profit during the day, he would close the position and disproportionately allocate the profitable trades to his personal accounts rather than those of his clients. He consented to a cease-and-desist order, a bar from the securities industry, and a penny stock bar, as well as a payment of nearly $400,000 in disgorgement and penalties. Additionally, the SEC charged the advisory firm with which he was affiliated with failing to supervise its employee and his trading activities, and failing to adopt and implement policies and procedures reasonably designed to prevent preferential trade allocations.[62] The firm agreed to pay disgorgement of $66,071 and a penalty of $100,000.

The same day, the SEC instituted settled proceedings against a Chicago-based investment adviser and two of its principals for an undisclosed conflict of interest.[63] According to the SEC, the respondents caused one of the funds managed by the investment adviser to lend money to two entities in which the adviser's owners held a significant interest without the proper disclosure to, or consent of, the fund's investors. The adviser also lent money from the fund to one of the principals so that he could invest in a business venture with other owners of the investment adviser, and the principal subsequently defaulted on the loan. The SEC also alleged that the respondents used nearly $950,000 in investor funds to pay for the adviser's overhead expenses, including salaries. The adviser and the two principals consented to pay disgorgement and interest of about $725,000 and penalties of $150,000, $75,000, and $50,000, respectively. The two principals agreed to be barred from the securities industry, with a right to apply for reentry after three years. One of the principals also agreed to be suspended from appearing or practicing before the SEC as an accountant.

In December, the SEC charged a private equity fund manager with, among other things, failing to disclose that he was investing client funds in companies that he either owned or in which he held a personal stake.[64] The SEC further alleged that the adviser falsely stated that investor funds would be held in escrow and returned to investors unless $2.5 million was raised, and that he used investor funds to apply for a loan to increase his own interest in the fund, and to buy out the stake of an investor who wanted to exit the fund. The SEC also charged the manager's former associate for improperly soliciting sales of interests in the funds. The manager agreed to pay disgorgement and penalties of approximately

$300,000 and to be barred from the securities industry; his business associate agreed to pay a $10,000 penalty.

C. **Misleading Disclosures**

The SEC also pursued a significant number of cases against investment advisers for myriad disclosure deficiencies and misrepresentations. In July, the SEC announced settled charges against a San Diego-based investment adviser and two of its principals for allegedly overstating the value of two private funds.[65] According to the SEC, the two funds held an interest in a private company which owned one asset, a renewable energy project being developed in Mexico. Although the energy project was unfinanced and construction had not yet begun, the respondents were alleged to have applied unrealistic assumptions regarding the project when determining the valuation of the private company. The principals agreed to pay civil penalties of $50,000 each and to be barred from the securities industry for at least two years.

Also in July, the SEC filed a settled administrative proceeding against two related investment advisers and their principal for a number of alleged misrepresentations and compliance failures.[66] Among other things, the SEC alleged that the respondents failed to comply with the Advisers Act's custody and compliance rules; provided inflated asset valuations to investors; and improperly spent fund assets to pay legal fees for expenses that they incurred in connection with the Commission's investigation. The settlement required a plethora of undertakings, as well as the imposition of a civil money penalty of $150,000.

The next month, the SEC sued a Nevada-based investment adviser and its founder in federal court, alleging that, from 2010 to 2013, the firm misled clients about the performance track record of certain investment strategies.[67] This is one of many cases brought against firms using the strategy obtained from F-Squared, which entered into a settlement with the SEC in 2014 regarding allegedly misleading track records marketed to potential clients. According to the SEC, the firm and founder breached their fiduciary duties by disregarding certain indicators that the investment strategies that it touted as successful in advertising materials were not actually performing well. The firm distributed these advertising materials to both clients and prospective clients. The SEC further alleged that, when the defendants learned of the issue, they sold the business rather than disclose the fraud to investors. The case is being litigated.

In September, the SEC sued a Colorado investment advisory firm and its sole owner, alleging that the defendants raised money for a hedge fund by lying about the owner's past experience as a portfolio manager, his track record, and the owner's personal investment in the fund.[68] In reality, according to the SEC, the owner had very limited fund portfolio management experience and employed a significantly risky investment strategy that he did not disclose to investors, which resulted in a near-total loss of the fund's assets. The case is being litigated.

In October, the SEC sued a Southern California advisory firm and its owner in federal court, alleging that they misled investors about the profitability of a fund they managed until SEC examiners discovered the fraud.[69] According to the SEC, the firm raised $1.7 million from investors for a purported quantitative stock trading strategy; however, the defendants later invested the money in two other investments that ultimately lost approximately $800,000, and they concealed those losses from the investors by issuing false and misleading account statements that made the fund appear to be profitable. The SEC also contended that investors who were able to redeem their interests received more money than they were entitled to because their redemptions were based on inflated asset values. The case is being litigated.

And in December, the SEC charged an Indiana-based private fund manager and two investment advisers he owned with multiple misrepresentations and omissions.[70] According to the SEC, the fund manager used one of the private fund's assets to make a $150,000 unsecured loan to certain individuals without accurately describing the loan to investors, even after the SEC examination staff expressed concerns about the loan. The SEC additionally alleged that the manager made misrepresentations to investors about his investment strategy, failed to disclose payments he received from the custodian of the funds' assets, and failed to comply with the SEC's custody rule. The defendants agreed to pay a $100,000 civil penalty.

D. <u>Misappropriation</u>

In addition to fraud and misrepresentation cases, the SEC brought a number of cases involving outright misappropriation by investment advisers. In August, the SEC sued a Los Angeles investment adviser for allegedly defrauding a high-profile professional athlete and his wife by deceiving them about the investment advisory fees they were paying.[71] The defendant allegedly told the clients that they were being charged a special, VIP rate of between 0.15% and 0.20% of their assets under management, when, in fact, they were being charged and paying 1.0%. In total, the clients paid $1.2 million more than the defendant represented they were paying. According to the SEC, the defendant went to great lengths to conceal his fraud, including by creating false management fee reports for the clients and sending them misleading emails to corroborate his lies. The case is in litigation.

In October, the SEC sued the principal of a New York investment adviser for allegedly stealing millions of dollars from a charitable organization whose investments he managed.[72] The SEC subsequently charged both the attorney and accountant who advised the charity, alleging that they aided and abetted the fraud by ignoring red flags indicative of the adviser's misappropriation.[73] The adviser pleaded guilty to parallel criminal claims, and the attorney and accountant are litigating the claims against them.

And in December, the SEC sued a Washington state investment adviser with fraud based on his misappropriation of fund assets and misrepresentations to retail investors about the financial condition of the funds.[74] The SEC alleged that over a five-year span, the adviser raised more than $20 million from over one hundred investors in three investment funds he controlled while misappropriating hundreds of thousands of dollars of fund assets by, among other things, living rent-free in a home owned by one of the funds and causing the funds to pay other personal expenses, including international travel and federal taxes. The SEC claims that he also induced new investments in one of the funds without disclosing its poor financial condition and repeatedly breached his fiduciary duties to the funds by commingling fund assets to satisfy the funds' liquidity requirements. Also named as a defendant is a

Utah-based investment adviser, charged with concealing additional compensation that he received in connection with sales of interests in one of the funds. The matter is being litigated in federal court.

E. Miscellaneous Cases

In September, the SEC announced settled charges against a Connecticut-based valuation services firm and one of its former experts in connection with improper valuations provided to an investment firm.[75] According to the SEC, the valuation expert failed to perform an independent valuation of four complex options as he had agreed to do, instead providing the investment firm with valuations that were derivative of the investment firm's own valuations. The valuation firm consented to pay disgorgement and penalties totaling around $100,000, about half of which will go to the investment firm as reimbursement for fees it paid for services that it did not receive. The individual agreed to pay a $50,000 penalty and to be barred from the securities industry for one year.

In October, the SEC issued a settled administrative order against a hedge fund advisory firm regarding alleged violations of Rule 105 of Regulation M.[76] According to the SEC's order, on four occasions in 2012 the firm allegedly sold short stocks in companies during the restricted period prior to secondary offerings in which it participated. Without admitting the allegations, the firm agreed to pay over $285,000 in disgorgement, and a penalty of approximately $300,000.

In December, the SEC charged a New York investment adviser, its president, and its Chief Compliance Officer with, among other things, violating Regulation S-P, which requires certain safeguards for the confidentiality of client information.[77] According to the SEC, client records were placed at risk when a former IT specialist forwarded all of the firm's email to an external Gmail account. The SEC also alleged the firm failed to comply with the custody rule and failed to maintain certain required records, despite being cited for such deficiencies in prior SEC examinations. The parties agreed to settle without admitting the allegations, with the firm paying a $50,000 penalty and the former CCO being barred from acting in a supervisory capacity in the securities industry.

And in a somewhat unusual case, the SEC in December announced settled charges against a hedge fund research analyst who shared confidential strategy information with his wife to help her start up her own hedge fund.[78] According to the SEC, the wife's fund used investment information that her husband provided her while competing with her husband's employer. Investors in the wife's fund were unaware of her husband's role in providing advice and investment recommendations. The SEC alleged that the analyst breached the duty of confidentiality he owed to his employer, and that the wife failed to disclose to her fund's investors that the true origins of the investment strategy she was purportedly deploying. The two individuals agreed to pay $200,000 penalties apiece.

One final legal development of note arose in the wake of infamous pharmaceutical fund manager Martin Shkreli's criminal conviction for securities fraud. In August, the SEC sought a securities industry bar based on the conviction. However, in November, an SEC administrative law judge found that Shkreli could not be barred from the securities industry absent a showing that he was associated with an investment adviser at the time of wrongdoing.[79] The ALJ stated that, although his conviction for securities fraud would be a basis for being barred from the industry, it was crucial whether Shkreli was working for an investment adviser at the time he committed the fraud; because the SEC had not yet provided such evidence, the SEC's request for summary disposition was denied.

IV. Brokers and Financial Institutions

A. Supervisory Controls and Internal Systems Deficiencies

In August, the SEC instituted a settled administrative proceeding against a broker and wholly owned subsidiary of an Italian bank for requesting the issuance of, and receiving, American Depositary Receipts (ADRs) without possessing the underlying foreign shares.[80] ADRs are United States securities that represent shares of a foreign company. For all issued ADRs, there must be a corresponding number of foreign shares held in a custody at a depositary bank, or alternatively, pursuant to "pre-release agreements," brokers may obtain ADRs without depositing the corresponding foreign shares if the broker owns or takes reasonable steps to determine that the customer owns the foreign shares that the ADR represents. The SEC's order alleged that the broker did not satisfy the aforementioned requirements, and that the broker's improper handling of ADRs allowed for the possibility that the ADRs could be used for inappropriate short selling or profiting around dividend record dates. The SEC recovered over $35 million in disgorgement, interest, and penalties from the broker, which did not admit or deny wrongdoing. This is the second case this year that the SEC has settled relating to ADRs.

In November, the SEC instituted a settled administrative proceeding against a St. Louis brokerage firm for failing to file Suspicious Activity Reports (SARs).[81] The SEC alleged that new management over the firm's Anti-Money Laundering program created confusion over the filing of SARs, leading to an environment in which the firm's total SAR filings dropped, and the firm failed to file (or timely file) at least 50 SARs. The firm consented to a civil penalty of $3.5 million without admitting or denying the SEC's allegations, and additionally undertook to review and update its policies and procedures and develop additional training. This case follows multiple other cases relating to the failure to file SARs this year.

B. Disclosure and Misrepresentation Cases

In September, the SEC announced two settlements totaling over $35 million with a Massachusetts broker-dealer and trust company, alleging that it (i) charged secret markups for transition management services, and separately (ii) omitted material information about the operation of its platform for trading U.S. Treasury securities.[82] With respect to the markups, the SEC's order alleged that the firm misrepresented its compensation on various transactions for transition management services—services marketed to customers that are undergoing significant changes to portfolios, which often require execution of a large quantity of orders—including the purchase and sale of bonds. The overcharges generated approximately $20 million in improper revenue for the firm, and the firm agreed to pay a $32.3 million penalty to settle the charges. In a separate order, the SEC alleged that the same firm failed to inform customers that its trading platform allowed one subscriber to reject a match to a submitted quote. The subscriber used the functionality to reject numerous matches, without the counterparties knowing that this functionality existed. The firm agreed to pay a $3 million penalty without admitting or denying the allegations.

In November, the SEC instituted a settled administrative proceeding against a New York broker dealer and investment adviser for failing to provide certain retirement and charitable brokerage accounts with sales charge waivers and/or lower fee share classes when selling certain mutual funds.[83] The SEC alleged that the firm disadvantaged certain retirement and charitable account customers by selling them mutual funds without ascertaining their eligibility for less expensive share classes, thus causing those customers to pay higher sales charges and fees than they would in the less expensive share classes. The SEC's order alleged that the firm did not disclose that it would receive greater compensation from the more expensive share classes or that those share classes would negatively impact the overall return on the customers' investments in light of the different fee structures. The firm agreed to a civil penalty of $3.5 million as well as payments and/or conversion to the lower fee share classes without admitting or denying the findings.

C. <u>Cases Against Individual Brokers</u>

Most of the SEC's recent enforcement actions have involved misconduct by individual brokers, rather than larger-scale institutional deficiencies. For example, in July, the SEC announced fraud charges against four former Atlanta-area brokers and the entity through which they were doing business for targeting federal employee retirees by fraudulently inducing them to roll over holdings from Thrift Savings Plan (TSP) accounts into higher-fee variable annuity products.[84] The SEC's complaint alleged that the brokers sold variable annuities of approximately $40 million, generating approximately $1.7 million in commissions, and misled investors concerning the variable annuity investments, including the fees and returns associated with the investments. The complaint additionally alleged that the brokers gave investors the misleading impression that they were affiliated with or approved by the federal government. The matter is being litigated.

In September, the SEC announced fraud charges against three New York-based brokers for making unsuitable recommendations that resulted in substantial losses to customers.[85] The SEC's complaint alleged that the brokers recommended investments that required frequent buying and selling of securities without any reasonable basis to believe their customers would benefit. The complaint further alleged that the brokers churned customer accounts, engaged in unauthorized trading, and concealed material information regarding the costs associated with their recommendations. One broker settled the charges, agreeing to a bar from the securities industry and payment of over $400,000 in disgorgement, interest, and penalties. The matter is being litigated as to the other two brokers.

In October, the SEC announced settled fraud charges against an Indiana broker for charging customers over $2.5 million in excessive commissions.[86] The SEC's complaint alleged that the broker represented to certain customers that the total annual commissions they paid would not exceed certain limits, and then traded in the accounts and generated commissions exceeding those limits. The complaint further alleged that the broker made unauthorized trades, and failed to inform customers that there were fee-based options that could be cheaper than the total annual commissions they paid. In settling the charges, the broker agreed to pay over $5 million in disgorgement, interest, and penalties. Additionally, in a parallel action, the U.S. Attorney's Office for the Southern District of Indiana pursued criminal charges against the broker.

In December, the SEC continued its crackdown on brokers by announcing charges against two registered representatives of a New York-based brokerage firm for making unsuitable trades.[87] According to the SEC's complaint, the brokers conducted short-term "in-and-out" trading, which led to total customer losses of over $500,000 while generating nearly $300,000 in commissions. One individual settled the charges by agreeing to pay disgorgement and a $160,000 penalty, without admitting or denying the allegations, while the other individual is litigating.

Finally, shortly before year-end, the SEC announced charges against a Wall Street broker for accepting over $1 million in kickbacks in exchange for giving certain customers preferential access to lucrative IPOs.[88] The complaint also charged one of the broker's customers who allegedly paid cash to the broker for the preferential allocations. The SEC's complaint alleged that the broker subverted policies and procedures at two brokerage firms where he worked in order to make arrangements with certain customers to give them larger allocations of coveted public offerings, leading to those customers turning a substantial profit in the secondary market at the expense of other customers and the issuers' interest in raising capital from long-term investors. The case is being litigated, and the U.S. Attorney's Office for the District of New Jersey also filed parallel criminal charges against the broker.

V. Insider Trading

A. Classical Insider Trading and Tipping Cases

The SEC's Enforcement Division maintained its steady drumbeat of insider trading cases, big and small, throughout the year.[89] The bulk of the cases involved executives or employees of public companies who traded ahead of market-moving news or tipped nonpublic information to friends and family members.

Notably, several recent cases involved IT personnel who obtained confidential information about their companies through their access to sensitive internal data. For example, in July, the SEC instituted settled proceedings against a former IT administrator of a biometrics company who traded after he learned that his company would be acquired by a major technology company.[90] According to the SEC, the trades earned the administrator approximately $136,000 in profits. The administrator agreed to pay nearly $280,000 in disgorgement and penalties to settle the charges, without admitting or denying the allegations. Then, in September, the SEC announced charges against seven individuals who generated millions in profits by trading on confidential information about dozens of pending mergers and acquisitions.[91] The SEC alleged that an IT employee at a large investment bank was at the center of the alleged scheme and misused his access to the bank's computer system to learn about confidential pending business combinations, information which he repeatedly passed to multiple individuals. According to the SEC, these individuals took steps to conceal their trades, including communicating via coded conversations and in-person meetings, trading in third-party and shell company accounts, and using encrypted, self-destructing smartphone messaging applications. The SEC detected the fraudulent scheme through the SEC Market Abuse Unit's Analysis and Detection Center, which uses data analysis tools to detect suspicious patterns such as the improbability of successfully trading across different securities over time. The United States Attorney also filed parallel criminal charges against the individuals.

In August, the SEC charged a former accountant at a pharmaceutical company with tipping two friends about the company's clinical drug trial results and its pending acquisition.[92] The SEC alleged that the two friends purchased company stock based on the insider information, with one of the friends also passing the tips to his father, all of whom traded ahead of the announcements. The matter is being litigated. The United States Attorney announced parallel criminal charges against the four individuals.

In September, the SEC brought charges against the former CEO of a Silicon Valley-based fiber optics company for allegedly generating more than $2 million in profits by trading ahead of earnings announcements and the company's merger, and tipping his brother about the announcements.[93] According to the SEC, the CEO took steps to conceal his trading activity by using secret brokerage accounts held in his wife's and brother's names, and obscuring his relationship with his wife in response to regulatory inquiries. The matter is being litigated. The United States Attorney's Office also filed criminal charges against the CEO.

Also in September, the SEC charged a former financial analyst of a large online retailer, his college friend, and the friend's trading partner for trading ahead of the company's earnings announcement.[94] The SEC alleged that the former analyst shared insider information with a fraternity brother, who, in turn, then "predicted" the company's results on multiple trading platform sites, with statements such as the "numbers are so obvious" that a "5 year old can guess what they will do," and also shared the information with his trading partner. Two of three individuals settled the charges with the SEC. The United States Attorney's Office also announced parallel criminal charges against the financial analyst.

Later in September, the SEC filed charges against a vice president of a fitness club chain and six other individuals for trading ahead of the company's announcement that it was being taken private.[95] According to the SEC, the vice president tipped a friend—who in turn tipped additional friends—with the understanding that they would share in the profits of the illegal trades. Parallel criminal charges were also filed against the individuals.

In yet another September action, the SEC instituted settled proceedings against a former executive of a Canadian affiliate of a Chinese oil company who tipped a friend about an acquisition being planned by his company.[96] According to the SEC, the friend traded on the information and asked another friend to buy stock on his behalf, netting over $76,000 in profits. To settle the charges, the executive and his friend agreed to disgorge their profits and pay penalties, without admitting or denying the allegations.

One day later, the SEC charged a Southern California tech manager with tipping several family members about his company's impending acquisition of another company.[97] The SEC alleged that prior to the acquisition's public announcement, the employee and his family bought stock in the target company, which they then liquidated post-announcement, generating $215,000 in profits. The matter is being litigated.

In November, the SEC announced a settled action against a former petroleum engineer of a Texas energy company, who had allegedly traded ahead of an announcement that the company had discovered a significant new oil source.[98] According to the SEC, the engineer traded in the days and weeks leading up to the announcement, amassing nearly $215,000 in profits. Without admitting or denying the allegations, the engineer agreed to pay approximately $435,000 in disgorgement and penalties.

Finally, in December, the SEC charged a procurement officer at an Arizona technology company with trading in his company's stock after learning the company was being acquired.[99] According to the SEC, the employee tipped a friend, who agreed to help conceal the trading by placing trades in his own account and to use the proceeds to pay the insider's personal expenses. The two agreed to settle the charges for $410,000 in penalties and disgorgement, with a credit for payments made in resolving a parallel criminal case.

B. Misappropriation by Friends & Family

Many of the insider trading cases instituted in the latter half of the year involved individuals who misappropriated confidential information from friends or family members. For example, in July, the SEC filed insider trading charges against a research scientist who allegedly traded on confidential information learned from his wife, a law firm associate who worked on various mergers and acquisitions.[100] The SEC alleged that the scientist took multiple steps to evade detection, including executing the trades in the name of his mother, who lived in China, and searching the internet for "how sec detect unusual trade." The scientist is alleged to have made approximately $120,000 trading in advance of various acquisition announcements, which the SEC flagged as suspicious through data analysis. The United States Attorney also filed parallel criminal charges against the scientist, to which he later pled guilty. Similarly, in August, the SEC charged the husband of a senior employee of a semiconductor company with trading ahead of the company's acquisition.[101] The SEC further alleged that the husband tipped two family members and a friend about the transaction; all told, the four traders netted approximately $155,000 in illicit profits. Without admitting or denying the allegations, the four individuals agreed to pay approximately $475,000 in disgorgement and penalties.

In another case filed in July, the SEC charged an individual with reaping nearly $300,000 in profits trading ahead of the acquisition of a Louisiana energy construction company.[102] The SEC alleged that, shortly before opening the brokerage account in which he placed the trades, the trader had multiple communications with two individuals (including his sister) who had personal relationships with an employee of the construction company who was privy to information about the acquisition.

The following month, the SEC filed new charges in connection with a high-profile tech merger.[103] The SEC had previously charged two individuals with insider trading without alleging how the traders obtained the information. After further investigation, the SEC charged a third individual, one of whom was the brother of one of the traders, with learning confidential information through a personal relationship he had with the founders of one of the companies. According to the SEC, the traders made over $925,000 trading ahead of the merger. The cases is being litigated

In October, the SEC charged a New Jersey doctor with trading on confidential information about an acquisition that he learned from his friend, an executive of the company making the acquisition.[104] The SEC alleged that the doctor made over $8,330 in profits from insider trading prior to the acquisition announcement. Without admitting or denying the allegations, the doctor agreed to pay approximately $34,000 in disgorgement and penalties.

And in December, the SEC brought charges against an individual who traded after learning confidential information from his brother, who worked at a biotech company.[105] According to the SEC, the individual made over $107,000 trading in advance of the company's announcement of positive clinical drug test results for the company's cancer drug, information which his sibling had shared with him in confidence. The trader agreed to settle the charges, without admitting or denying the allegations, by paying $226,000 in penalties and disgorgement.

C. Misappropriation by Accountants and Other Outside Consultants

In September, the SEC charged a former accountant at an audit firm with tipping his relative about an acquisition planned by his audit client.[106] According to the SEC, the individual told his relative that the acquisition was a "sure thing," prompting the relative to immediately purchase options ultimately generating nearly $24,000 in profits. To settle the charges, and without admitting or denying the allegations, the former accountant agreed to pay a penalty, and his relative agreed to pay a penalty plus disgorgement.

Also in September, the SEC charged a CPA providing consulting services to an advertising technology company with insider trading after he was asked to provide accounting advice in connection with the company's pending acquisition.[107] The SEC alleged that immediately after learning about the nonpublic acquisition offer, the CPA purchased more than 18,000 shares of company stock, which he then sold after the public announcement, for a profit of about $8,000. The matter is being litigated.

And in a somewhat more unusual case, the SEC in December charged a therapist with improperly trading based on information that he learned during confidential counseling sessions with a company employee.[108] According to the SEC, after learning from a patient that the patient's company was about to be acquired, the therapist purchased the company's stock, earning approximately $10,000 in profits. Without admitting or denying the allegations, the therapist agreed to pay a total of about $21,000 in disgorgement and penalties.

D. Other Trading Cases and Developments

The SEC continued its focus on investment advisers lacking adequate controls around the protection of nonpublic information. In August, a hedge fund manager agreed to pay more than $4.6 million to settle charges that it failed to establish, maintain, and enforce policies designed to prevent the misuse of insider information.[109] The SEC had previously filed individual charges against one of the hedge fund's analysts for allegedly trading on insider information passed to him from government sources.

In September, the SEC charged a stock market analyst with insider trading prior to the publication of research reports he authored.[110] The SEC alleged that the analyst misled investors by representing that he was not trading or holding stocks he was writing about while secretly trading the same stocks based on the nonpublic information about the publication date of his research. The SEC also charged two other financial advisors who shared information with the analyst. All three agreed to settle the charges in return for disgorgement of profits, payment of penalties, and a lifetime bar on trading penny stocks. The financial advisors also agreed to a bar in working in the securities industry.

Finally, the legal fallout has continued from last year's Supreme Court decision in *Salman v. US*, in which the Court held that a gift of inside information was sufficient to establish insider trading liability even in the absence of pecuniary benefit to the tipper. In August, the Second Circuit issued a divided decision construing the personal benefit element of an insider trading violation. In *US v. Martoma*, the court affirmed the defendant's conviction for insider trading, finding that a "meaningfully close personal relationship" was not a requisite to infer that the tipper received a personal benefit from his "gift" of inside information.[111] The defendant, who was convicted in February 2014 and sentenced to nine years in prison, had argued that he did not have a meaningfully close relationship to sustain his conviction after trading on a tip from two casual acquaintances in advance of the public release of poor drug trial results.

VI. Municipal Securities and Public Pensions Cases

After several years in which the SEC's Public Finance Abuse Unit generated a large number of enforcement actions—primarily through the Enforcement Division's Municipalities Continuing Disclosure Cooperation (MCDC) Initiative, under which the SEC brought several large sweeps against muni bond issuers and underwriters who self-reported continuing disclosure deficiencies—the Unit has returned to its traditionally slower pace, with three enforcement cases announced in the latter half of the year.

In August, the Beaumont, California Municipal Financing Authority and its then-executive director agreed to settle charges that they made false statements about prior compliance with continuing disclosure obligations in five bond offerings from 2012 through 2013.[112] According to the SEC, the city failed to provide investors with annual continuing disclosures regarding the performance of 24 separate bond offerings. The SEC also charged the underwriter of the bond offerings and one of its investment bankers for conducting inadequate due diligence in determining whether the bond issuer was in compliance with its disclosure obligations. Without admitting the allegations, Beaumont agreed to retain an independent consultant to review its policies and procedures, and its former executive director agreed to pay a $37,500 penalty, in addition to agreeing to be barred from future municipal offerings. The underwriter agreed to pay a $150,000 penalty and retain an independent compliance consultant to review its, policies and procedures, and its principal agreed to pay a $15,000 penalty and serve a six-month suspension from the securities industry. The SEC noted that the parties would have been eligible for more lenient penalties had they self-reported during the MCDC Initiative.

In November, the SEC charged the Town of Oyster Bay, New York, and its former top elected official with defrauding investors in the town's municipal securities offerings by concealing the existence of side deals with a businessman who owned and operated restaurants and concession stands at several town facilities.[113] The SEC's complaint alleges that the town guaranteed more than $20 million in private loans to the concessionaire, in part stemming from his political support and kickbacks to town officials. According to the SEC, the financial arrangements were material to bond investors due to the potential impact on the town's finances. Parallel criminal charges were also filed against the then-town supervisor by the U.S. Attorney's Office for the Eastern District of New York. The case is being litigated.

Finally, in December, the Commission charged the former mayor of Markham, Illinois with engaging in a "pay-to-play" scheme by soliciting and receiving a $75,000 bribe from a construction contractor in association with a $5.5 million 2012 municipal bond offering.[114] In exchange for the alleged bribe, the mayor allegedly promised to steer a multi-million dollar city construction project to the contractor. The official agreed to partially settle the SEC's charges by agreeing to be barred from future municipal bond offerings and to pay disgorgement and penalties in amounts to be determined by a federal judge.

In addition to the Enforcement Division's filings, the SEC's Office of Compliance Inspections and Examinations (OCIE) published a risk alert titled "Observations from Municipal Advisor Examinations," outlining the results of 110 examinations of municipal advisors.[115] The key takeaway was that municipal advisors should take steps to educate themselves regarding their compliance obligations. "Exam staff frequently observed deficiencies in [municipal advisor] compliance with regulatory obligations regarding registration, recordkeeping, and supervision." The Risk Alert went on to outline numerous violations that were observed, primarily relating to registration and recordkeeping. In addition to more technical violations, some firms were referred to the Enforcement Division as a result of conduct uncovered during the examination. The example cited was an advisor that breached its fiduciary obligation by failing to disclose a conflict of interest to a municipal client.

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[1] *See* Gibson Dunn, 2017 Mid-Year Securities Enforcement Update (Jul. 18, 2017), *available at* www.gibsondunn.com/publications/Pages/2017-Mid-Year-Securities-Enforcement-Update.aspx.

[2] Dave Michaels, Senate Confirms Robert Jackson, Hester Peirce to Join SEC, WSJ (Dec. 22, 2017), *available at* www.wsj.com/articles/senate-confirms-robert-jackson-hester-peirce-to-join-sec-1513955157.

[3] Hazel Bradford, SEC Nominees Commit to Revisiting Regulations, Holding Executives Accountable, Pensions & Investments (Ot. 24, 2017), available at www.pionline.com/article/20171024/ONLINE/171029926/sec-nominees-commit-to-revisiting-regulations-holding-executives-accountable.

[4] SEC Speech, Stephanie Avakian, The SEC Enforcement Division's Initiatives Regarding Retail Investor Protection and Cybersecurity (Oct. 26, 2017), *available at* www.sec.gov/news/speech/speech-avakian-2017-10-26.

[5] SEC Speech, Andrew Ceresney, Financial Reporting and Accounting Fraud (Sept. 19, 2013), *available at* www.sec.gov/news/speech/spch091913ac.

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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.

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