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# 2018 YEAR-END SECURITIES ENFORCEMENT UPDATE

To Our Clients and Friends:

## I. Introduction: Themes and Developments

### A. 2018 In Review

The Securities and Exchange Commission, like most federal agencies, ended 2018 with a whimper, not a bang. Most staffers were furloughed as part of the federal government shutdown, a note on the SEC homepage cautioning that until further notice only a limited number of personnel would be on hand to respond to emergency situations.

The shutdown curtailed the Division of Enforcement's ability to close out the year with a raft of last-minute filings, not to mention causing most SEC investigations to grind to a halt. That said, between the December 27 shutdown and the date of this publication, the SEC did manage to institute two enforcement actions – a settlement with a car rental company for accounting errors occurring between 2012 and 2014[1]; and a settlement with a small accounting firm for failing to comply with the Custody Rule in connection with audits of an investment adviser conducted between 2012 and 2015.[2] Given the age of the conduct, it is unclear the nature of the "emergency" requiring unpaid SEC staffers to come to work in the midst of the shutdown to release these two particular cases, though perhaps an impending statute of limitations was to blame.

While the shutdown may have cut the Enforcement Division's year short, it was more than compensated for by the flurry of actions filed as the agency's September 30 fiscal year-end loomed. Indeed, the SEC issued nearly a dozen press releases announcing enforcement actions on the last three days of the fiscal year, including several significant cases involving prominent public companies and financial institutions.

The (fiscal) year-end rush appeared intended to blunt some of the criticism of the Enforcement Division's productivity in the new administration. After filing 446 new stand-alone enforcement actions in fiscal 2017, an over 18% drop from the 548 actions filed in 2016, the docket recovered somewhat in 2018, with the SEC filing 490 new actions.[3] (The SEC's tally of "stand-alone" enforcement actions excludes "follow-on" proceedings sanctioning individuals separately charged for violating the securities laws, and routine administrative proceedings to deregister the stock of companies with delinquent SEC filings.) While still falling short of the final years under the prior SEC and Enforcement Division leadership, the current Division Directors were quick to note in their Annual Report that the 2015 and 2016 results were somewhat skewed by the SEC's Municipalities Continuing Disclosure (MCDC) Initiative, under which municipal securities issuers and underwriters who self-reported disclosure violations to the Division received leniency. The initiative produced nearly 150 enforcement actions; stripped of those matters, the 2018 results actually exceeded those of recent years.

The Division Directors further explained that these results were achieved notwithstanding a hiring freeze in place at the SEC since the onset of the Trump administration, and the Division's Annual Report included a plea for additional resources. As stated in the Report, "While this achievement is a testament to the hardworking women and men of the Division, with more resources the SEC could focus more on individual accountability, as individuals are more likely to litigate and the ensuing litigation is resource intensive." The Directors also noted the challenges posed by the Supreme Court's decision in *Kokesh v. SEC*, which confirmed a strict five-year statute of limitations on SEC demands for disgorgement[4], as well as the Court's more recent decision in *Lucia v. SEC*, which held that the SEC's method of appointing its administrative law judges violated the Appointments Clause of the U.S. Constitution and has necessitated the potential re-litigation of myriad administrative proceedings.[5]

Thematically, the Enforcement Division (as well as SEC Chairman Clayton) repeatedly reiterated their focus on protecting "retail" or "Main Street" investors. Indeed, the Division's Annual Report invoked the word "retail" no fewer than twenty-six times. (A close second was "cyber," another Division priority, which appeared twenty-four times in the Report.) The "retail" focus has led the SEC to highlight cases in which average investors appear to be victimized, particularly offering frauds, pump-and-dump-schemes, and misconduct by investment advisers and broker dealers directed at individual clients. For fiscal 2018, according to the Annual Report, securities offering cases (which range from Ponzi schemes to various disclosure and registration violations in connection with securities offerings) comprised 25% of the year's enforcement actions, the largest single category. Cases against investment advisers and investment companies were just behind at 22% of the caseload; and while the SEC continues to bring cases involving private funds and institutional investors, the lion's share of investment adviser cases fit within the SEC's "retail" focus.

Despite efforts in recent years for the Enforcement Division to renew its scrutiny of public company financial reporting and disclosure – which in the past had often been the top category of SEC enforcement actions, representing a quarter or more of the docket – such cases comprised only 16% of the SEC's enforcement actions in 2018. Rounding out the docket were cases involving broker-dealers (13%), insider trading (10%), and market manipulation (7%); FCPA cases and public finance abuse checked in at 3% of the enforcement filings apiece.

### B. Whistleblowers

The whistleblower bounty program enacted as part of Dodd-Frank continues to grow apace with each new year. In its November 2018 annual report to Congress, the SEC's Office of the Whistleblower reported that the program had once again netted a record number of tips.[6] A total of 5,282 whistleblower complaints were received in fiscal 2018, up nearly 18% from 2017. (The report noted that the Whistleblower Office appears to have its share of vexatious whistleblowers who submit an "unusually high" number of tips, which are excluded from the tally.)

As with enforcement cases ultimately filed by the Enforcement Division in 2018, the largest single category for tips for 2018 was offering frauds, representing 20% of all complaints; tips concerning corporate disclosures and financials were a close second, representing 19% of the complaints.

The SEC has also continued to announce large award payments to whistleblowers whose tips led to successful enforcement actions. In September, the SEC announced that it had awarded $39 million to a single whistleblower, the second highest award in the history of the program; the same investigation also resulted in a $15 million payment to a second whistleblower.[7] However, due to the whistleblower regulations' confidentiality requirements, the nature of the enforcement action resulting in these awards is not reported.

The SEC announced two additional whistleblower awards later that same month. First, the SEC reported a $1.5 million payment, while noting that "the award was reduced because the whistleblower did not promptly report the misconduct and benefitted financially during the delay."[8] And in a second case, the SEC awarded $4 million to an overseas whistleblower, touting the important service that even those outside the U.S. can provide to the SEC.[9] The SEC further heralded the tipster's continuing assistance throughout the course of the investigation.

According to its most recent release, the SEC has now awarded over $326 million to 59 individuals under its whistleblower program.

### C. Cybersecurity and Cryptocurrency

As noted above, the SEC's Enforcement Division remains acutely focused on all things "cyber." While this has manifested itself primarily, in recent months, on enforcement actions involving cryptocurrency and digital assets, the Division also had several noteworthy firsts in matters of cybersecurity in the latter half of the year.

First, in September, the SEC brought its first enforcement action alleging violations of the Identity Theft Red Flags Rule.[10] The SEC alleged that a broker-dealer lacked adequate safeguards to prevent intruders from resetting contractor passwords in order to gain access to personal information about certain customers. Without admitting the allegations, the firm agreed to pay a $1 million penalty and to retain a consultant to evaluate its compliance with the Safeguards Rule and the Identity Theft Red Flags Rule.

Then, in October, the Enforcement Division issued a report on its investigations of nine public companies which had been victimized by cyber fraud.[11] According to the SEC, attackers had used fraudulent emails to pose as executives or vendors in order to dupe company personnel into sending about $100 million (in the aggregate) into bank accounts controlled by the perpetrators. The SEC declined to charge the companies with wrongdoing, but cautioned companies that the internal controls provisions of the federal securities laws require them to ensure they have adequate policies and procedures to mitigate such incidents and safeguard shareholder assets.[12]

But most of the high-tech action happened on the cryptocurrency front, with the Enforcement Division similarly touting a number of firsts. Most of these actions related to registration-related conduct engaged in after the Commission's 2017 DAO Report, in which the Commission concluded that digital assets may be securities under the federal securities laws.

In September, the SEC settled an action against a so-called "ICO superstore" and its owners for acting as unregistered broker-dealers by operating a website that permitted visitors to purchase tokens in ICOs and engage in secondary trading.[13] This was the first case in which the SEC charged unregistered broker-dealers for selling digital assets. Collectively, the company and owners paid nearly $475,000 in disgorgement, while the owners also paid $45,000 each in penalties and consented to industry and penny stock bars and an investment company prohibition with a right to reapply after three years.

The same day, the SEC found for the first time that a hedge fund manager's investments in digital assets constituted an investment company registration violation.[14] According to the SEC, the fund falsely claimed to be regulated by and to have filed a registration statement with the SEC, and raised more than $3.6 million in four months. It also engaged in an unregistered public offering and invested more than 40% of its assets in digital asset securities. The fund and its sole principal consented to pay a combined $200,000 penalty to settle the case.

In November, the SEC settled an action against the founder of a digital token-trading platform, finding for the first time that such a platform operated as an unregistered national securities exchange.[15] The platform in question matched buyers and sellers of digital assets, executed smart contracts, and updated a distributed ledger via the Ethereum blockchain, among other things. The founder consented to disgorge $300,000 and pay a $75,000 penalty. The SEC noted that its investigation remains ongoing.

Also in November, the SEC settled actions against two technology companies for failing to register their ICOs pursuant to federal securities laws.[16] Both companies raised over $10 million worth of digital assets to fund their respective business ventures. These were the first cases in which the SEC imposed civil penalties solely for ICO-related registration violations. The companies consented to return funds to investors, register their tokens as securities, file periodic reports with the SEC for at least one year, and pay $500,000 in total penalties.

That same month, the SEC also for the first time brought actions against individuals for improperly promoting ICOs. The SEC settled actions against two celebrities for their respective failures to disclose that they were being compensated for promoting upcoming ICOs on their social media accounts.[17] The celebrities received approximately $350,000 in total for their promotions, all of which they were required to disgorge, along with $400,000 in total penalties. The celebrities also consented to a combined five-year ban on promoting any security.

The second half of this year also saw the SEC crack down on ICOs claiming to be registered with the SEC. In October, the SEC suspended trading of a company's securities after the company issued two press releases falsely claiming to have partnered with an SEC-qualified custodian for use with cryptocurrency transactions and to be conducting an "officially registered" ICO.[18] Also in October, the SEC obtained an emergency court order halting a planned ICO that falsely claimed to be SEC-approved.[19] On October 11, a federal judge froze the assets of the defendants—the company and its founder. Notably, in one of the few setbacks to the SEC's aggressive enforcement program in the cryptocurrency space, the same judge subsequently denied the SEC's motion for a preliminary injunction, finding that the Commission had failed to show that the digital asset offered in the ICO was a security subject to federal securities laws.[20] Litigation remains ongoing.

Finally, September saw the SEC file a litigated action against an international securities dealer and its CEO for soliciting investors to buy and sell securities-based swaps.[21] The SEC filed the case after an undercover FBI agent allegedly purchased securities-based swaps on the company's platform despite not meeting the required discretionary investment thresholds. The SEC alleged that the company failed to register as a security-based swaps dealer and transacted the securities-based swaps outside of a registered national exchange.

## II. Issuer and Auditor Cases

### A. Accounting Fraud and Internal Controls

In July, the SEC charged a drainage pipe manufacturer and its former CFO with reporting and accounting violations.[22] According to the SEC, the company allegedly overstated its income before taxes from 2013-2015 as a result of insufficient internal accounting controls, improper accounting, and "unsupported journal entries directed or approved" by the former CFO. Without admitting or denying the allegations, the company agreed to pay a $1 million penalty while the CFO agreed to pay a $100,000 penalty, reimburse the company approximately $175,000 in stock sale profits, and be barred from practicing as an accountant before the SEC.

In early September, the SEC announced a settlement with a telecommunications expense management company and three members of the company's senior management related to allegedly fraudulent accounting practices.[23] According to the complaint, the company prematurely reported revenue for work that had not been performed or for transactions that did not actually produce revenue. The SEC also alleged that the company's former senior vice president of expense management operations falsified business records that were provided to auditors. The company and three executives agreed to pay a combined penalty of $1.67 million to settle the allegations. The litigated action against the senior VP of expense management operations remains pending.

Later that month, the SEC charged a U.S.-based CFO of a public company in China with using his personal bank account to transfer over $400,000 in corporate funds from China to the U.S. to pay the company's U.S. expenses.[24] The SEC's complaint alleged that he had previously engaged in the same practice for at least two other China-based public companies. The SEC contended that the commingling of corporate and personal funds put the company's assets at risk of misuse and loss, and that the CFO had failed to implement an adequate set of internal accounting controls. The CFO agreed to settle the charges without admitting wrongdoing, agreeing to pay a $20,000 fine and to be barred from serving as a public company officer or director for five years.

Also in September, the SEC initiated enforcement actions against a business services company, its former CFO, and the company's former controller related to allegations of accounting fraud.[25] The complaint alleged that the CFO manipulated the company's books to hide the increasing expense of its workers' compensation relative to revenue from its independent auditor. When the company announced that it needed to restate its financial results to reflect the actual workers' compensation expenses, the stock price fell by 32%. Without admitting or denying the allegations, the company agreed to pay $1.5 million to settle the charges, and the controller, who allegedly approved some of the CFO's accounting entries, agreed to pay $20,000 and be suspended from appearing before the SEC as an accountant for one year. The case against the CFO is being litigated, and he has also been charged criminally by the United States Attorney's Office for the Western District of Washington. The company's CEO, who was not charged with wrongdoing, agreed to pay the company back his $20,800 in cash bonuses received during the period of the alleged accounting violations.

The following day, a pipeline construction company agreed to settle charges that it failed to implement adequate internal accounting controls, and failed to adequately evaluate its control deficiencies when assessing the effectiveness of its Internal Control over Financial Reporting ("ICFR"), after problems with its revenue recognition surfaced.[26] According to the SEC, the company used contingent cost estimates to cover potential risks inherent in a project that could add unanticipated expenses to its total costs. The company failed to implement adequate controls around its contingent cost estimates, despite recognizing that such estimates were critical for properly recognizing revenue. Without admitting liability, the company agreed to pay a $200,000 civil penalty.

Later in September, the SEC announced a settled action against a pharmaceutical company and its former CFO for allegedly understating the amount of inventory held by its wholesaler customers, which occurred as a result of the company flooding its distribution channel with products.[27] According to the complaint, this created more short-term revenue at the expense of future sales. Without admitting or denying the allegations, the company agreed to be enjoined from future violations and the former CFO agreed to pay approximately $1 million in penalties and disgorgement, be subject to an officer and director bar for five years, and to be barred from appearing before the SEC as an accountant with a right to apply for reinstatement after five years.

In a November case involving the Kenyan subsidiary of a U.S.-based tobacco company, the SEC charged that managers at the subsidiary overrode existing internal controls and failed to report accounting errors to the parent company.[28] As a result, the parent company filed materially misstated financial statements for more than four years, including errors to its inventory, accounts receivable, and retained earnings numbers. The parent company agreed to settle the internal controls violations on a no admit/no deny basis. The SEC imposed a cease-and-desist order, noting the company's remedial actions already undertaken, including sharing the results of its internal investigation with the SEC, hiring new accounting control positions within the African region, and implementing new internal accounting control procedures and policies.

In December, the SEC filed a complaint against a multinational agricultural company and its executive chairman, alleging that they concealed substantial losses by improperly accounting for the divestiture of its China-based operating company.[29] According to the SEC, the company overstated the value of stock received in the transaction and assigned a value of nearly $60 million to worthless land use rights. The company agreed to pay a $3 million penalty and to cooperate with the SEC in future investigations, without admitting or denying the allegations. Additionally, the CEO agreed to pay $400,000 and accept a five year officer and director bar.

The next day, the SEC brought charges against a natural food company stemming from alleged weaknesses in the company's internal controls regarding end-of-quarter sales practices that helped the company meet its internal sales targets.[30] According to the SEC, the company's sales personnel regularly offered incentives to customers to move inventory near quarter-end, including the right to return products that expired or spoiled prior to ultimate purchase, cash incentives, substantial discounts, and extended payment terms. The company had failed to implement adequate controls to both detect and document these practices. According to the SEC's press release, no monetary penalties were imposed based on the company's self-reporting to the SEC and significant remediation efforts, which included significant organizational changes and changes to its revenue recognition policies.

Also in December, the SEC also instituted settled proceedings against a publicly-traded issuer of subprime automobile loan securities related to allegations that the company failed to accurately calculate its credit loss allowance from certain impaired loans and failed to segregate those loans from its general loan assets.[31] The SEC also alleged that flaws in the company's internal controls led to its errors in calculating credit loss allowance and caused the company to restate its financial statements twice in a one-year period. Without admitting or denying the allegations, the company agreed to pay a $1.5 million penalty.

Finally, the SEC brought a settled proceedings against five separate companies for filing quarterly financial forms without having their financial statements reviewed in advance, which is a violation of Regulation S-X.[32] The SEC announced the charges against all five companies in a single press release, and each company agreed to remedial action, including payment of penalties ranging from $25,000 to $75,000.

### B. Misleading Disclosures

Beyond the accounting-related cases discussed above, the SEC pursued an unusual number of cases based on misleading disclosures by public companies in the latter half of the year.

#### *Misleading Metrics*

Many of the disclosure cases instituted by the SEC involved the use of allegedly misleading metrics of interest to investors.

In July, the SEC filed settled proceedings against an engineering and construction company related to allegations that it inflated a key performance metric and had various accounting control deficiencies.[33] According to the SEC's order, the company's "work in backlog" metric, which measured the revenue the company expected to earn from future firm orders under existing contracts, improperly included at least $450 million from orders that the company had not received. Additionally, the SEC alleged that the company's deficient accounting controls caused it to make inaccurate estimates of the costs to complete seven contracts, leading the company to restate its earnings. Without admitting wrongdoing, the company agreed to pay a $2.5 million penalty.

In August, the SEC separately instituted proceedings against a cloud communications company and two of its executives as well as executives at two online marketing companies related to allegations that they provided misleading numbers to investors. In the first order, the SEC alleged that the company projected first quarter 2015 revenue of $74 million based on improperly reclassified sales forecasts when the CFO was aware of red flags that undermined confidence in that figure.[34] Just a week before the end of the quarter, the company announced revenue projects that were approximately $25 million lower, causing the stock price to fall 33%. Without admitting wrongdoing, the company agreed to pay $1.9 million and the two executives agreed to pay penalties ranging from $30,000 to $40,000. In the second complaint, the SEC alleged that the former CEO and CFO of two online marketing companies, which formed a parent-subsidiary relationship in 2016, knowingly provided inflated subscriber figures.[35] These charges arose out of a settled enforcement action the SEC brought against the companies themselves in June, in which the parent company agreed to pay a $8 million penalty. Without admitting or denying the allegations, the two executives agreed to pay $1.38 million and $34,000, respectively.

In September, the SEC announced a settled action with a payment processing company and its CEO.[36] According to the SEC's allegations, the company materially overstated a key operating metric that caused research analysts to overrate the company's stock and promoted it in its filings with the SEC, even though both the company and CEO had reason to know that the metric was inaccurate. Without admitting or denying the allegations, the company agreed to pay a penalty of $2.1 million while the former CEO agreed to pay $120,000.

Finally, in a relatively novel action, the SEC settled charges against a seller of home and business security services for failing to afford equal or greater prominence to comparable GAAP earnings measures in two of its financial statements containing non-GAAP measures.[37] While the SEC has highlighted concerns about the prominence of non-GAAP metrics previously, this appears to be the first case in which that issue alone has resulted in an enforcement action. Without admitting or denying the allegations, the company agreed to pay $100,000 to settle the matter.

***Executive Perks***

The SEC also brought several cases involving executive perks. In July, the SEC announced a settlement with a chemical company related to charges that the company allegedly failed to adequately disclose approximately $3 million in perquisites given to its CEO in its 2013-2016 proxy statements.[38] The SEC alleged that the company failed to disclose personal benefits not widely available and not integrally and directly related to an executive's job duties. The company agreed to pay a $1.75 million penalty and hire an independent consultant to help implement new perquisite disclosure policies.

Also in July, the SEC alleged that the CEO of an oil company hid approximately $10.5 million in personal loans from a company vendor and a prospective member of the board.[39] Additionally, the SEC alleged that the CEO received undisclosed compensation and perks, and that the company failed to report more than $1 million in excess compensation in its disclosures. Without admitting or denying the SEC's allegations, the CEO agreed to pay a $180,000 penalty and be subject to a five year bar from serving as an officer or director of a public company. The board member also agreed to pay a penalty.

***Other Disclosures***

In July, the SEC instituted settled proceedings against a publicly-traded real estate investment trust and four executives, alleging that they failed to adequately disclose certain cashflow issues and the status of real property within its portfolio.[40] The parties agreed to settle the charges without admitting or denying the allegations.

In September, the SEC instituted proceedings against an industrial waste water treatment company and two senior executives, alleging that they failed to disclose to investors certain contractual contingencies that had not occurred in a material contract with Nassau, New York.[41] To settle the allegations, without admitting or denying the SEC's findings, the company agreed to pay $133,000 in penalties, disgorgement, and pre-judgment interest and the two executives agreed to pay civil penalties of $60,000 and $35,000 respectively.

Also in September, the SEC announced a settlement with SeaWorld Entertainment Inc. and its former CEO.[42] The SEC's complaint alleged that the company and its CEO failed to adequately disclose the damaging impact a critical documentary had on the company's business. Without admitting or denying the allegations, the company and former CEO agreed to pay $5 million in penalties and disgorgement. A former vice president of communications also agreed to pay $100,000 in disgorgement and prejudgment interest, without admitting or denying the allegations.

That same day, the SEC filed a settled action against a biopharmaceutical company, its CEO, and former CFO, related to allegations that the company failed to timely disclose questions about the efficacy of its flagship lung cancer drug.[43] Without admitting or denying the SEC's allegations, the company and the executives agreed to the payment of disgorgement and penalties.

Later that month, the SEC filed a settled action against a large drugstore chain, its former CEO, and former CFO for failing to communicate the increased risk of missing operating income projections in the wake of a corporate merger.[44] The SEC alleged that in 2012, one of the predecessor entities had reaffirmed earlier projections despite internal projections showing an increased risk of falling short. Without admitting or denying the allegations, the company paid a $34.5 million penalty and the two executives each agreed to pay $160,000.

And at the end of September, the SEC announced a settlement with Tesla, Inc. and its CEO arising out of the CEO's tweets about plans to take the company private.[45] The SEC alleged that the potential transaction was subject to numerous contingencies, and that the company lacked sufficient controls to review the CEOs tweets. Without admitting or denying the allegations, the company and its CEO agreed to pay civil penalties; additionally, the CEO agreed to step down from the board and be replaced by an independent chairman, and the company agreed to install two new independent directors, implement controls to oversee the CEO's tweets, and establish a new committee of independent directors.

### C. Auditor Cases

In September, the SEC instituted proceedings against an accounting firm for improper professional conduct and violations of the securities law during the course of an audit of an information technology company.[46] According to the SEC's complaint, the firm ignored a series of red flags concerning cash held by a related entity and provided an unqualified opinion. The firm and two of its principals agreed to be barred from appearing before the SEC as accountants for five years, and to pay monetary penalties.

In October, the SEC suspended three former accountants from a larger audit firm related to allegations that they violated auditing standards and engaged in unprofessional conduct during an audit of an insurance company.[47] According to the SEC's order, the audit team fell behind schedule during the audit, but the senior manager directed team members to sign off on "predated" workpapers to make it appear that the audit had been completed before the company's annual report was filed with the SEC. The SEC also concluded that the engagement partner and quality review partner failed to exercise due professional care that would have prevented these deficiencies in the audit. Without admitting or denying the SEC's findings, the three accountants agreed to be suspended from practicing before the SEC as accountants for periods ranging from one to five years, pending applications for reinstatement.

In December, the SEC instituted proceedings against an audit firm, two of its partners, and two partners from a now-defunct auditing firm, relating to "significant failures" in their audit of a company that went bankrupt after the discovery of more than $100 million in federal tax liability.[48] According to the SEC's order, the firm identified pervasive risks of fraud in the company but failed to undertake additional steps to address the risk. The SEC also alleged that the audit firm was not actually independent of the company due to an ongoing business relationship. To settle the allegations, the firm agreed to pay a penalty of $1.5 million, and hire an independent compliance consultant. All four partners agreed to be suspended from practicing before the SEC for between one and three years, and to pay penalties ranging from $15,000 to $25,000.

Finally, outside the public company audit context, the SEC charged an audit firm with failing to maintain its independence when conducting "Custody Rule" and broker-dealer audits. The SEC alleged that the firm violated independence standards by both preparing and auditing client financial statements, accompanying notes, and accounting entries for more than 60 audits over five years. Without admitting nor denying the allegations, the firm settled with the SEC, agreeing to pay a $300,000 penalty and to cease any engagements that fall within the purview of the SEC for one year. If the firm later chooses to accept such engagements, it must retain an independent complaint consultant for a three-year period and comply with all of the consultant's recommendations for auditor independence.

### D. Private Company Cases

Finally, the SEC brought a number of financial reporting and disclosure cases against private (or pre-public) companies, including the following:

In September, the SEC instituted settled proceedings against a seller of drones, toys, and other consumer products and its CEO related to allegations that they provided inaccurate sales information to the company's auditor, which caused its Form S-1 registration statement to overstate the company's revenue by approximately 15%.[49] Without admitting or denying the SEC's allegations, the CEO agreed to pay a $10,000 penalty and the company agreed to withdraw its registration statement, which had never been declared effective.

Also in September, the SEC instituted proceedings against a California-based medical aesthetics company and its former CEO.[50] The SEC alleged that just days before the company was going to close a stock offering, the CEO learned that its Brazilian manufacturer's certificate to sell products in the

European Union had been suspended, but concealed it from the company's General Counsel and underwriters. After the offering closed and the suspension subsequently became public, the stock price fell by 52% and the CEO continued to misrepresent his knowledge. The SEC settled with the company, recognizing the company's self-reporting to the SEC and extensive cooperation. The SEC is litigating against the CEO.

In November, the SEC instituted proceedings against an entertainment media company and five of its former officers and directors.[51] According to the complaint, the company purchased downloads for its mobile app from outside marketing firms in order to boost its download ranking in the Apple App Store. The company allegedly misrepresented to its shareholders why its app had risen in the download rankings, and continued to allegedly lie to shareholders about the growth of its downloads even after it stopped paying for downloads and its rankings plummeted. The parties agreed to settle the charges without admitting or denying the allegations; the individuals agreed to pay penalties of varying amounts, three agreed to a permanent officer and director bar, and one agreed to a five-year bar.

## III. Investment Advisers and Funds

### A. Fees and Expenses

In November, a California-based investment adviser settled allegations that it overcharged clients by failing to apply "breakpoint" discounts as provided in its fee schedule.[52] According to the SEC, the adviser's fee schedule entailed "breakpoints" which would decrease advisory fees as the amount of client assets under management increased. For approximately eight years, however, the advisory fee discounts were applied haphazardly, resulting in overcharges to certain client accounts. Without admitting the allegations, the adviser agreed to pay a penalty of $50,000. The SEC recognized that, during the investigation, the adviser undertook remedial efforts, including reimbursements to clients of overcharged fees and modifications to its policies.

In December, a formerly SEC-registered fund manager settled allegations that it misallocated expenses (such as rent, overhead, and compensation) to its business development company clients as well as failed to review valuation models that caused a client to overvalue its portfolio companies.[53] The adviser agreed to pay approximately $2.3 million disgorgement and prejudgment interest, as well as a civil money penalty of approximately $1.6 million.

Also in December, the SEC filed a settled administrative proceeding against a Milwaukee-based investment adviser and its owner/chairman in connection with alleged undisclosed fees.[54] According to the SEC, the adviser added a sum to client transactions, which it called a "Service Charge." Part of this "Service Charge" would go towards paying a third-party broker, while the remainder went to the adviser. The SEC alleges that the adviser did not disclose these payments to clients. Without admitting or denying the allegations, the investment adviser and its owner agreed to pay approximately $470,000 in disgorgement and prejudgment interest, as well as a $130,000 civil penalty.

Later that month, the SEC settled with a private equity fund adviser for allegedly improperly allocating compensation-related expenses to three private equity funds that it advised.[55] According to the SEC, firm employees charged the funds for work unrelated to the three funds, violating the mandates of the governing documents of the funds. The alleged wrongdoing spanned four years. The firm cooperated extensively with the SEC, and the Commission accounted for those remedial efforts in settlement. The firm agreed to more than $2 million in disgorgement and a civil monetary penalty of $375,000. In a similar case also filed in December, the SEC settled with a fund manager for inadequate disclosures regarding certain expense allocations, as well as the alleged failure to disclose potential conflicts of interest arising from certain third-party service providers.[56] Without admitting or denying the SEC's allegations, the company agreed to pay $1.9 million in disgorgement and prejudgment interest and a $1 million civil penalty to settle the charges.

At the end of December, the SEC settled with a private equity investment adviser in connection with allegations of improper expense allocations.[57] According to the SEC, the investment adviser manages private equity funds and as well as co-investment funds on behalf of the company's employees. The two types of funds invest alongside each other. When the adviser sought to acquire certain portfolio companies, co-investors were able to provide additional capital to invest. According to the SEC, over the course of approximately fifteen years, the adviser failed to allocate certain expenses on a proportional basis between the private equity funds and the co-investor funds. In connection with settlement, the SEC acknowledged that, following an examination by the Commission's Office of Compliance Inspections and Examinations but prior to being contacted by the Division of Enforcement staff, the adviser proactively made full reimbursements, with interest, to affected funds. The adviser agreed to pay a civil money penalty of $400,000.

The SEC also brought a number of cases involving wrap fee programs.

In August, an investment advisory firm settled allegations that it lacked policies and procedures to provide investors with sufficient information for investors to evaluate the appropriateness of their investments in the company's wrap fee programs.[58] Without admitting or denying the allegations, the firm agreed to pay a $200,000 civil penalty and to undertake efforts to enhance its procedures. And in September, an affiliated investment adviser settled allegations that it failed to disclose conflicts of interest in connection with wrap fee programs.[59] According to the SEC, over the course of three years, the investment adviser recommended that its clients invest in wrap fee programs, one of which was sponsored by the investment adviser. Without admitting or denying the allegations, the company agreed to pay a $100,000 civil penalty.

### B. Conflicts of Interest

In July, the SEC filed a settled administrative proceeding against the managing partner and chief compliance officer of a private equity fund adviser, alleging that he arranged for one of his funds to make a loan to a portfolio company, the proceeds of which were used to purchase his personal interest in the company.[60] The SEC alleged that the manager failed to disclose the conflicted transaction to the fund's limited partnership advisory committee. The manager agreed to pay a civil money penalty of $80,000 without admitting or denying the allegations. The SEC's order noted that the fund ultimately did not lose any money on the transaction.

In late August, the SEC instituted settled proceedings against an investment adviser in connection with alleged failures to disclose a conflict of interest relating to third-party products.[61] According to the SEC, the adviser's retail advisory accounts were invested in third-party products that a U.S. subsidiary of a foreign bank managed. In contravention of established practice, the adviser's governance committee did not vote on a proposed recommendation to terminate the third-party products, and instead later permitted new adviser accounts to invest in these products. In so doing, according to the SEC, the adviser did not disclose a conflict of interest. Without admitting or denying the allegations, the adviser agreed to pay nearly $5 million in disgorgement and prejudgment interest, as well as a $4 million penalty.

### C. Fraud and Other Misconduct

In July, the SEC charged a Connecticut-based advisory firm and its CEO with placing around $19 million of investor funds into risky investments, including into companies in which they had an ownership stake, while charging large commissions on top of those investments.[62] The complaint further alleged that the company overbilled some of its clients by calculating fees based on the earlier value of investments that had decreased in value. The case is being litigated.

In August, a Michigan-based investment management firm and its representative settled claims that they had engaged in a cherry-picking scheme.[63] According to the SEC, the representative disproportionately allocated profitable trades to favored accounts, including personal and family accounts, at the expense of other clients. The firm agreed to pay $75,000, and the individual respondent agreed to pay approximately $450,000 in disgorgement and penalties and to be barred from the industry. The following month, the SEC pursued similar cherry-picking claims against a Louisiana-based adviser and its co-founder.[64] That case is being litigated. According to the SEC, it was the sixth case arising out of a recent initiative to combat cherry picking.

September was a particularly busy month, as the SEC settled a number of fraud-based cases with investment advisers. The SEC settled charges with two New York City-based investment advisers and their 100% owner and president.[65] The advisers allegedly engaged in a complex scheme to conceal the loss in the value of their clients' assets by making false statements, improperly redeeming investments, and failing to disclose a variety of conflicts of interest. To settle the charges, the advisers agreed to jointly and severally pay disgorgement of approximately $1.85 million and a civil penalty of $600,000.

Also in September, the SEC charged a hedge fund adviser and its principal with running a "short and distort" scheme, taking a short position and then making a series of false statements to shake investor confidence and lower the stock price of a publicly-traded pharmaceutical company.[66] According to the SEC, the fund used written reports, interviews and social media to spread untrue claims, driving the stock price down by more than a third. The matter is being litigated.

Later that month, the SEC settled with an asset manager, its former president, and its former CFO.[67] The asset manager and former president were charged with fraudulently using investor funds to purchase interests in products offered by the firm's parent corporation to benefit the parent, at which the former president also worked. The individuals were also charged with improperly adjusting fund returns to show more favorable results to investors. No charges were pursued against the parent corporation because of its prompt reporting of the misconduct, extraordinary cooperation with the SEC, and the reimbursement of around $1 million to adversely impacted investors. The company settled for more than $4.2 million in penalties and disgorgement. The former president and CFO agreed to pay penalties, and the president also agreed to a three-year bar from the securities industry.

Early in December, an investment company settled charges of improperly recording and distributing taxable dividends, when those monies should have been recorded as return of capital.[68] According to the SEC, while the error was not quantitatively large, it impacted a key metric used by investors and analysts to evaluate performance. The only sanction imposed was a cease-and-desist order. The firm admitted that its conduct violated federal securities laws and consented to the imposition of the order.

### D. Share Class Selection

The SEC has been particularly focused on advisers which recommend mutual funds to clients without adequately disclosing the availability of less expensive share classes. In February 2018, the Division of Enforcement announced its Share Class Selection Disclosure Initiative, under which the Division agreed not to recommend financial penalties against advisers which self-report violations of the federal securities laws relating to mutual fund share class selection and promptly return money to victimized investors. While the SEC has yet to announce any enforcement actions resulting from the self-reporting initiative, it has filed a number of actions against advisers which did not self-report such violations.

In August, the SEC filed a settled administrative proceeding against a Utah-based investment adviser and broker-dealer relating to mutual fund distribution fees, known as 12b-1 fees.[69] According to the SEC, for more than four years, the company, in its capacity as a broker-dealer, reaped compensation in the form of 12b-1 fees due to its clients' mutual fund investments. However, the company, in its capacity as an investment adviser, disclosed to advisory clients that it did not receive compensation from the sale of mutual funds. In addition, the adviser recommended more expensive share classes of certain mutual funds when cheaper shares of the same funds were available. The company agreed to pay over $150,000 to compensate advisory clients and a $50,000 civil money penalty.

In mid-September, the SEC filed a settled administrative proceeding against a limited liability company in connection with 12b-1 fees.[70] According to the SEC, for approximately three years, the adviser improperly collected 12b-1 fees from clients by recommending more expensive mutual fund share classes with 12b-1 fees when lower-cost share classes, without 12b-1 fees, were available. Further, the SEC alleged that the adviser received, but did not disclose, compensation it received when the adviser invested its clients in certain no-transaction fee mutual funds. The SEC acknowledged remedial acts undertaken and the company's cooperation with the Commission. The adviser agreed to pay over $1.3 million in disgorgement and penalties.

On the same day in late December, the SEC settled two additional share class selection cases. In the first, a Tennessee-based investment adviser settled charges in connection with the recommendation and sale of higher-fee mutual fund shares when less expensive share classes were available.[71] The SEC alleged that for a period of approximately four years, the company's president and investment adviser representative were the top two recipients of avoidable 12b-1 fees. The investment adviser agreed to pay approximately $850,000 in disgorgement and prejudgment interest, as well as $260,000 as a civil penalty; collectively, the two individuals agreed to pay approximately $430,000 in disgorgement and prejudgment interest, in addition to $140,000 in civil penalties. In the second case, the SEC settled charges with two investment advisers and a CEO of one of the firm on the ground that, despite the availability of less expensive share classes of the same funds, advisory clients' funds were invested in mutual fund share classes that paid 12b-1 fees to the firms' investment adviser representatives.[72] In total, the investment advisers and CEO agreed to pay more than $1.8 million to settle the charges.

### E. Misleading Disclosures

The SEC brought a number of cases alleging misleading disclosures and omissions in the second half of 2018. In July, the SEC announced a settlement with a California-based investment adviser and its majority owner.[73] In the firm's written disclosures to clients, the firm allegedly made material misstatements about the firm's financial condition – most saliently, omitting to disclose the firm was insolvent during the relevant period and was operating on $700,000 in loans. The SEC also alleged that the firm improperly withheld refunds of prepaid advisory fees from clients who requested via email to terminate their relationships. The firm and its majority owner agreed to pay $100,000 and $50,000 respectively in civil monetary penalties to settle the charges.

In August, the SEC settled two cases based on failures to disclose and misleading disclosures by investment advisers. First, a Boston–based employee-owned hedge fund sponsor settled with the SEC over allegations of omissions, misrepresentations, and compliance failures relating to its practices which resulted in materially different redemption amounts when the fund lost value in a short period of time.[74] The allegations included a failure to implement a compliance program consistent with the adviser's obligations under the Advisers Act, a lack of disclosure to all investors of their option to redeem their investment in the fund, and inaccurate statements concerning assets in the Form ADV filed annually with the SEC. The firm agreed to pay a civil penalty of $150,000.

Four days later, the SEC settled with four related investment adviser entities for allegedly misleading investors through the use of faulty investment models.[75] According to the SEC, the quantitative investment models contained errors, and after discovering the issue the firms discontinued their use but did not disclose the errors. The entities agreed to pay $97 million in disgorgement and penalties without admitting liability. Two individual defendants, the former Chief Investment Officer and the former Director of New Initiatives of one of the entities, were also charged and settled with civil penalties of $65,000 and $25,000 respectively.

Also in August, the SEC filed a litigated case against a Buffalo-based advisory firm and principal.[76] According to the SEC, in anticipation of an SEC imposed bar, the owner of the firm sold the firm to his son. Yet, after the imposition of the bar, his son failed to apprise clients of the bar and made misleading statements when clients inquired about the bar. Moreover, the father allegedly impersonated his son when on phone calls with clients.

A Massachusetts-based investment manager settled with the SEC on the final day of August.[77] The company allegedly disseminated advertisements touting hypothetical returns based on blended research strategies while failing to disclose that some key quantitative ratings were determined using a retroactive, back-tested application of the financial model. The company agreed to pay a civil penalty in the amount of $1.9 million to settle the allegations of violating the Advisers Act by publishing, circulating, and distributing advertisements containing misleading statements of material fact.

In the first week of September, the SEC settled with a private investment firm and its managing partner for allegedly failing to provide limited partners in a fund with material information related to a change in the valuation of the fund.[78] The respondents jointly agreed to pay a civil penalty in the amount of $200,000. A week later, the SEC filed a lawsuit against an Indianapolis-based investment advisory firm and its sole owner for omitting to disclose that the firm and its owner would receive commissions of almost 20% on sales of securities which it encouraged its clients to buy.[79] The latter case is being litigated.

In December, the SEC settled with a California-based registered investment adviser for material misstatements and omissions in its advertising materials, allegedly inflating the results and success of the back-tested performance for one of its indexes over the course of eight years.[80] The adviser agreed to pay a civil penalty of $175,000.

And in late December, the SEC brought its first enforcement action against robo-advisers for misleading disclosures.[81] Robo-advisers provide software-based, automated portfolio management services. In the first robo-adviser case, the company disclosed to clients that it would monitor client accounts for "wash sales," which could negate the tax-loss harvesting strategy it provided to clients. According to the SEC, however, for approximately three years the adviser did not provide such monitoring, and wash sales took place in almost one-third of accounts enrolled in the tax-loss harvesting program. This robo-adviser agreed to pay a $250,000 penalty. In a separate case, a second robo-adviser agreed to settle charges that it provided misleading performance information on its website and social media. According to the SEC, the company purported to show its investment performance as compared to robo-adviser competitors, but only included a small fraction of its client accounts in the comparison. This adviser agreed to pay a $80,000 penalty to settle the matter.

### F. Other Investment Adviser Issues

#### *Supervision and Oversight*

In August, the SEC announced a settled action against a Minnesota-based diversified financial services company that had allegedly failed to protect retail investor assets from theft by its agents.[82] The SEC alleged that the respondents' agents, many of whom pled guilty to criminal charges, committed fraudulent actions such as stealing client funds and forging client documents. The company allegedly failed to adopt and implement policies and procedures reasonably designed to safeguard investor assets against misappropriation by its representatives. The company agreed to pay a penalty of $4.5 million to settle the charges.

In November, the SEC settled charges with a formerly registered investment adviser and its former CEO for negligently failing to perform adequate due diligence on certain investments.[83] The SEC alleges that the firm failed to implement and reasonably design compliance policies and procedures which led to a failure to escalate and advise clients regarding concerns surrounding the investments, which turned out to be fraudulent. Without admitting or denying the allegations, the firm agreed to pay a $400,000 civil penalty and the CEO agreed to a $45,000 civil penalty.

***Cross-Trades***

The SEC brought a handful of cases involving cross-trades between client accounts which favored one client at the expense of another. In August, an investment adviser settled allegations that it had engaged in mispriced cross trades that resulted in the allocation of market savings to selected clients.[84] According to the SEC, approximately 15,000 cross trades were executed at the bid price, resulting in the allocation of market savings to the adviser's buying clients, while depriving selling clients of market savings. The SEC further alleged that the adviser cajoled broker-dealers into increasing the price of certain municipal bonds and executed cross trades at these inflated prices, thereby causing buying advisory clients to overpay in these transactions. To settle the matter, the adviser agreed to reimburse its clients over $600,000, plus interest, and pay a $900,000 penalty. The following month, the SEC instituted a similar settled administrative proceeding against a Texas-based investment adviser for failing to disclose two cross trades, causing its clients to sustain $125,000 in brokerage fees.[85]

Also in September, the SEC brought a settled action against a Boston firm and one of its portfolio managers, alleging that they facilitated a number of pre-arranged cross-trades between advisory client accounts that purposefully benefited certain clients at the expense of others.[86] In addition to paying a $1 million penalty, the company agreed to reimburse approximately $1.1 million to its harmed clients. The former portfolio manager agreed to pay a $50,000 penalty and to submit to a nine-month suspension.

***Testimonial Rule Violations***

In July, the SEC instituted five distinct settled proceedings against two registered investment advisers, three investment adviser representatives, and one marketing consultant in connection with violations of the Testimonial Rule, which bars investment advisers from publishing testimonial advertisements.[87] The advertisements were published on social media and YouTube. The civil penalties ranged from $10,000 to $35,000 for each of the individuals.

In September, a Kansas-based investment adviser and its president/majority owner agreed to settle charges in connection with violations of the Testimonial Rule and ethics violations.[88] The SEC alleges that the investment adviser broadcast advertisements through the radio, and one of the radio hosts later became a client and broadcast his experience. According to the SEC, the investment adviser contravened its policies by not monitoring the radio coverage. The firm agreed to pay a civil penalty of $200,000. Separately, the company's president/majority owner violated the company's code of ethics by not reporting transactions in brokerage accounts held for the benefit of his family. He agreed to pay a civil penalty of $50,000.

### *Pay To Play Abuses*

There were two "pay to play" cases settled on the same day in July. In the first matter, the SEC alleged that three associates of a California-based investment adviser made campaign contributions to candidates who had the ability to decide on the investment advisers for public pension plans.[89] Within two years of the contributions, in contravention of the Advisers Act, the investment adviser received compensation in connection with advising the public pension plans. The investment adviser agreed to pay a civil penalty of $100,000. In the other case, the SEC alleged that the firm's associates made contributions in a number of states, and the investment adviser similarly received payment to advise public pension plans in those states.[90] The investment adviser agreed to pay a $500,000 civil penalty to settle the charges.

### *Custody Rule Compliance*

The second half of the year entailed two Custody Rule cases against New York-based investment advisory firms. Neither firm distributed annual audited financial statements in a timely fashion. In the July matter, the SEC also alleged that the investment adviser lacked policies and procedures to preclude violations of the Advisers Act. Without admitting or denying the allegations, the adviser agreed to pay a $75,000 civil penalty.[91] In the September matter, the SEC also alleged that the firm violated the Compliance Rule by failing to review its policies and procedures on an annual basis.[92] Without admitting or denying the allegations, the adviser agreed to pay $65,000 as a civil penalty.

## IV. Brokers and Financial Institutions

### A. Supervisory Controls and Internal Systems Deficiencies

In the latter half of 2018, the SEC brought a number of cases relating to failures of supervisory controls and internal systems – an increase in this area over the first half of the year. As part of its ongoing initiative into American Depositary Receipt ("ADR") practices, the SEC brought numerous cases relating to the handling of ADRs—U.S. securities that represent foreign shares of a foreign company and require corresponding foreign shares to be held in custody at a depositary bank. In July, the SEC announced settled charges against two U.S. based-subsidiaries, a broker-dealer and a depositary bank, of an international financial institution alleging improper ADR handling that led to facilitating inappropriate short selling and profits.[93] Without admitting or denying the allegations, the subsidiaries agreed to pay $75 million in disgorgement and penalties. In September, the SEC brought settled charges against a broker-dealer and subsidiary of a French financial institution; the broker-dealer agreed to pay approximately $800,000 in disgorgement and penalties without admitting or denying the findings.[94] In December, the SEC settled charges against a depositary bank; the bank agreed to pay $38 million in disgorgement and penalties without admitting or denying the findings. [95]

And finally, also in December, the SEC brought settled charges in two cases for providing ADRs to brokers when neither the broker nor its customer owned the corresponding foreign shares. In the first December case, the SEC settled charges with a depositary bank headquartered in New York; the bank agreed to disgorgement, interest, and penalties of approximately $55 million without admitting or denying the charges.[96] In the second case, the SEC settled charges with another depositary bank, a subsidiary of a large New York financial services firm.[97] The SEC's order alleged that the improper

ADR handling led to inappropriate short selling and dividend arbitrage. The firm agreed to pay over $135 million in disgorgement, and penalties without admitting or denying the charges.

In addition to the ADR cases, the SEC also brought supervision cases for the failure to safeguard customer information and for the failure to supervise representatives who sold unsuitable products. In July, the SEC brought settled charges against an international investment banking firm for failing to maintain and enforce policies and procedures designed to protect confidential customer information, including the failure to maintain effective information barriers.[98] The SEC's order alleged that traders at the bank regularly disclosed material nonpublic customer stock buyback information to other traders and hedge fund clients; the bank agreed to a $1.25 million penalty without admitting or denying the charges. In September, the SEC announced settled charges against a New York-based broker-dealer and two of its executives for failure to supervise representatives in sales of a leveraged exchange-traded note ("ETN") linked to oil.[99] The SEC's order alleged that the broker-dealer's representatives did not reasonably research or understand the risks of the ETN or the index it tracked. The broker-dealer agreed to pay over $500,000 in penalties, interest, and customer disgorgement without admitting or denying the charges, and the two executives agreed to penalties as well as a 12-month supervisory suspension. The broker who recommended the largest number of ETN sales also agreed to a penalty of $250,000.

Along with the supervisory cases described above, the SEC also brought a few cases relating to internal controls. In August, the SEC announced settled charges in two cases against a large financial institution and two subsidiary broker-dealers involving books and records, internal accounting controls, and trader supervision.[100] The charges in one action related to losses due to trader mismarking and unauthorized proprietary trading, which the SEC alleged were not discovered earlier due to a failure to supervise. In the second action, the SEC alleged that the bank lacked controls necessary to prevent certain fraudulent loans. The financial institution and subsidiaries agreed to pay over $10 million without admitting or denying the allegations.

Also in August, the SEC initiated settled proceedings against a credit ratings agency for alleged internal controls deficiencies relating to a purported failure to consistently apply credit ratings symbols which were used in models used to rate residential mortgage backed securities.[101] The ratings agency agreed to pay over $16 million without admitting or denying the allegations.

### B. Anti-Money Laundering

As in the first half of the year, the SEC continued to bring a number of cases in the anti-money laundering ("AML") area, all relating to the failure to file suspicious activity reports ("SARs"). The Bank Secrecy Act requires broker-dealers to file SARs to report transactions suspected to involve fraud or with no apparent lawful purpose.

In July, the SEC announced the settlement with a national broker-dealer relating to the failure to file SARs on the transactions of independent investment advisers that it had terminated.[102] The broker-dealer agreed to pay a $2.8 million penalty to settle the action, without admitting or denying the charges. Similarly, in September, the SEC instituted a settled administrative proceeding against a New York brokerage firm for failing to file SARs relating to a number of terminated investment advisers.[103] Without admitting or denying the allegations, the firm agreed to pay a penalty of $500,000; the SEC's Order noted that the settlement took into account remedial acts undertaken by the firm. Also in September, the SEC settled charges against a clearing firm for failure to file SARs relating to suspicious penny stock trades.[104] As part of the settlement, the clearing firm agreed to pay a penalty of $800,000 without admitting or denying the allegations, and also agreed that it would no longer sell penny stocks deposited at the firm.

In December, the SEC brought settled charges against a broker-dealer alleging that during the period 2011-2013 it neglected to monitor certain movements of funds through customers' accounts and to properly review suspicious transactions flagged by its internal monitoring systems.[105] The firm agreed to pay a $5 million penalty to resolve the charges, as well as a $10 million penalty to the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) and the Financial Industry Regulatory Authority (FINRA) to resolve parallel charges. The broker-dealer did not admit or deny the SEC's allegations except to the extent they appeared in the settlement with FinCEN.

Also In December, the SEC announced settled charges against a broker-dealer for the failure to file SARs concerning over $40 million in suspicious wire transfers made by one customer in connection with a payday lending scam.[106] The firm agreed to certain undertakings, including the hiring of an independent compliance consultant, without admitting or denying the allegations. The U.S. Attorney's Office for the Southern District of New York also instituted a settled civil forfeiture action against the broker-dealer in which it paid $400,000; the U.S. Attorney's Office additionally entered into a deferred prosecution agreement with the firm.

### C. Market Abuse Cases

In the second half of 2018, the SEC's Market Abuse Unit was involved in bringing three cases relating to "dark pools" (*i.e.*, private exchanges) and the use and execution of customer orders. In September, the SEC announced settled charges against a large financial institution relating to alleged misrepresentations in connection with the operation of a dark pool by one of its affiliates.[107] The SEC alleged that the firm misled customers relating to high-frequency trading taking place in the pool and also failed to disclose that over half of the orders routed to the dark pool were executed in other trading venues. The firm and its affiliate agreed to pay over $12 million in disgorgement and penalties without admitting or denying the SEC's allegations.

Also in September, the SEC, together with the New York Attorney General ("NYAG"), brought settled charges against an investment bank relating to the execution of customer orders by one of its desks responsible for handling order flow for retail investors.[108] The SEC alleged that while the firm promoted the desk's access to dark pool liquidity, a minimal number of orders were executed in dark pools; additionally, the firm allegedly failed to disclose that retail customers did not receive price improvement on non-reportable orders. The firm agreed to pay a total of $10 million ($5 million to the SEC and $5 million to the NYAG) without admitting or denying the allegations.

And in November, the SEC brought charges against a financial technology company and its affiliate for misstatements and omissions relating to the operation of the firm's dark pool.[109] The SEC alleged that the firm failed to safeguard subscribers' confidential trading information despite assuring firm clients that it would do so, and also did not disclose certain structural features of the dark pool to clients. The firm and its affiliate agreed to pay a $12 million penalty to settle the charges without admitting or denying the allegations.

### D. Books and Records

In July, the SEC brought settled charges against a New York-based broker-dealer relating to its failure to preserve records.[110] The SEC alleged that the broker-dealer deleted audio files after receiving a document request from the Division of Enforcement (because the department responsible for the files was unaware of the request), and also failed to maintain books and records that accurately recorded expenses. Without admitting or denying the allegations, the firm agreed to pay a penalty of $1.25 million.

In September, the SEC announced charges against a broker-dealer for providing the SEC with incomplete and deficient securities trading information known as "blue sheet data" used by the SEC in its investigations.[111] The SEC's order alleged that approximately 29% of the broker-dealer's blue sheet submissions over a four-year time period contained deficiencies due to coding errors. The broker-dealer admitted the findings in the SEC's Order and agreed to pay a $2.75 million penalty to settled the charges. In December, the SEC instituted settled administrative proceedings against three broker-dealers for recordkeeping violations in another matter relating to deficient blue sheet data submissions.[112] The SEC's Orders noted that as a result largely of undetected coding errors, the three firms submitted blue sheet data that continued various inaccuracies. The three broker-dealers admitted the findings in the SEC's Orders and agreed to pay penalties totaling approximately $6 million. The SEC's Orders noted the remedial efforts undertaken by the firms, including the retention of an outside consultant and the adoption of new policies and procedures for processing blue sheet requests.

### E. Individual Brokers

Finally, in addition to its cases involving large financial institutions, the SEC brought a number of cases against individual broker-dealer representatives. In September, the SEC filed complaints against two brokers in New York and Florida for excessive trading in retail customer accounts which generated large commissions for the brokers but caused losses for their customers.[113] The case is being litigated.

Also in September, the SEC filed a complaint against a broker for a cherry-picking scheme in which the broker allegedly misused his access to an allocation account to cherry pick profitable trades for his own account while placing unprofitable trades in customer accounts.[114] The SEC noted that it uncovered the alleged fraud using data analysis. The case is being litigated, and the U.S. Attorney's Office for the District of Massachusetts announced parallel criminal charges.

Finally, in December, the SEC settled with a self-employed trader (and entities that he owned and controlled) for violations of Rule 105 of Regulation M, which prohibits a person from purchasing an equity security during the restricted period of an offering where that person has sold short the same security.[115] The SEC's Order alleged that the trader violated Rule 105 by effecting short sales during restricted periods and mismarking short sales as "long sales" in a total of 116 offerings. The trader agreed to pay disgorgement, interest, and penalties total approximately $1.1 million without admitting or denying the charges

## V. Insider Trading

### A. Cases Against Corporate Insiders

***Corporate Executives***

July was a busy month for corporate executives accused of insider trading and tipping. First, the SEC charged the former CEO of a New Jersey-based payment processing company and his romantic partner in an insider trading scheme that leveraged nonpublic information about the potential acquisition of his company by another payment processing company.[116] On the CEO's instructions and with his funds, the romantic partner opened a brokerage account and used almost $1 million of the funds to purchase stock in the target company. According to the SEC, the pair generated $250,000 in profits after the merger was announced. The case is being litigated.

The SEC also settled with a former VP of Investor Relations at a company operating country clubs and sports clubs alleged to have traded in his company's stock after learning that it was negotiating to be acquired.[117] After receiving an inquiry from FINRA, the officer resigned from the company and retained counsel who reported the misconduct to the SEC and provided them substantiating documentation. In return, the SEC agreed to a settlement that involved disgorgement of his profits of approximately $78,000 and a civil penalty equal to about one-half of the disgorgement amount.

Later in July, the SEC sued a senior executive at a Silicon Valley tech company for allegedly short selling as well as selling stock in his company ahead of three different quarterly announcements that the company was likely going to miss its revenue guidance.[118] According to the SEC, the executive made nearly $200,000 in profits from these trades. Without admitting wrongdoing, the executive agreed to disgorge his profits and pay a corresponding civil penalty, and to bebarred from acting as an officer or director of a public company for five years. The SEC noted that it had utilized data analysis from its Market Abuse Unit's Analysis and Detection Center to detect suspicious trading patterns in advance of earnings announcements over time.

And at the end of July, the SEC sued a VP of Finance who learned from a senior executive at his company that a Chinese investment group might acquire the company.[119] While preparing financial projections and conducting diligence, the VP allegedly used his spouse's brokerage account to purchase shares of his company. When it became public that his company had rejected the Chinese investment group's offer in the hopes of receiving a higher price, the company's share increased 24%, resulting in the VP earning nearly $90,000. Without admitting liability, the officer agreed to disgorgement of his gains and a corresponding civil penalty.

In August, the SEC charged a former biotech executive and others with participating in a scheme that generated $1.5 million of profits by trading ahead of the announcement of a licensing agreement between his company and another large pharmaceutical company.[120] According to the complaint, the executive informed a friend of the license agreement. The friend then tipped a former day trader, who, in connection with an insider-trading ring, purchased stock and options and made $1.5 million in illegal profits when the agreement was announced and the company's stock price jumped 38 percent. In a parallel action, the U.S. Attorney's Office for the District of New Jersey charged the day trader and four members of his group with illegal insider trading ahead of secondary public stock offerings. All five defendants have pled guilty to the parallel criminal charges; the four members of the insider-trading ring other than the trader have agreed to partial settlements with the SEC for conduct including their trading on the license agreement, with potential monetary sanctions to be determined at a later date. The SEC is continuing a previous action against the trader for alleged insider trading ahead of the secondary stock offerings.

In August, the SEC sued a former Sales VP at a cemetery and funeral home operator for allegedly benefiting from confidential information obtained through his employer.[121] After learning about a substantial decline in sales that would necessitate a reduction in the company's distribution payments, the executive sold all of his shares in the company. As part of a settlement, the executive agreed to pay disgorgement and a civil penalty.

Also in August, the SEC settled charges against a former executive of a cloud security and services company.[122] According to the SEC, the executive informed his two brothers, to whom he had gifted stock in the past, that the company would miss its revenue guidance, and contacted his brothers' brokerage firm to coordinate the sale of all of their stock. When the negative news was announced, the stock price dropped significantly and the brothers collectively avoided losses of over $580,000. Under the terms of his settlement, the former executive will be barred from serving as an officer or director of a public company for two years and will pay a $581,170 penalty.

In September, the SEC brought a settled action against a former executive at a mortgage servicing company.[123] The SEC alleged that the executive engaged in insider trading surrounding three separate events, including the resolution of litigation and a CFPB enforcement action against the company, as well as negotiations to sell the company. Without admitting or denying the allegations, the executive agreed to disgorge his ill-gotten gains of almost $65,000 and to pay a penalty equal to the disgorgement amount.

In October, the SEC charged a company's former Director of SEC Reporting with trading ahead of a corporate acquisition.[124] The complaint alleged that the individual bought call options and stock in a company targeted for acquisition by a subsidiary of the company. The matter is being litigated.

In November, the acquisition of two health care networks by a large health care company led to two separate misappropriation cases. The SEC charged a man with insider trading based on information he misappropriated from his wife, a human resources executive at the acquiring company, about the planned acquisitions.[125] According the SEC, the man overheard his wife's phone calls while she was working at home. The husband agreed to pay disgorgement of about $64,000 and a penalty of $72,144. The SEC also settled an insider trading charge against a man alleged to have misappropriated information from his brother, an executive at one of the target companies.[126] According to the SEC, the insider had shared the information in confidence at a family holiday party. The trader agreed to pay disgorgement and penalties totaling about $40,000.

***Board Members***

In a high profile case involving drug trials, the SEC and DOJ filed parallel charges for insider trading against a U.S. Congressman, his son, and a host of other individuals.[127] According to the SEC's complaint, the Congressman learned of negative drug trial results through his seat on a biotech company's board. The Congressman allegedly provided his son the inside information, who then told a third individual. Over the next few days, the Congressman's son, the third individual, and a number of their friends and family members sold over a million shares of the biotech company's stock, which plummeted more than 92 percent following the announcement of the negative results. As a result of the trading, the Congressman's son and the third individual avoided approximately $700,000 in losses. Two of the individuals sued ultimately settled with the SEC without admitting or denying the charges, agreeing to disgorge their gains totaling approximately $35,000 and to pay a matching civil penalty. The SEC's cases against the Congressmen, his son, and a third individual are ongoing.

In August, the SEC sued the son of a bank board member who learned of the bank's potential acquisition by another bank from his father prior to the acquisition's public announcement.[128] The son realized approximately $40,000 in gains after the acquisition became public. Without admitting or denying the charges, the son agreed to disgorge the gains and to pay a matching civil penalty.

***Employee Insiders***

In July, the SEC sued a former financial analyst at a medical waste disposal company and his mother for trading on inside information that the company would miss its revenue guidance.[129] Following the company's earnings announcement, its stock fell 22%, resulting in the analyst and his mother avoiding losses and earning profits of approximately $330,000. Both the analyst and his mother agreed to settle the case without admitting liability. They will be required to disgorge their profits and pay a civil penalty in amounts to be later determined by the court.

Also in July, in the second SEC case arising out of the Equifax data breach, the SEC charged a software engineer tasked with constructing a website for consumers who were impacted by the data breach for trading the company's stock before the data breach was publicly disclosed .[130] The engineer was fired after refusing to cooperate with the company's investigation, though he and the SEC ultimately settled the case. As part of that settlement, the engineer was ordered to disgorge $75,000 in profits. The U.S. Attorney's Office also filed criminal charges against the engineer.

The SEC also filed a number of cases involving corporate scientists. In July, the SEC charged a scientist at a California biotech company for trading based on positive developments in a genetic sequencing platform.[131] According to the SEC, the scientist traded during company trading blackouts, in a brokerage account not disclosed to his employer. He settled the case, agreeing to disgorge approximately $40,000 in profits and paying a similar civil penalty. In August, the SEC filed suit against a scientist who learned that his healthcare diagnostics company was about to acquire another company in a tender offer.[132] On the date the acquisition was announced, his company's stock increased 176%. As part of the settlement, the scientist agreed to disgorge $14,000 in profits and pay a corresponding civil penalty. And in a third case, the SEC settled with a scientist at a pharmaceutical company for allegedly trading in advance of positive results of a clinical trial.[133] The scientist agreed to disgorgement of $134,000, but based on her voluntarily coming forward and reporting her improper trades, the SEC agreed to a reduced penalty of $67,000.

The SEC brought charges in August against an in-house attorney for a shipping company who traded on inside information that his company had entered into a strategic partnership with a private equity fund.[134] As part of a settlement, he was ordered to disgorge nearly $30,000 in profits with a matching civil penalty.

And in September, the SEC charged a former professional motorcycle racer handling promotional activities for a beverage company, as well as his father, family friend, and investment adviser, with insider trading for tipping and trading ahead of an impending deal with a large beverage company.[135] According to the SEC, after the racer had learned a significant deal was imminent, the four individuals collectively purchased over $770,000 in stock and options, in certain instances borrowing funds for the purchases. Following the announcement, they made over $283,000 in trading profits. Without admitting or denying the findings, the individuals agreed to disgorge ill-gotten gains and to pay civil penalties.

### B. Misappropriation by Investment Professionals and Other Advisors

Several deal advisors, including bankers, corporate advisors, and accountants, were charged with insider trading by the SEC. In August, the SEC charged a professional football player and a former investment banker with insider trading in advance of corporate acquisitions.[136] The SEC alleges that after meeting at a party, the player began receiving illegal tips, facilitated through coded text messages and FaceTime conversations, from the banker about upcoming corporate mergers. The player allegedly made $1.2 million in illegal profits by purchasing securities in companies that were soon to be acquired, in one instance generating a nearly 400 percent return. In return, he is alleged to have rewarded the analyst by setting up an online brokerage account that both men could access, by providing cash kickbacks, free NFL tickets, and an evening on the set of a pop star's music video in which the player made a cameo appearance. The SEC action is being litigated; both men have pled guilty to related criminal charges. In November, the SEC also charged a family friend of the banker in connection with the same scheme.[137] The U.S. Attorney's Office announced parallel criminal charges against this individual.

In September, the SEC filed insider trading charges against a corporate deal advisor for trading in securities of two China-based companies based on confidential information about their impending acquisitions.[138] According to the SEC, the individual, who had been providing advice to the acquiring companies, opened a brokerage account in his wife's name and used that account to generate more than $79,500 in trading profits. That same executive later became a director at a Hong Kong-based investment banking firm. In connection with advising a client on an acquisition of its rival, he was alleged to have again used his wife's brokerage account to buy high risk call options, which he sold after news of the acquisition for profits of more than $94,400. The case is being litigated.

And in December, the SEC charged an individual with misappropriating information from his fiancé, an investment banker working on a merger between two airline companies.[139] According to the SEC, the trader overheard calls his now-wife made at home on nights and weekends, purchasing call options in the target company and netting approximately $250,000 in profits. Without admitting or denying liability, the trader agreed to disgorge his profits and pay a matching penalty.

Also in December, the SEC alleged that an IT contractor working at an investment bank had traded, and tipped his wife and father, based on information he'd learned from the bank.[140] According to the SEC, the three collectively reaped approximately $600,000 in profits by trading in advance of at least 40 corporate events. The SEC obtained a court-ordered freeze of assets in multiple brokerage accounts connected to the alleged trading.

The SEC brought several cases against accountants and their tippees. In August, the SEC brought a settled action against a CPA who learned of an acquisition through his work as an accountant providing tax advice to a private company owned by a member of one of the companies.[141] The individual agreed to disgorge his profits of approximately $8,000 and pay a matching civil penalty.

Also that month, the SEC sued a former director of a major accounting and auditing firm for trading ahead of a merger between two of the firm's clients.[142] According to the SEC, after learning of the planned merger, the director used a relative's account to purchase call options, which increased in value by about $150,000 following announcement of the merger. Though the director later allowed the options to expire without selling or exercising them, he did not inform his employer that he controlled the account when the relative's name appeared on a list of individuals in connection with a FINRA investigation into suspect trading. Without admitting liability, the director agreed to pay a $150,500 penalty and to be barred from appearing and practicing before the SEC as an accountant for two years.

The SEC brought several other cases involving misappropriation by industry professionals. In July 2018, the SEC settled charges against a broker who traded ahead of a multi-billion dollar acquisition.[143] According to the SEC, the broker misappropriated the information from a friend who was a certified public accountant providing personal tax advice to a senior executive at the company being acquired, and who had shared the information in confidence. Without admitting liability, he agreed to disgorgement of his nearly $90,000 in profits, a comparable civil penalty, and debarment from being a broker. And in September, the SEC settled a claim against a CPA and a doctor for allegedly trading while in possession of confidential information regarding an impending acquisition.[144] According to the SEC, the CPA misappropriated the information from a friend who worked at one of the companies. The SEC alleges that after the CPA shared the information with the doctor, both purchased call options in the target company. Both the CPA and doctor agreed to pay disgorgement and civil penalties.

## VI. Municipal Securities and Public Finance Cases

With the SEC's Municipalities Continuing Disclosure (MCDC) Initiative (which as noted above generated a significant number of cases) completed, the SEC's Public Finance Abuse Unit returned to its traditionally slower pace, filing just a few cases in the latter half of the year.

In August, the SEC charged two firms and 18 individuals with participating in a municipal bond "flipping" scheme (i.e. improperly obtaining new bond allocations from brokers and reselling to broker-dealers for a fee.[145] According to the SEC, the firms and their principals used false identities to pose as retail investors in order to receive priority from the bond underwriters, and then resold the bonds to brokers for a pre-arranged commission. The SEC also charged a municipal underwriter with taking kickbacks as part of the scheme. Most of the parties settled (with sanctions including disgorgement, penalties, and industry bars and suspensions), but aspects of the case are being litigated as well. The SEC filed another settled case for municipal bond flipping in December.[146]

In September, the SEC instituted a settled action against a municipal adviser and its principal for failing to register as municipal advisor and failing to disclose its nonregistration to a school district to which it provided services.[147] The firm and its principal agreed to pay about $50,000 in disgorgement and penalties, and the principal agreed to be barred from the securities industry.

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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.*

*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.*

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