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2019 MID-YEAR SECURITIES ENFORCEMENT UPDATE

To Our Clients and Friends:

I. Introduction: Themes and Notable Developments

A. Continued Focus on Protection of Main Street Investors

The first half of 2019 has seen a continuation of the Commission's emphasis on protecting the interests of Main Street investors. Chairman Clayton reiterated these themes in his testimony in May before the Financial Services and General Government Subcommittee of the U.S. Senate Committee on Appropriations.[1] In addition to the no less than 43 references to Main Street investors, the Chairman's testimony highlighted: (1) the Retail Strategy Task Force, formed in 2017, to use data-driven strategies to generate leads for investigation of industry practices that could harm retail investors, as well as (2) the mutual fund share class initiative as an example of returning funds to retail investors through a program to incentivize self-reporting and cooperation. To be sure, the Commission brought a number of enforcement actions focusing on various offering frauds, often with themes related to some form of cryptocurrency or digital asset.[2] The Chairman also noted in his Congressional testimony that the Commission's FY 2020 budget request contemplates adding add six positions to the Commission's investigations of conduct affecting Main Street investors.

On June 5, 2019, the SEC adopted a set of rules intended to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers.[3] The new “Regulation Best Interest” requires broker-dealers to act in the best interest of a customer when making recommendations for securities transactions or investment strategies to a retail consumer. This means broker-dealers may not place the financial or other interests of the broker-dealer ahead of the customer. In order to satisfy the fiduciary obligations required by Regulation Best Interest, broker-dealers must: (1) make certain disclosures regarding any conflicts of interest; (2) exercise reasonable diligence, care, and skill in making recommendations; (3) maintain policies and procedures designed to address conflicts of interest; and (4) maintain policies designed to achieve compliance with the regulation.[4] Regulation Best Interest takes effect on September 10, 2019. Firms will have until June 30, 2020 to comply with the regulation.

B. Full Commission and other Senior Staffing Updates

During the first six months of this year, there were a number of leadership changes, several of which reflect the advancement of lawyers with many years of experience in the Division of Enforcement to positions of senior leadership.

On June 20, the U.S. Senate confirmed Allison Lee to serve as the fifth Commissioner with a term ending in 2022. Commissioner Lee was sworn in on July 8, bringing the Commission back to its full complement

of Commissioners. Commissioner Lee replaces prior Democratic Commissioner Kara Stein. Commissioner Lee previously served at the Commission for over a decade, including as counsel to Commissioner Stein, as well as a Senior Counsel in the Complex Financial Instruments Unit of the Division of Enforcement. How long the full Commission will last is uncertain as there have been reports that Commissioner Robert Jackson, the only other Democratic Commissioner, may be stepping down in the near future to return to teaching and NYU Law School. Commissioner Jackson has not commented on his plans.

Other changes in the senior staffing of the Commission include:

- In June, David Peavler was appointed Director of the Fort Worth Regional Office. Mr. Peavler rejoined the SEC after serving two years as the General Counsel of HD Vest Inc. He previously worked for 15 years in the Division of Enforcement in the SEC's Fort Worth Regional Office.

- In May, Erin Schneider was appointed Director of the San Francisco Regional Office. Ms. Schneider joined the Commission in 2005 as a Staff Attorney in the Division of Enforcement in the San Francisco Office, became an Assistant Director in the Asset Management Unit in 2012 and an Associate Director in the San Francisco Office in 2015.

- Also in May, Adam Aderton was appointed Co-Chief of the Asset Management Unit of the Division of Enforcement. Mr. Aderton joined the Commission as a staff attorney in the Division of Enforcement in 2008, joined the Asset Management Unit in 2010, and became an assistant Director of the Unit in 2013.

More broadly, until recently, the Commission had been subject to a hiring freeze which led to an approximately 10% decline in staffing both in the Enforcement Division and the Commission overall. Under its FY 2019 budget, the Commission has been able to resume some hiring, but not sufficient to restore staffing levels to their prior levels. Accordingly, the Enforcement Division will continue to endeavor to accomplish more with less for the foreseeable future.

C. Change to Commission Practice on Consideration of Settlement Offers with Waiver Requests

On July 3, Chairman Jay Clayton announced a change in the process by which the Commission will consider settlement offers from prospective defendants who are also seeking a waiver from a regulatory disqualification that would be triggered by the settlement.[5] In effect, the new policy actually restores Commission practice to what it had been historically, prior to a change under the last administration, and represents a much-needed, common sense improvement to the Commission's settlement process.

The issue arises when negotiating a settlement that triggers a regulatory disqualification. The client can request a waiver from the disqualification. However, the last administration had revoked the authority previously delegated to the regulatory divisions to decide waivers and required a party to make an unconditional offer of settlement without assurance as to whether the Commission would grant the waiver. This meant that a party could be bound to a settlement that triggered a disqualification without assurance of receiving a waiver. In some cases, the risk was significant.

Under the new policy, the Commission will still be the decision-maker on waivers, but will consider the settlement offer and waiver request simultaneously and as a single recommendation. Most important, if the Commission approves the settlement offer, but not the waiver, the party could withdraw the settlement offer and will not be bound by the offer.

As the Chairman's statement explains:

> … an offer of settlement that includes a simultaneous waiver request negotiated with all relevant divisions . . . will be presented to, and considered by, the Commission as a single recommendation from the staff. . . . [I]n a matter where a simultaneous settlement offer and waiver request are made and the settlement offer is accepted but the waiver request is not approved in whole or in part, the prospective defendant would need to promptly notify the staff (typically within a matter of five business days) of its agreement to move forward with that portion of the settlement offer that the Commission accepted. In the event a prospective defendant does not promptly notify the staff that it agrees to move forward with that portion of the settlement offer that was accepted (or the defendant otherwise withdraws its offer of settlement), the negotiated settlement terms that would have resolved the underlying enforcement action may no longer be available and a litigated proceeding may follow.

In sum, under the new procedure, parties will simply receive the same benefit as any settling party – certainty, finality and the clarity of knowing the full consequences of their offer to settle.

D. Whistleblower Awards Continue

The Commission continued to issue significant awards to whistleblowers for providing information that led to financial recoveries in enforcement actions. As of June 2019, the SEC has awarded over $384 million to 64 whistleblowers since the program began in 2012.[6]

In March, the Commission announced a pair of awards totaling $50 million to two whistleblowers (one for $37 million and another for $13 million).[7] The $37 million award was the Commission's third highest award. One of the awards was notable because the Commission finding in its order that the claimant had "unreasonably delayed in reporting the information to the commission," and had "passively financially benefitted from the underlying misconduct during a portion of the period of delay."[8]

In May, for the first time, the SEC issued an award under a provision of the whistleblower rules which permits claims by whistleblowers who first report a tip to a company if the whistleblower also reports the same tip to the SEC within 120 days.[9] In this case, the whistleblower sent an anonymous tip to the company, as well as to the SEC. The whistleblower's report triggered an internal investigation by the company, which resulted in the company reporting its findings to the SEC, resulting in an SEC investigation and action. In calculating the award, the SEC credited the whistleblower "for the company's internal investigation, because the allegations were reported to the Commission within 120 days of the report to the company." The whistleblower was awarded more than $4.5 million.

In June, the SEC announced an award of $3 million to whistleblowers for a tip that led to the successful enforcement action related to "an alleged securities law violation that impacted retail investors."[10]

The key takeaway from these awards is that they provide powerful financial incentives to would be whistleblowers to report suspicions of misconduct – real or perceived – to the Commission staff. The financial incentives and anti-retaliation protections for whistleblowers put a premium on companies implementing a rigorous, proactive and documented response to internal complaints to protect against second-guessing by regulators and prosecutors.

Last year, in *Digital Realty Trust v. Somers*, the Supreme Court held that Dodd-Frank's anti-retaliation measures protect only whistleblowers who report their concerns to the SEC and not those who only report internally.[11] In response to the Supreme Court's decision, on May 8, 2019, the House Committee on Financial Services passed the Whistleblower Protection Reform Act of 2019, H.R. 2515, which would extend the anti-retaliation protections in Dodd-Frank to whistleblowers who report alleged misconduct to a superior.[12]

E. Notable Litigation Developments

There were a number of litigation developments of note during the first half of this year.

In *Lorenzo v. SEC*, the Supreme Court held that an individual who is not a "maker" of a misstatement may nonetheless be held primarily liable under Rule 10b-5(a) and (c) for knowingly "disseminating" a misstatement made by another person.[13] The decision refines the Court's 2011 decision in *Janus v. First Derivative Traders*, in which the Court held that liability under Rule 10b-5(b) for a misstatement only extent to the "maker" of a statement which is the "person or entity with ultimate authority over the statement."

The impact of the *Lorenzo* decision for Commission enforcement actions may be more academic than practical because the Commission has the ability to bring actions for secondary liability for aiding and abetting or causing a violation by another party. Nevertheless, Commissioner Hester Peirce has cautioned against the Commission's use of *Lorenzo* to expand so-called "scheme" liability beyond the bounds of secondary liability.[14] The practical import of the decision for private civil litigation may be more significant, since, in the absence of secondary liability, private plaintiffs may be able to craft broader allegations of primary liability against defendants based on their participation in a "device, scheme, or artifice to defraud" under Rule 10b-5(a) or an "act, practice or course of business" that "operates … as a fraud or deceit" under Rule 10b-5(c).

In *Robare Group, Ltd. v. SEC*, the U.S. Court of Appeals for the D.C. held that a "willful" violation of Section 207 of the Investment Advisers Act of 1940 requires more than proof of mere negligence, even though negligence may be sufficient to establish a violation under Section 206(2) of the Advisers Act. The decision represents a change from the holding in a 2000 decision by the same court in *Wonsover v. SEC*, which held that "willfully" means "intentionally committed the act with constitutes the violation" but does not require that "the actor…be aware that he is violating" the law. In *Robare*, the court clarified that the willfulness standard could not be met by proof of merely negligent conduct.

Historically, in cases in which parties settle to Commission orders finding willful violations, the settled order often contained a footnote articulating the *Wonsover* standard of willfulness. Notably, despite the decision in *Robare*, the Commission has continued to use the *Wonsover* formulation.[15] In the long

term, the Commission will likely seek to reconcile the *Robare* and *Wonsover* decisions. In the near term, the *Robare* decision potentially provides prospective defendants with additional arguments to oppose alleged violations of statutory provisions that require proof of willfulness, and as a consequence, to avoid forms of relief that turn on findings of willful violations.

Finally, over the years, the Commission been continually challenged to conduct investigations and either resolve or commence actions in a timely manner. In addition, all investigative and prosecutorial agencies have been subject to criticism at various times for "piling on" with seemingly duplicative investigations and enforcement actions in high profile matters. This year, the Commission's late arrival to an already crowded regulatory party has become the subject of an unusually pointed judicial inquiry in the Commission's litigation against Volkswagen. The Commission filed the action in March 2019, years after the company had already resolved actions by other federal and state governments as well as private civil actions. In a quote that will likely resonate for some time to come, the court questioned the Commission's delay in bringing the action and reminded counsel that "the symbol of the SEC is the symbol … of the eagle, not a carrion hawk that simply descends when everything is all over and sees what it can get from the defendant." In an unusual step, the court order the Commission to file a declaration stating when the Commission learned of the facts alleged in each paragraph of the 69-page complaint. On July 8, the Commission filed its submission which seeks to explain the various challenges the Commission faced in its investigation, including delays in obtaining evidence from abroad, that led to the timing of the agency's action. Regardless of the outcome of this particular case, perhaps the court's commentary will lead investigative agencies to undertake a more thoughtful approach to the need to add to multi-agency investigations.

F. Legislative Response to Supreme Court's *Kokesh* Decision

In 2018, in *Kokesh v. SEC*, the Supreme Court held that a 5-year statute of limitations applies to the Commission's ability to recover disgorgement of ill-gotten gains from defendants. In a footnote to the unanimous decision, the Court somewhat cryptically suggested that the Commission's authority to obtain disgorgement may not be entirely without question. In particular the Court stated that the decision was limited to the applicability of the statute of limitations, and not reaching the issue of "whether courts possess authority to order disgorgement in SEC enforcement proceedings…." In its 2018 annual report, the Enforcement Division estimated the *Kokesh* decision may cause the Commission may forego up to $900 million in disgorgement claims.

The issue of the SEC's ability to obtain disgorgement is a question that continues to play out in lower courts. Thus far, the Second Circuit and district courts within the Second Circuit have upheld disgorgement awards post-*Kokesh*, finding disgorgement to be a proper equitable remedy.[16] The meaning of *Kokesh* is also being hashed out in cases involving regulators other than the SEC, such as the CFTC. For example, in a case from May of this year, a district court found that, contrary to the defendants' reading of *Kokesh*, the amount of disgorgement to be paid to the CFTC did not need to be reduced based on costs incurred by the defendants in the commission of their violations.[17]

In March of this year, Senators Mark Warner (D-Va) and John Kennedy (R-La) introduced a bipartisan bill designed to address the concerns sounded by the Commission in the wake of *Kokesh*. Titled the

Securities Fraud and Investor Compensation Act, the bill would provide explicit statutory authority for the Commission to obtain disgorgement for gains actually received or obtained by a defendant, subject to a 5-year statute of limitations. Of potentially greater consequence, however, the bill would also authorize the Commission to obtain *restitution* of losses sustained by investors caused by defendants in the securities industry, such as broker-dealers and investment advisers, and create a 10-year statute of limitations for equitable relief, including restitution, injunctions, bars and suspensions.

Historically, the Commission has not sought to advance an argument for restitution in court. It is not uncommon for the financial benefit to a defendant to be far less that the alleged harm incurred by an arguable class of victims. Consequently, for many defendants, the risk of restitution could represent a substantial increase in the potential exposure created by an enforcement action. As of this writing, the bill has not advanced.

G. Litigation Challenge to the "Neither-Admit-Nor-Deny" Settlement

The "neither admit nor deny" settlement has long been a staple of the Commission's enforcement program. Specifically, prospective defendants typically settle enforcement actions by consenting to either issuance of a Commission order containing findings, or the entry of a civil judgment based on a complaint containing allegations, to which the proposed defendant neither admits nor denies. Under the prior administration, the Commission had adopted a policy of requiring admissions in certain exceptional cases. Nevertheless, the neither admit nor deny formulation remained the predominant settlement formulation.

Importantly, as a corollary to not being required to admit to any findings or allegations, parties are also prohibited from denying the findings or allegations. The requirement is spelled out in a regulation adopted in 1972:

> The Commission has adopted the policy that in any civil lawsuit brought by it or in any administrative proceeding of an accusatory nature pending before it, it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur. Accordingly, it hereby announces its policy not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings. In this regard, the Commission believes that a refusal to admit the allegations is equivalent to a denial, unless the defendant or respondent states that he neither admits nor denies the allegations.

17 C.F.R. § 202.5(e).

The requirement is also contained in the form of settlement offer executed by a settling party:

> Defendant understands and agrees to comply with the Commission's policy "not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegation in the complaint or order for proceedings." 17 C.F.R. § 202.5. In compliance with this policy, Defendant agrees not to take any action or to make or cause to be made any public statement denying, directly or indirectly, any allegation in the complaint or creating the

> impression that the complaint is without factual basis. . . . . If Defendant breaches this agreement, the Commission may petition the Court to vacate the Final Judgment and restore this action to its active docket.

In a lawsuit filed in January of this year, the Cato Institute is challenging the constitutionality of the so-called "gag rule" as a violation of a defendant's right to free speech under the First Amendment.[18] The Cato Institute's interest in the issue is grounded on its desire to publish a manuscript by a party who settled a Commission enforcement action. According to the Cato Institute's complaint, the manuscript describes what the author believes to be the Commission's overreach in coercing the author into a settlement despite the author's belief that the charges were without merit in order to avoid crippling litigation expenses. The complaint alleges that the regulation and policy constitutes an unconstitutional content-based restriction on speech.

Not surprisingly, the Commission filed a motion to dismiss the complaint in May, arguing, among other things, that the plaintiff's action was flawed in three key ways: (1) the Cato Institute lacked standing under Article III because it was challenging a contract reviewed, approved and entered by a district court—a contract to which the plaintiff was neither a party nor an intended beneficiary; (2) the court lacked jurisdiction on ripeness grounds because the plaintiff's claims were premised upon speculation about future events that would implicate other courts' authority, in effect asking the court to invalidate no-deny provisions in every single past consent judgment, regardless of whether all past settling defendants wanted this outcome; and (3) the Cato Institute did not state a First Amendment claim because the no-deny provisions were negotiated provisions and were not imposed against a defendant's free will. The Commission further asserted that there were compelling interests that would justify these no-deny provisions, such as avoiding investor and market confusion and deterring future defendants.

The Cato Institute opposed the Commission's motion to dismiss, arguing that the Commission's no-deny provisions amounted to a lifetime ban on speech, and former SEC defendants who want to complain about the SEC's conduct in their cases are unable to do so because of these provisions. The Cato Institute asserted three main arguments in response to the Commission's motion to dismiss: (1) the Cato Institute has standing as a would-be publisher because it is currently required to abstain from constitutionally protected speech; (2) the court could adjudicate the instant claims without invading the jurisdiction of any other court; and (3) the unconstitutional-conditions doctrine applies to this matter and therefore the Cato Institute has properly pleaded a justiciable claim under the First Amendment.

Needless to say, the lawsuit has had no impact whatsoever on the Commission's continued practice of settling actions on a neither-admit-nor-deny basis.

II. Public Company Disclosure, Accounting and Audit Cases

A. Internal Controls

In late January, the SEC announced a settlement with four public companies based on the companies' alleged failure to maintain adequate internal controls over financial reporting ("ICFR").[19] The SEC alleged that, although the companies disclosed material weaknesses in their ICFR, the took months or years to remedy the issues, including after SEC staff notified the companies of the issues. Without

admitting or denying the allegations, all four companies agreed to a cease and desist order and to pay civil penalties Ranging from $35,000 to $200,000. One company, a Mexican steel manufacturer and processor, continues to remediate material weaknesses and, as part of the settlement, has undertaken to have an independent consultant to review the remediation.

B. Company Disclosures Concerning the Business

In March, the SEC instituted a settled action against a U.S. home improvement company based on allegations that the company made misstatements regarding its products' compliance with regulatory standards.[20] Following a media report on certain of the company's products in 2015, the company stated that third-party test results demonstrated its products were in compliance with regulatory standards. The company also stated that individuals featured in the media reporting were not employees of the company's suppliers. The SEC alleges that the company knew that one of its Chinese suppliers had failed third-party testing and had evidence that the individuals featured in the media reporting were employees of the company's suppliers. Without admitting or denying the findings in the SEC's order, the company agreed to pay a $6 million penalty. On the same day the SEC instituted its settled action, the Department of Justice announced that the company entered into a deferred prosecution agreement and agreed to pay $33 million in forfeiture and criminal fines.

As discussed above in our introductory section, in March of this year, the SEC filed an unsettled complaint against a car manufacturer, two of its subsidiaries, and its former CEO for alleged misstatements concerning the compliance of the company's vehicles with emissions standards at a times when the company issues bonds and asset backed securities.[21] The complaint alleges that the misstatements enabled the company to issue bonds as a lower interest rate than otherwise. As discussed above, the litigation remains pending.

C. Financial Reporting Cases

In early April, the SEC brought a settled action against the founder and former CEO of a Silicon Valley mobile payment startup based on allegations that he overstated the company's revenues and then sold shares he owned to investors in the secondary market.[22] The former CEO agreed to settle the charges without admitting wrongdoing, agreeing to pay more than $17 million in disgorgement and penalties and to be barred from serving as an officer or director of a publicly traded U.S. company. The SEC instituted a separate settled administrative action against the company's former CFO for based on allegations that he failed to exercise reasonable care in the company's financial statements and signed stock transfer agreements that inaccurately implied that the company's board of directors had approved the CEO's stock sales. The CFO, who had also sold some of his shares in the company, entered into a cooperation agreement with the SEC and, in connection with his settlement, agreed to pay approximately $420,000 in disgorgement and prejudgment interest.

Also in April, the SEC filed an unsettled action against the former CFO and two former employees of a publicly traded transportation company.[23] The SEC's complaint alleges that the former CFO hid expenses and manipulated the company's finances, while the other two employees failed to write-off overvalued assets and overstated receivables at one of the company's operating companies. The

complaint also alleges that the defendants misled the company's outside auditor, causing the company to misstate financial results in periodic reports filed with the SECs. The U.S. Department of Justice's Fraud Section also filed parallel criminal charges against the three individuals.

Later in April, the SEC instituted a settled proceeding against a Silicon Valley market place lender that, through its website, sold securities linked to performance of its consumer credit loans.[24] According to the SEC's administrative order, the company excluded certain non-performing charged off loans from its performance calculations reported to investors, and as a result, overstated its net returns. Pursuant to the settlement, the company agreed to pay $3 million.

Also in April, the SEC filed a settled action against a U.S. truckload carrier with accounting fraud, books and records, and internal control violations.[25] The SEC's complaint alleges that the company avoided recognizing impairment charges and losses by selling and buying used trucks at inflated prices from third-parties, which enabled the company to overstate its pre-tax and net income and earnings per share in one annual and two quarterly reports. In the settlement, the company agreed to pay $7 million in disgorgement, which is deemed satisfied by the company's payment of restitution in settlement of a parallel action brought by the Department of Justice. This is also one of the few settled SEC actions under this administration in which the defendant admitted to the violations alleged in the SEC's complaint.

In May, the SEC instituted settled administrative proceedings against a New Hampshire-based manufacturer and its former CEO based on allegations that the company misled investors regarding the company's ability to supply “sapphire glass” for Apple's iPhones.[26] According to the SEC's orders, the company entered into an agreement with Apple to provide sapphire glass that met certain standards, but that the company failed to meet the standards required by the Apple contract, which triggered Apple's right to withhold payment and accelerate a large repayment from the New Hampshire company. Despite Apple's exercise of this withholding and repayment, the company reported that it expected to meet performance targets and receive payment from Apple. In settlement, the former CEO agreed to pay approximately $140,000 in disgorgement and penalties. The company, which had since filed for, and exited from, bankruptcy as a private company, was not assessed a penalty.

D. Cases Against Audit Firms

In February, the SEC instituted a settled administrative proceeding against a large Japanese accounting firm and two of the firm's former executives (the former CEO and the former Reputation and Risk Leader and Director of Independence) based on allegations that the firm violated certain provisions of the SEC's audit independence rules.[27] The SEC's order alleges that the firm issued audit reports for a client notwithstanding that certain personnel within the accounting firm were aware that the client's subsidiary maintained dozens of bank accounts for employees of the accounting firm with balances that exceeded depositary insurance limits. The SEC's order alleges that the firm's quality control system did not provide reasonable measures to help ensure the firm was independent from its audit clients. Without admitting or denying the allegations, the firm agreed to pay a $2 million penalty. The former executives agreed to be suspended from appearing or practicing before the SEC as accountants with a right to apply

for reinstatement after two years in the case of the former CEO and one year in the case of the former Reputation Risk Leader and director of Independence,

In June, the SEC instituted a settled administrative proceeding against an international accounting firm based on allegations that certain former firm personnel obtained confidential lists of inspection targets from a now former employee of the Public Company Accounting Oversight Board (PCAOB) and used the information to alter past audit work papers to reduce the likelihood of deficiencies being found during the PCAOB inspections.[28] Last year, the SEC had previously instituted enforcement actions against the former personnel of the audit firm and the PCAOB. The SEC's settled order against the firm also alleges that a number of the firm's audit professionals engaged in misconduct in connection with internal training exams. Pursuant to the settlement, the firm agreed to pay a $50 million penalty, to retain an independent consultant to review and evaluate the firm's quality controls relating to ethics and integrity, and other remedial measures. The firm also admitted the facts in the SEC's order and acknowledged that its actions violated a PCAOB rule requiring integrity.

III. Cases Against Investment Advisers

A. Representation Concerning Brokerage Commissions

In March, the SEC instituted a settled action against a dually registered broker-dealer and investment adviser in connection with the activity of a firm it had acquired.[29] According to the SEC, the firm represented to advisory clients that they were receiving a discount off the firm's retail commission rates. However, according the SEC's order, the firm did not adequately disclose that clients could have chosen other outside brokerage options at lower commission rates. The SEC alleged that the firm charged commissions on average 4.5 times more than what clients would have paid using other brokerage options, but did not provide any additional services to advisory clients using its in-house brokerage than it did to advisory clients who chose other brokerages with considerably lower commission rates. Without admitting or denying the findings, the firm agreed to pay approximately $5.2 million in disgorgement and prejudgment interest, and a $500,000 civil penalty.

B. Conflicts of Interest

In March, the SEC instituted settled proceedings against a registered investment adviser and its former Chief Operating Officer, alleging they manipulated the auction of a commercial real estate asset on behalf of one client for the benefit of another client.[30] According to the SEC, instead of identifying bona fide bidders, the COO used the firm's affiliated private fund client for one bid and assured two other bidders that they would not win if they participated. According to the SEC, the selling client was thereby deprived of the ability to receive multiple genuine offers which could maximize its profit. Without admitting or denying the findings in the order, the investment adviser agreed to pay approximately $83,000 in disgorgement and prejudgment interest, and a $325,000 civil penalty. The former COO, without admitting or denying the findings in the order, agreed to pay a $65,000 civil penalty and a 12-month industry suspension.

C. Advisory Fees

In March, the SEC filed an unsettled complaint against the former Chief Operating Officer of an investment adviser for allegedly aiding and abetting the advisory firm's overbilling of advisory clients in order to generate additional revenue and improperly inflate his own pay.[31] The U.S. Attorney's Office for the Southern District of New York brought accompanying criminal charges on the same day the SEC action was announced.

In May, the SEC announced a settled action against a now-defunct registered investment adviser in North Carolina alleging that the adviser overcharged clients for advisory fees, misrepresented the reason the adviser's custodian arrangement ended (the custodian observed irregular billing practices), and overstated assets under management in Commission filings.[32] Without admitting or denying the findings in the SEC's order, the owner agreed to pay approximately $400,000 in disgorgement and prejudgment interest, and a $100,000 civil penalty.

D. Misuse of Client Funds

In March, the SEC instituted a settled administrative proceeding against a Seattle-based registered investment adviser and its principal.[33] According to the SEC, the company's principal misused more than $3 million from a private client fund to pay business and personal expenses, sent fraudulent account statements and tax documents to investors, overstated assets in the fund and falsely represented that the fund had undergone an independent audit. The settled order provides that the investment adviser's registration is revoked, the principal is barred from the securities industry, and the company and owner are liable jointly and severally for disgorgement and prejudgment interest of approximately $1.2 million, but with an allowance for offset as to the principal by the amount of any restitution ordered against him in a parallel criminal action in which he agreed to plead guilty.

E. Compliance Policies and Procedures

In June, the SEC instituted a settled administrative proceeding against a private fund manager and its Chief Investment Officer alleging that the manager failed to adopt and implement policies and procedures to address the risk that the traders' pricing of illiquid mortgage-backed bonds may not conform to generally accepted accounting principles.[34] Without admitting or denying the findings in the SEC's order, the fund manager agreed to a civil penalty of $5,000,000 and the CIO agreed to pay a civil penalty of $250,000.

IV. Cases Against Broker-Dealers

A. Cases Concerning ADRs

The SEC continued a 2018 initiative focused on investigating practices related to American Depositary Receipts ("ADR")—U.S. securities that represent foreign shares of a foreign company and that require foreign shares in the same quantity to be held in custody at a depositary bank. Pre-released ADRs are issued without the deposit of foreign shares, but require that either a customer owns the number of foreign shares in equal amounts to the number of shares represented by the ADRs, or that the broker

receiving the shares has an agreement with a depository bank. The SEC settled three cases involving pre-released ADRs in the first half of 2019—one in March and two in June.

In March, a broker-dealer agreed to pay more than $8 million in disgorgement and penalties to settle charges of improperly handling pre-released ADRs.[35] According to the SEC's order, the broker-dealer improperly borrowed pre-released ADRs from other brokers when it should have known that the middlemen did not own the foreign shares required to support the ADRs. As a result of borrowing these pre-released ADRs, there was inappropriate short selling and other improper trading activity.

In June, the SEC settled with a broker-dealer subsidiary of a large bank, and the $42 million that the broker-dealer agreed to pay in disgorgement and penalties resulted in the largest recovery against a broker in connection with ADRs to date.[36] In that matter, the broker-dealer improperly bought pre-released ADRs. The SEC alleged that the broker-dealer falsely represented that the company or its customers owned the requisite number of foreign shares to justify pre-release transactions.

A few days later in June, the SEC instituted settled proceedings against a broker-dealer. The SEC Order alleged that, for approximately two years, the firm failed to take reasonable steps to ensure that the parties who received pre-released ADRs owned the corresponding shares. Without admitting or denying the charges, the broker-dealer agreed to pay $7.3 million in disgorgement and penalties.[37] The Commission noted that the firm undertook voluntary remediation efforts by discontinuing pre-release activity even before the staff began its investigation.

B. Other Broker-Dealer Cases

The SEC also instituted several proceedings against broker-dealers unrelated to ADRs in the first half of 2019. The SEC has filed a number of enforcement actions relating to “blank check” companies, the most recent of which was in February. In February, the SEC announced charges against a broker-dealer, three of the firm's principals, and a transfer agent, alleging that the firm and transfer agent helped create and sell at least 19 sham companies, and that the individuals signed the false applications and failed to investigate.[38] According to the SEC, those charged created these “blank check” companies from 2009 to 2014.

In March, the SEC settled charges with a broker-dealer headquartered in California for allegedly failing to take appropriate measures to supervise one of its registered representatives, who was found to be involved in a pump-and-dump scheme.[39] The SEC instituted proceedings in March 2018, since which time the firm undertook remedial measures such as revising its policies and procedures, and changes to senior leadership. Without admitting or denying the charges, to settle the pending administrative proceeding, the firm agreed to pay a $250,000 penalty and be censured.

In May, a Manhattan jury ruled in favor of the SEC in a case in which the SEC had charged a brokerage firm and its indirect owner and president with fraud and related charges for making material misrepresentations and omissions in a financial company's private placement offering and continuing to use the offering documents to solicit sales despite knowing they were inaccurate.[40] The jury found the firm and individuals liable on all counts.

V. Insider Trading Cases

A. Cases Involving Lawyers

In the first half of 2019, the SEC and Department of Justice twice brought insider trading charges against attorneys who traded on nonpublic information regarding upcoming financial disclosures. In February, the SEC filed an unsettled insider trading action against a former senior attorney at a major technology company, alleging that he traded securities in the company after reviewing confidential information regarding upcoming earnings announcements.[41] The SEC characterized the alleged conduct as particularly serious because the attorney's prior responsibilities included executing the company's insider trading compliance program. The U.S. Attorney's Office for the District of New Jersey announced a parallel criminal complaint on the same day.

In April, the SEC filed a partially-settled insider trading action against a former senior attorney of an entertainment company, for allegedly trading on nonpublic information after reviewing confidential drafts of an earnings release showing better than expected revenues.[42] The attorney consented to a permanent injunction, with penalties and disgorgement to be determined by the district court. The Department of Justice filed a parallel criminal complaint on the same day.

In May, the SEC filed a settled insider trading action against a defendant who had been a houseguest of the general counsel of a company. According to the complaint, the defendant misappropriated nonpublic information, misappropriated from the general counsel's home office, concerning a pending merger involving the general counsel's company, and then traded on the basis of that information in accounts in the name of his ex-wife and an ex-girlfriend.[43] The defendant agreed to a settlement including a penalty of $253,000. The SEC also named as relief defendants the defendant's ex-wife and ex-girlfriend in whose accounts he had traded. They agreed to disgorge the alleged profits of $250,000, along with prejudgment interest.

B. Continued Fallout from *Newman* Decision

In criminal insider trading cases, the impact of the Second Circuit's 2014 ruling in *United States v. Newman*,[44] since abrogated in part by the Supreme Court in *United States v. Salman*,[45] continues to have an impact. In *Newman*, the Court held that, in cases against a defendant who is a downstream tippee, the government must prove the defendant knew the insider source of the information received a personal benefit in exchange for the tip in breach of their duty of confidentiality. In June of this year, the District Court for the Southern District of New York overturned the 2012 guilty plea and conviction of a tippee in light of *Newman*, finding the record plea factually insufficient because "nothing in the record . . . speaks directly or indirectly to [the defendant's] knowledge of any personal benefit the corporate insiders received as a result of divulging confidential information."[46] By contrast, in January of this year, the Second Circuit upheld the 2012 conviction of a former executive, finding *inter alia* that he was not prejudiced by the pre-*Newman* jury instructions in that case.[47]

C. Other Cases Involving Tipper and Tippee Liability

The SEC filed several other insider trading actions involving tipper/tippee liability. In April, the SEC instituted a settled administrative proceedings against a respondent who purchased options in a grocery store chain after learning about its impending acquisition from his wife, who had in turn learned about it from a family member who was a corporate insider.[48] In the settlement, the respondent agreed to pay approximately $57,000 in disgorgement and prejudgment interest.

In June, the SEC obtained final judgments by consent against three defendants -- an executive and two of his friends.[49] The executive had been entrusted by a friend, an employee at Concur Technologies, with confidential information of a forthcoming merger. The executive then tipped one of his friends, who then tipped his brother. The two brothers and other family members then placed short-term trades in call options in Concur, resulting in over $500,000 in profits, a portion of which they gave to their executive friend. The three defendants agreed to pay disgorgement and prejudgment interest all of which was deemed satisfied by orders of forfeiture entered against each of the three individuals in parallel criminal actions in which they pleaded guilty and were sentenced to prison terms ranging from six to twenty-four months.

Also in June, the SEC obtained consent judgments against two defendants, an executive at a pharmaceutical company and a business associate of the executive, in an insider trading case filed last year.[50] The SEC's complaint alleged that the executive tipped the business associate regarding nonpublic negotiations of a licensing agreement, and that the business associate then tipped other defendants who traded on the information, resulting in $1.5 million in gains. Without admitting or denying the allegations in the complaint, the pharmaceutical executive consented to a civil monetary penalty of $750,000 and a five-year officer and director bar. The amount of monetary relief as to the business associate remains to be determined by the court. All but one of other defendants have agreed to partial settlements with the SEC.

Also in June, the SEC filed an amended complaint adding a Swiss businessman as a defendant to an insider trading case filed last year.[51] The defendant allegedly purchased out of the money call options in the target company based on a tip regarding a pending merger from the son of a senior executive of the acquirer. The proceeds of the transaction were previously frozen in the United States and Switzerland. The U.S. Attorney's Office for the Southern District of New York announced a parallel criminal action against the defendant on the same day the SEC filed the amended complaint.

Also in June, the SEC filed a settled insider trading action against a defendant who allegedly sold shares in an energy company after learning about a proposed secondary offering from individuals either at the company or affiliated with an investment bank that endeavored to participate in the offering.[52] According to the complaint, after acquiring the information and before the public announcement, the defendant sold over 9,000 shares of company stock, avoiding approximately $46,000 in losses. The defendant, without admitting or denying the allegations, agreed to pay disgorgement, prejudgment interest, and a one-time civil penalty.

D. Trading by Insiders

In February, the SEC filed a settled insider trading action against a former employee of a biotech company, alleging he sold stock in the company after learning the FDA had recommended withdrawal of two of the company's products, thereby avoiding a loss of approximately $70,000.[53] In the settlement, the defendant agreed to pay approximately $146,000 in disgorgement, prejudgment interest, and a civil penalty.

VI. Cases Concerning Cryptocurrency and Cybersecurity

The SEC has focused on cybersecurity and cryptocurrency issues throughout the first half of the year. In addition to bringing enforcement actions, in May, the SEC's Strategic Hub for Innovation and Financial Technology ("FinHub")[54] hosted a public forum on distributed ledger technology and digital assets.[55] The forum focused on engagement with market participants on new financial technologies, including initial coin offerings.

A. Cybersecurity

In January, the SEC brought its first enforcement action of the year alleging that a Ukrainian hacker along with eight persons and entities engaged in a scheme to extract nonpublic information from the SEC's EDGAR filing system.[56] The SEC alleged that by hacking into the EDGAR system, the accused were able to access documents that had been filed with the SEC, but that had not yet been released publicly, and pass the documents to traders who traded on the nonpublic information to the benefit of $4.1 million. This action follows 2015 charges against the same hacker and other traders for engaging in a similar scheme involving hacking into newswire services for nonpublic information about impending corporate earnings announcements. The U.S. Attorney's Office for the District of New Jersey brought accompanying criminal charges on the same day the SEC action was announced.

B. Failure to Register Initial Coin Offerings

In February, the SEC continued its recent trend of enforcement actions against companies who fail to register an initial coin offering ("ICO") pursuant to federal securities law.[57] Unlike the two ICO-related actions the SEC settled last year,[58] the company at issue in February self-reported its late-2017 unregistered ICO. The company had raised $12.7 million from the sale of these instruments after the Commission had publicly articulated its position that ICOs can constitute securities offerings. The company agreed to fully cooperate with the investigation, to register the token offering, and to compensate any investors who request a return of funds. Because of its self-reporting and remediation measures, the SEC did not impose a penalty.

C. Other Offerings Involving Digital Assets

In May, the SEC obtained a temporary restraining order, asset freeze, and appointment of a receiver against several related companies engaged in an alleged international Ponzi scheme involving cryptocurrency and diamond mines.[59] The principal is accused of using $10 million of the proceeds

from an unregistered cryptocurrency offering by one of his companies to repay the investors in his previous diamond company and to fund his personal expenses.

Also in May, the SEC filed a civil injunctive action charging an individual with operating a $26 million pyramid scheme.[60] The complaint alleges that for over a year the individual conducted an unregistered securities offering where investors purchased instructional business packages as well as "points" that could be converted into a digital asset. Investors earned more of these points through cash investments and by recruiting new investors to purchase digital assets and join the pyramid scheme.

In June, the SEC filed a complaint alleging the defendant company raised $55 million from U.S. investors through an unregistered offering of a digital currency.[61] Investors were allegedly told that the currency's value would increase when the company created a transaction service based on the currency that would be available within and without the company. The SEC alleges these services were never offered and that the value of the currency has decreased by nearly half since it was initially offered.

In June, the SEC filed an amended complaint against a company and its CEO for allegedly conducting a fraudulent IPO and for engaging in accounting fraud by recording more than $66 million in excess revenue.[62] In connection with the original complaint filed last year, the court granted the SEC's request for preliminary relief freezing more than $27 million raised from the allegedly fraudulent offering.[63] Also in June, the U.S. Attorney's Office for the District of New Jersey brought parallel criminal charges against the CEO.

VII. Municipal Securities Cases

A. New Actions

In March, the SEC filed a settled action against a former County Manager, alleging that he provided an unfair advantage to an investment adviser who was selected to manage county pension funds.[64] The complaint alleges the County Manger, who allegedly had a romantic interest in an associate of the adviser, provided access to competitor's proposals, and also failed to disclose the conflict of interest in selecting the adviser. The County Manager consented to a judgment enjoining him from further violations of the Investment Advisers Act and from involvement with the management of public pensions, the selection of underwriters and municipal advisers, and the offering of municipal securities, as well as a $10,000 civil penalty.

Also in March, the SEC announced partially settled charges against the former controller of a not-for-profit college, alleging he misrepresented the college's finances in statements published in connection with its continuing disclosure obligations to investors pursuant to a bond issuance in 1999.[65] According to the SEC's complaint, the former controller created false financial records, and his actions resulted in overstating the college's net assets by almost $34 million in the 2015 fiscal year. The former controller agreed to a permanent injunction, with monetary relief to be determined at a later date. In a parallel criminal action, the former controller agreed to plead guilty. The college was not charged, in light of its cooperation and efforts to remediate the misconduct.

In June, the SEC filed an unsettled action against a municipal adviser and managing partner based on allegations of breach of fiduciary duty in connection with a municipal bond offering for a public library.[66] The complaint alleges the adviser failed to provide sufficient advice on selecting the underwriter for the offering and on pricing bonds, resulting in mispriced bonds which will cost the library additional interest over the life of the bonds. In a related action, the SEC also instituted a settled administrative proceeding against the broker-dealer that underwrote the bonds based on allegations of a failure to act with reasonable care in underwriting the offering. The broker-dealer agreed to a $50,000 civil penalty and to engage an independent compliance consultant.

B. Settlements in Previously Filed Actions

In March, in an action previously filed in 2016, the SEC resolved litigation against a financial institution that had been the placement agent for a municipal bond offering intended to finance a finance startup video game company.[67] The SEC alleged that the institution had failed to disclose that the project faced a shortfall in financing and that the institution was receiving compensation tied to the issuance of the bonds from the startup. Pursuant to the settlement, without admitting or denying the allegations in the complaint, the financial institution agreed to pay approximately $800,000 in civil penalties. The SEC's litigation against the lead banker on the deal is ongoing.

In June, the SEC announced a settlement of a 2017 action against the Town of Oyster Bay, New York for allegedly failing to disclose an agreement to guarantee $20 million of loans to a third-party restaurant and concession stand operator in connection with certain municipal securities offerings.[68] In addition to consenting to an injunction, the Town agreed to retain an independent compliance consultant to advise on its disclosures for securities offerings. The litigation against the former town supervisor is continuing.

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[11] *See* Gibson, Dunn & Crutcher LLP 2018 Mid-Year Securities Enforcement Update (July 30, 2018), *available at* https://www.gibsondunn.com/2018-mid-year-securities-enforcement-update/.

[12] House Financial Services Committee Passes Bill to Expand Dodd-Frank Whistleblower Protection to Internal Whistleblowers (May 30, 2019), *available at* https://www.jdsupra.com/legalnews/house-financial-services-committee-88658/.

[13] *Lorenzo v. SEC*, 587 U.S. ___, No. 17-1077 (U.S. Mar. 27, 2019).

[14] *See* Speech by Commissioner Hester M. Peirce, "Reasonableness Pants," (May 8, 2019), *available at* https://www.sec.gov/news/speech/speech-peirce-050819 ("Congress defined aiding and abetting liability to be the provision of 'substantial assistance' to a securities law violator. It is important for us and the courts not to ascribe primary liability to every violation and thus write aiding and abetting out of the statute.") (footnote omitted).

[15] *See, e.g.*, *Matter of Deer Park Road Management Company, LP*, Rel. No. 5245 (June 4, 2019), n. 7 ("A willful violation of the securities laws means merely 'that the person charged with the duty knows what he is doing…. There is no requirement that the actor 'also be aware that he is violating one of the Rules or Acts.'") (citations omitted).

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[18] *Cato Institute v. SEC, et al.*, Case 1:19-cv-00047 (D.D.C. Jan. 9, 2019).

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[21] SEC Press Release, SEC Charges Volkswagen, Former CEO with Defrauding Bond Investors During "Clean Diesel" Emissions Fraud (Mar. 14, 2019), *available at* https://www.sec.gov/news/press-release/2019-34.

[22] SEC Press Release, SEC Charges Former CEO of Silicon Valley Startup with Defrauding Investors (Apr. 2, 2019), *available at* https://www.sec.gov/news/press-release/2019-50.

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[27] SEC Press Release, Deloitte Japan Charged with Violating Auditor Independence Rules (Feb. 13, 2019), *available at* https://www.sec.gov/news/press-release/2019-9.

[28] SEC Press Release, KPMG Paying $50 Million Penalty for Illicit Use of PCAOB Data and Cheating on Training Exams (June 17, 2019), *available at* https://www.sec.gov/news/press-release/2019-95.

[29] SEC Press Release, BB&T to Return More Than $5 Million to Retail Investors and Pay Penalty Relating to Directed Brokerage Arrangements (Mar. 5, 2019), *available at* www.sec.gov/news/press-release/2019-26.

[30] SEC Press Release, SEC Charges Registered Investment Adviser and Former Chief Operating Officer With Defrauding Client (Mar. 15, 2019), *available at* www.sec.gov/news/press-release/2019-36.

[31] SEC Press Release, SEC Charges New Jersey Man With Fraudulently Causing Advisory Firm to Overbill Clients (Mar. 28, 2019), *available at* www.sec.gov/news/press-release/2019-44.

[32] SEC Press Release, SEC Charges Investment Adviser With Fraud (May 28, 2019), *available at* www.sec.gov/news/press-release/2019-77.

[33] SEC Press Release, Investment Adviser Charged With Stealing Millions From Private Fund (Mar. 28, 2019), *available at* www.sec.gov/news/press-release/2019-45.

[34] SEC Press Release, Hedge Fund Adviser to Pay $5 Million for Compliance Failures Related to Valuation of Fund Assets (June 4, 2019), *available at* www.sec.gov/news/press-release/2019-86.

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[43] SEC Press Release, SEC Charges Nevada Man Who Traded on Confidential Information Taken from Lifetime Friend (May 7, 2019), *available at* https://www.sec.gov/news/press-release/2019-67.

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[46] *United States v. Lee*, No. 13-cr-539 (S.D.N.Y. June 21, 2019); *see also* Jody Godoy, Newman Cited in Tossing Ex-SAC Capital Exec's Guilty Plea, Law 360 (June 21, 2019), *available at* https://www.law360.com/articles/1171838/newman-cited-in-tossing-ex-sac-capital-exec-s-guilty-plea.

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[52] SEC Litigation Release, SEC Charges New Jersey Investor with Insider Trading (June 18, 2019), *available at* https://www.sec.gov/litigation/litreleases/2019/lr24503.htm.

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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.

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

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