BakerHostetler

TOP 10 SEC ENFORCEMENT HIGHLIGHTS OF 2016

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REGULATORY PERSPECTIVES

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We have compiled our annual Top Ten list of Enforcement Highlights. This time, it occurs towards the end of the tenure of SEC Chair Mary Jo White. Sullivan & Cromwell corporate securities and capital markets partner, Jay Clayton, is being considered for the next Chairmanship. We like Clayton's nomination. Mr. Clayton fits the traditional role of the SEC Chair with his deep federal securities laws knowledge and experience in capital markets and formation, two of the hallmark missions for the SEC which are impactful upon the U.S. and world economies. Below we recount the actions and focus of the SEC under Chair White.

1. Looking Back on Her Tenure, Outgoing Chair Mary Jo White Touts the SEC's Aggressive and "Unrelenting" Enforcement Program

SEC Chair White plans to leave her position at the end of the Obama administration.[2] In the press release, an accompanying report, and a published speech she delivered on November 18, 2016, Chair White reflected on her time at the SEC, hailing various changes and developments since she became Chair in April 2013, including an aggressive "new model for enforcement."[3] Among the accomplishments cited:

- More than 2,800 enforcement actions, including insider trading charges against more than 250 individuals; a record 868 actions in fiscal year 2016 (ended Sept. 30, 2016) alone; judgments and orders in fiscal 2016 totaling more than $4 billion in disgorgement and penalties; and "first of their kind" enforcement cases in asset management, market structure and public finance.
- Implementation of a new policy requiring admissions of wrongdoing in certain cases.
- A focus on charging individuals as well as companies, particularly in financial reporting cases.
- Dedicated groups and taskforces focused on financial fraud, microcap abuse, pyramid schemes, and other areas.
- Awarding, since 2011, more than $100 million to 34 whistleblowers who provided original information leading to successful enforcement actions.

It will be interesting to see which changes in the Division of Enforcement occur with a new Chair and at least two new Commission members.

2. The Supreme Court's Affirmance of the Insider Trading Conviction in Salman v. United States

On December 6, 2016, the U.S. Supreme Court unanimously affirmed the insider trading conviction of Bassam Salman in *Salman v. United States*.[4] In so doing, the Court handed a victory to both criminal prosecutors and the SEC, and appeared to resolve a split in the Circuits in favor of the Ninth Circuit's affirmance in Salman and against the Second Circuit's 2014 reversal of insider trading convictions in *United States v. Newman*.[5] In fact, much of Newman remains intact, and the reach of the Court's decision in Salman remains to be determined.

Both Salman and Newman centered on the Supreme Court's holding in *Dirks v. SEC*[6] that a tippee's liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information to receive a personal benefit. *Dirks* instructed courts to focus on

"objective criteria," such as pecuniary gain, in determining whether the insider received a personal benefit, but also held that a jury can infer that the tipper received a personal benefit where the tipper "makes a gift of confidential information to a trading relative or friend."[7]

In *Newman*, the Second Circuit reversed the convictions of two portfolio managers who were "several steps removed from the corporate insiders," where the initial tipper and tippee were merely "casual acquaintances" and friends who were not "close," and where no evidence was introduced at trial to indicate that the defendants knew the source of the inside information or that the insiders received any personal benefit in exchange for the tips.[8] In that context, the Second Circuit held that an inference that the insiders received a personal benefit was impermissible "in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[9]

Salman had made over $1.5 million in profits trading on tips regarding mergers and acquisitions he had received from his friend Michael Kara, who had received the confidential information from Kara's younger brother Maher Kara, an investment banker at Citigroup who was also Salman's brother-in-law. In contrast to the facts in *Newman*, the evidence at Salman's trial established that the initial tipper and tippee (the Kara brothers) had a very close relationship, that the tipper (Maher) provided the tippee (Michael) inside information for the purpose of benefiting him, and that the trading defendant (Salman) had been told the source of the inside information. The Supreme Court affirmed the Ninth Circuit's judgment affirming Salman's conviction, finding that Maher's gift of confidential information to his close relative fit squarely within the Court's holding in *Dirks* that a tipper breaches a fiduciary duty by making a gift of confidential information to a "trading relative."[10]

The Court in *Salman* rejected as inconsistent with *Dirks* any application of *Newman* that would require that a tipper receive something of a "pecuniary or similarly valuable nature" in exchange for a gift to family or friends.[11]

Notably, however, the Court did not suggest that *Newman* was wrongly decided, and it is likely that the Court would have affirmed the Second Circuit's decision based on the facts in that case. The Court also noted that, while *Dirks'* rule concerning tips to a "trading relative" "easily resolves" the issue in *Salman*, future cases will present courts with more difficult tests in determining the factual question whether an insider personally benefited from a particular disclosure.[12]

3. FCPA Action Against Hedge Fund Manager Och-Ziff Capital Management Group LLC

On September 29, 2016, the SEC announced its first ever enforcement action charging a hedge fund manager with violations of the Foreign Corrupt Practices Act (FCPA).[13] The SEC's settled administrative action included charges against hedge fund manager Och-Ziff Capital Management Group LLC, its affiliated registered investment adviser OZ Management LP, and two senior officers of Och-Ziff. An investigation by the SEC had found that Och-Ziff used intermediaries, agents and business partners to pay bribes to high-level government officials in Africa, so as to induce Libya's sovereign wealth fund to invest in Och-Ziff managed funds and to secure mining rights and influence government officials in five African countries.

In settling the charges, Och-Ziff and OZ agreed to pay one of the largest FCPA fines in history, with disgorgement plus prejudgment interest totaling almost $200 million. Och-Ziff's CEO agreed to pay disgorgement plus interest totaling over $2 million. Och-Ziff further agreed to implement several specified enhanced internal accounting controls and policies, to retain an independent monitor for a period of at least three years, and to follow recommendations regarding improving the effectiveness of the firm's FCPA policies and procedures to be made by the monitor in a series of reports.

4. In SEC v. Graham, Eleventh Circuit Applies Five-Year Statute of Limitations to Declaratory Relief and Disgorgement

On May 26, 2016, the Eleventh Circuit issued its opinion in *SEC v. Graham*, the first ever Circuit Court decision applying the five-year statute of limitations set forth in 28 U.S.C. § 2462 to

declaratory relief and disgorgement.[14] Section 2462 governs SEC actions "for the enforcement of any civil fine, penalty, or forfeiture."

The SEC commenced the *Graham* civil enforcement action in federal court in January 2013, alleging that defendants engaged in securities fraud between November 2004 and July 2008. The SEC requested that the District Court: (1) declare that defendants violated federal securities laws; (2) permanently enjoin defendants from future securities law violations; (3) direct defendants to disgorge profits; (4) order defendants to repatriate funds held outside the court's jurisdiction; and (5) require three defendants to pay civil penalties. The District Court dismissed the case, finding that the SEC's claims were time-barred under Section 2462.[15] The District Court relied on the U.S. Supreme Court's 2013 decision in *Gabelli v. SEC*, which involved an SEC claim for a civil penalty. *Gabelli* held that, under Section 2462, there was a five-year statute of limitations for the SEC to bring a civil suit seeking a civil penalty and further, it begins to accrue when the fraud occurs, not when it is discovered.[16]

On appeal, the Eleventh Circuit in *Graham* reversed in part, holding that an injunction is a forward-looking remedy, not a penalty, and therefore not time-barred under Section 2462.[17] But the court affirmed the remainder of the District Court's ruling, holding that Section 2462 applies to declaratory relief and disgorgement, because both are backward-looking and would operate as penalties under Section 2462.[18] Notably, the Eleventh Circuit created an apparent Circuit split in holding that Section 2462 applies to claims for disgorgement, because the D.C. Circuit and Ninth Circuit previously held, pre-*Gabelli*, that disgorgement claims were not subject to the statute of limitations.[19] This new issue on disgorgement now seems ripe for consideration by the Supreme Court.

5. Expansive Interpretation of Advisers Act Rule Targets Fund Administrators as Gatekeepers

Fund administrators have been the target of several recent SEC enforcement actions that seek to hold administrators liable for the misconduct of fund managers and their principals. These aggressive enforcement actions are the first of their kind to argue that administrators serve in a gatekeeper role. The most recent ones were brought against Apex Fund Services (US), Inc. in June 2016 for allegedly violating Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 (Advisers Act) and Rule 206(4)-8 thereunder in connection with its administrative services for ClearPath Wealth Management, LLC[20] and EquityStar Capital Management, LLC,[21] each of which were subject to separate enforcement actions for fraud.

In both enforcement actions, the SEC alleged that Apex contracted with each of ClearPath and EquityStar to maintain records and prepare financial statements and investor account statements but failed to take reasonable steps in response to red flags indicating each fund manager was misappropriating assets. Those red flags included: (1) undisclosed withdrawals, margin accounts and pledged assets; (2) a warning from a prior fund administrator; and (3) a background check on one of the adviser's principals revealing a previous wire fraud conviction. In each settled order, Apex allegedly continued to prepare inaccurate NAV statements and reports despite being aware of these red flags. Pursuant to the settled orders in which Apex neither admitted nor denied the findings, Apex was required to retain an independent compliance consultant to review and recommend improvements to its policies and procedures and to pay approximately $185,000 in disgorgement, $16,000 in prejudgment interest, and $150,000 in civil penalties.
These enforcement actions, which were not litigated, are significant because they imposed liability on Apex by expansively interpreting existing statutes to regulate its conduct as an administrator where they would not otherwise be subject to the SEC's explicit regulation. In particular, the SEC supported this apparent expansion by citing Section 203(k) of the Advisers Act, which allows the SEC to impose a cease-and-desist order upon, among others, any "person that is, was, or would be a cause of [a violation of the Advisers Act], due to an act or omission the person knew or should have known would contribute to such violation."
In this sense, it appears that the SEC viewed Apex as being complicit in the misconduct because they contributed to the environment that supported the underlying fraud. Indeed, Andrew Ceresney, Director of the SEC Division of Enforcement, noted in the press release

announcing these settlements that "Apex failed to live up to its gatekeeper responsibility and essentially enabled the schemes to persist at each of these advisory firms until the SEC stepped in."[22]

It will be interesting to see if the SEC attempts to use this untested and expansive interpretation to broaden its regulatory purview in the coming year.

6. New Initiative Encouraged Broker-Dealers to Self-Report Violations

In June 2016, the SEC announced a significant regulatory and enforcement initiative for clearing broker-dealers, the Customer Protection Rule Initiative, which seeks to encourage broker-dealers to self-report to the SEC historical and ongoing violations of Section 15(c)(3) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 15c3-3 thereunder by November 2016.[23] The Customer Protection Rule requires that clearing broker-dealers, among other things, maintain a reserve bank account that is at least equal in value to the net cash owed to customers and retain physical possession or control over their customers' fully paid and excess margin securities.

This initiative is significant because it offered standardized settlement terms for participating broker-dealers, namely a settled order finding violations of Rule 15c3-3 and any applicable books and records and reporting charges where the broker-dealer:

- Neither admits nor denies the findings minimizing deleterious collateral consequences and investor civil litigation;
- Undertakes to enhance their compliance program, cooperate with any subsequent investigation regarding the violation (including against individuals), and retain an independent compliance consultant if necessary; and
- Pays disgorgement and penalties, which may be reduced for cooperation.

For those broker-dealers that did not self-report by the November deadline, the initiative threatens substantial sanctions if they are later found to be not in compliance with the Customer Protection Rule. To emphasize this regulatory risk, the SEC simultaneously announced a settled order with Merrill Lynch and Pierce, Fenner & Smith Incorporated for Customer Protection Rule violations in which Merrill Lynch admitted to the misconduct and paid $415 million in the form of a civil penalty, disgorgement, and prejudgment interest for (i) engaging in complex options trades that did not have any economic basis but reduced the required deposit of customer cash in its reserve account, which allowed Merrill Lynch to use that customer cash to finance its own trading activities and (ii) holding customer securities in accounts that were subject to liens.[24] If Merrill Lynch had not retained an independent consultant prior to the settlement, the order would have also required it to do so as an undertaking.

Since then, there have been no publicized enforcement actions stemming from this initiative or the targeted sweep. It is likely that a few will be announced in 2017 after examination referrals are made to the Division of Enforcement.

7. Private Equity Remained in Enforcement Crosshairs

The SEC continued to scrutinize public equity funds and advisers throughout 2016 by bringing several enforcement actions relating to conflicts of interest, disclosure lapses and compliance failures. One of the most notable of them occurred in August 2016 involving four private equity fund advisers affiliated with Apollo Global Management, LLC.[25] According to the SEC's settled order, the four Apollo advisers violated Sections Rules 203(e)(6), 206(2), 206(4), and 206(8) of the Advisers Act and 206(4)-7, 206(4)-8, and thereunder in several ways.[26]

First, for nearly four years, the advisers failed to disclose the benefits the funds received from accelerating the payment of future monitoring fees owed by the funds' portfolio companies upon their sale. Because such fees reduced the amount available for distribution to investors, the SEC viewed them as a conflict of interest that required disclosure.

Second, one of the advisers failed to disclose certain information about how loan interest was allocated between the adviser's affiliated general partner, and five of the adviser's funds. Instead of allocating the interest to the funds

as disclosed in their financial statements, the interest was allocated solely to the general partner thus making those financial statement disclosures misleading.

Third, the advisers failed reasonably to supervise a senior partner who improperly charged personal items and services to their funds and portfolio companies. After repeated reprimands of and repayments by the partner, the advisers voluntarily reported the expense issues to the SEC and executed a formal separation agreement with the partner. Without admitting or denying the SEC's findings, the four Apollo advisers agreed to pay approximately $37.5 million in disgorgement, $2.7 million in prejudgment interest, and $12.5 million in civil penalties. It appears that the advisers were able to limit the civil penalty to one-third the possible amount and avoid even stiffer sanctions "based upon their cooperation" that included, among other things, conducting their own reviews of the expense issues, self-reporting those issues to the SEC, and voluntarily and promptly providing documents and information to the staff during the investigation.

Because the SEC has stated that it is deploying more of its staff to focus on examinations of investment advisers in the coming year, it is likely that there will be more enforcement actions in 2017 like the one against the four Apollo advisers.

8. Data Analytics Harnessed to Build Enforcement Actions

Throughout 2016, the SEC increasingly used data analytics to reinforce its enforcement program through the involvement of the Division of Economic and Risk Analysis (DERA). In fact, Chair Mary Jo White emphasized these new capabilities during a November 2016 speech: "There are now huge quantities of data available for nearly all parts of the market, including corporate equity and bond trading, trading in complex financial instruments, municipal bond trading, and other market activity. More than ever, the SEC is developing in-house innovative analytical tools to take advantage of today's data-rich environment. The result is that the number of cases we are able to originate in-house has risen dramatically."[27]

One of this past year's notable analytic enforcement actions was brought against the investment adviser, TPG Advisors, LLC, and its principal, Larry M. Phillips, in December 2016 for systematically and unfairly allocating trades to benefit certain favored clients to the detriment of other clients for over four years.[28] According to the order, the performance of the favored client accounts was a "statistical anomaly" with a less than 1% "likelihood that their profitability originated from random chance."[29] Pursuant to the order, the defendants admitted to wrongdoing in violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 206(1), 206(2), and 207 of the Advisers Act, and agreed to pay approximately $25,000 in disgorgement, $3,000 in prejudgment interest, and $300,000 in civil penalties. The order also imposed on Phillips a permanent bar. As the SEC continues to develop these in-house capabilities, DERA will continue to play a role in the SEC's enforcement program in 2017.

9. SEC Charges Investment Adviser with Inaccurate Form ADV Disclosures Regarding Wrap Fee Costs

In its fiscal year ended September 30, 2016, the SEC brought its most ever cases involving investment advisers or investment companies (160) and its most ever standalone cases involving investment advisers or investment companies (98).[30] Included in these were several cases against investment advisers alleging misrepresentations or inadequate disclosures concerning fees and expenses, including fees charged in connection with wrap fee programs. In such programs, clients pay an annual fee intended to cover the cost of services such as custody, trade execution and portfolio management. Transaction charges on trades sent to the broker-dealer designated in the program are typically included in the wrap fee. If, however, the investment adviser "trades away" by sending trades to another broker-dealer for execution, the advisory client typically incurs additional costs.

One example of the SEC's wrap fee cases was the settled administrative action against registered investment adviser RiverFront Investment Group, LLC.[31] On July 14, 2016, the SEC announced settled charges that RiverFront made materially inaccurate disclosures in its Form ADV, stating that it "will generally"

execute transactions for wrap fee clients through the wrap program's sponsor. In fact, RiverFront traded away for a majority of the volume for its wrap clients. Notwithstanding RiverFront's position that it did so to seek best execution, the SEC determined that RiverFront's practice made its Form ADV disclosures materially inaccurate, in violation of Section 204(a) of the Advisers Act and Rule 204-1(a) thereunder. RiverFront was ordered to pay a civil penalty of $300,000.

10. Steps Taken to Further Incentivize and Protect Whistleblowers

Over the past year, the SEC continued to develop its Whistleblower Program by issuing millions of dollars of awards, sanctioning companies for violating the Whistleblower Protection Rule through restrictive severance agreements and retaliatory actions,[32] and conducting a sweep examination of registered investment advisers and broker-dealers to assess their compliance with Dodd Frank's whistleblower rules.[33]

The SEC's Office of the Whistleblower further incentivized whistleblowers by handing out over $79 million in awards to 15 whistleblowers in 2016, including, among others:

- $22 million to "a whistleblower whose detailed tip and extensive assistance helped the agency halt a well-hidden fraud at the company where the whistleblower worked."[34]
- $20 million to "a whistleblower who promptly came forward with valuable information that enabled the SEC to move quickly and initiate an enforcement action against wrongdoers before they could squander the money."[35]
- $17 million to "a former executive whose tip substantially advanced the agency's investigation and resulted in a successful enforcement action."[36]
- $900,000 to "a whistleblower whose tip enabled the SEC to bring multiple enforcement actions against wrongdoers."[37] and
- $700,000 to "a company outsider who conducted a detailed analysis that led to a successful SEC enforcement action."[38]

The flurry of awards over the past year appears to be the result of the tips working their way through the investigation and enforcement process, suggesting a sign of things to come in 2017. Since the inception of the Whistleblower Program, the SEC has awarded more than $136 million to 37 whistleblowers resulting in more than $504 million being ordered in sanctions, including more than $346 million in disgorgement and interest for harmed investors.[39]

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6. *Dirks v. SEC*, 463 U.S. 646 (1983).
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