SEC REPORTS RECORD-BREAKING FIGURES IN ENFORCEMENT ACTIONS AND MONETARY SANCTIONS FOR FISCAL YEAR 2014

On October 16, 2014, the SEC announced its enforcement statistics for FY 2014, highlighting a record-breaking year for sanctions imposed and the first year-over-year increase in cases filed since 2011. In what represents SEC Chair Mary Jo White’s first full fiscal year in charge, the SEC filed 755 enforcement actions and obtained orders for $4.16 billion in penalties and disgorgement, both of which are record figures. By comparison, FY 2013 saw 686 enforcement actions and $3.4 billion in penalties and disgorgement, the latter being a then-record amount. In November 2014, the SEC also released its annual financial report, providing further details on the Enforcement Division’s FY 2014 activities and priorities.
Fiscal year 2014 saw increases in almost all enforcement categories with only delinquent filing, investment adviser, and securities offering actions seeing declines. The year saw significant increases in actions related to broker-dealers, issuer reporting and disclosure, and market manipulation.

As the SEC moves away from financial-crisis era cases, it is touting a new and broader enforcement strategy that appears to result in more enforcement actions. At the same time, fewer of those cases are the kind of “blockbuster actions” that some see as an important aspect of the SEC’s role. Fiscal year 2014 saw multiple “first-of-its-kind” cases, including the first two enforcement actions charging violations of Rule 15c3-5, known as the Market Access Rule. Other firsts in 2014 included the first ever anti-retaliation enforcement action. Additionally, in its first action under the Municipalities Continuing Disclosure Cooperation (MCDC) Initiative, the SEC reached a settlement with a California school district for charges of misleading bond investors. The SEC also brought its first “pay-to-play” action against a private equity firm, its first action alleging a failure to maintain procedures designed to prevent employees from misusing customers’ nonpublic information, and its first action for violations of auditor independence lobbying rules.

This year’s enforcement tally highlighted several SEC priorities likely to continue in 2015. Among the most controversial is the SEC’s insistence on admissions of wrongdoing in some cases. Since announcing its new admissions policy in June 2013, the SEC has procured at least 13 settlements with firms where an admission of wrongdoing was a condition of settlement. According to the SEC, it will continue to seek admissions in cases where the violations include “particularly egregious conduct, where large numbers of investors were harmed, where the markets or investors were placed at significant risk, where the conduct obstructs the Commission’s investigation, where an admission can send a particularly important message to the markets, or where the wrongdoer poses a particular future threat to investors or the markets.”

As discussed elsewhere in this edition of the SEC Enforcement Quarterly, the SEC has also continued to prioritize the prosecution of seemingly small legal violations under the SEC’s “broken windows” strategy and to focus on the role of gatekeepers. Although the “broken windows” strategy has been criticized by many—including SEC Commissioner Michael Piwowar—Andrew Ceresney, Director of the SEC’s Division of Enforcement, indicated in October that the strategy is working and the SEC will continue to use it to promote a culture of compliance.

Fiscal year 2014 also featured several high-profile enforcement cases involving exchanges and trading venues that reflected the SEC’s concerns with the rise of sophisticated trading technologies and venues and its attempts to employ technology to more effectively leverage “big data.” The New York Stock Exchange and two affiliates paid $4.5 million to settle charges that they repeatedly engaged in business practices that either violated exchange rules or required an exchange rule where none was in effect. A brokerage firm that operated a “dark pool” trading venue paid $2 million to settle charges that it improperly used subscribers’ confidential trading information in marketing its services. At $2.85 million, FY 2014 also saw the largest-ever penalty against an Alternative Trading System (i.e., a non-exchange trading system), as well as the first-ever case against a high-frequency trading firm. The latter case yielded a $16 million penalty, which is the largest-ever net capital rule penalty.

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The SEC also intensified its enforcement actions in areas of financial reporting and accounting fraud, with 99 actions in FY 2014. This was a marked increase from the 68 enforcement actions in 2013 related to reporting and disclosure.

In the post-Dodd Frank era, an increasing number of enforcement actions are generated from the SEC Whistleblower Program. As discussed elsewhere in this edition of the *SEC Enforcement Quarterly*, in FY 2014, the program awarded nine whistleblowers with awards totaling approximately $35 million, including a single $30 million award—the largest-ever whistleblower award.

With the financial crisis now behind it, Director Ceresney has indicated that in 2015 the Enforcement Division aims to bring cases in a broad range of areas, including insider trading, market structure, microcap-stock fraud, pyramid schemes, municipal securities, complex financial instruments, and investment-adviser fraud. Industry participants should be aware of these trends and should be prepared for heightened regulatory scrutiny in areas that may have been relatively “under the radar” in recent years.

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**SEC Issues Fourth Annual Whistleblower Report**

The SEC Whistleblower Program provides significant awards to any person who provides “original information” to the SEC that results in monetary sanctions over $1 million. Specifically, an eligible whistleblower is entitled to an award ranging from 10% to 30% of any such recovery. The awards are paid from the Investor Protection Fund, which was created by Dodd-Frank and had, as of the end of the reporting period, a robust balance of over $437 million.

As was discussed in a prior edition of the *SEC Enforcement Quarterly*, FY 2014 saw the largest whistleblower award yet under the program which, at more than $30 million, was double the previous record amount. Several whistleblowers who had received awards in previous years also received further payments during the reporting period due to the SEC’s collection of additional amounts in connection with the related actions.

Another award was issued to an individual with compliance or internal audit responsibilities. Such whistleblowers are only eligible for awards under limited circumstances, including if the disclosure of the information is necessary to prevent conduct likely to cause substantial injury to the financial interest of the firm or its investors, or if the firm’s conduct will impede an investigation. In this case, the whistleblower was eligible for an award because the individual had reported the violations internally to designated persons at least 120 days before providing the information to the Commission. In another case noted in the Annual Report, the Commission granted an award even though the whistleblower’s disclosure was not technically “voluntary” under the program because the individual had received a request related to the same subject matter in connection with an outside investigation. However, because the whistleblower had aggressively worked to report the issues internally, but was unsuccessful in getting its employer to change its practices, the SEC determined that an award was “in the public interest and consistent with the protection of investors.”

In recent interviews, Sean McKessy, Chief of the SEC’s Office of the Whistleblower, has emphasized the importance of maintaining the anonymity of whistleblowers, explaining that the identities of those who provide tips to the agency are protected even against disclosure to other segments of the government. Consistent with the focus on anonymity, the Annual Report provides only aggregate information about award recipients. For example, over 40% of the individuals who have received awards were company insiders, and over 20% were contractors or consultants. In addition, over 80% of these individuals reported their concerns internally before bringing them to the SEC.

The Annual Report noted that commonalities exist among the tips and complaints that award recipients submitted. For example, their information was specific,
generally identifying individuals involved in or documents associated with the wrongdoing. In addition, the alleged wrongdoing was relatively current or ongoing. Moreover, after submitting their initial reports, these whistleblowers provided additional information or assistance to SEC staff conducting the investigations.

In FY 2014, the SEC brought its first enforcement action designed to combat retaliatory measures taken against a whistleblower. That case centered around a trader at a financial institution who reported to the SEC that the firm had engaged in prohibited transactions. After learning of the trader’s actions, the firm engaged in a series of retaliatory actions, including changing the trader’s role at the institution. The action ultimately resulted in a $2.2 million penalty against the financial institution.

Importantly, in public statements, Mr. McKessy has identified anti-retaliation cases as a priority for his office and has noted that these cases could include not only situations of post-reporting retaliation but also situations where employment agreements would prevent employees from reporting violations to regulators in the first place. In addition, during FY 2014, the Annual Report highlighted that the SEC filed several amicus curiae briefs arguing that the Dodd-Frank protections against retaliation should be broadly interpreted. These efforts reinforce the SEC’s position that employers’ retaliation against whistleblowers in any form is unacceptable, and employers should be careful not to engage in these practices.

SECOND CIRCUIT’S DECISION IN NEWMAN SHEDS DOUBT ON THE GOVERNMENT’S RECENT APPROACH TO INSIDER TRADING PROSECUTIONS

On December 10, 2014, in a decision that could have far-ranging implications, the United States Court of Appeals for the Second Circuit, in United States v. Newman, reversed the insider-trading convictions of two hedge fund managers, Todd Newman and Anthony Chiasson. The court held that “in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit.” The decision may make it more difficult for the government to establish insider-trading cases against remote tippees who are at the end of a chain of tippees, far away from the original tipper. The case may also create a more stringent standard for what qualifies as a “personal benefit” to an insider in exchange for disclosing information.

The Newman case arose out of the recent investigative focus of the Manhattan United States Attorney’s Office on insider trading within the hedge fund industry. Newman and Chiasson were portfolio managers convicted of insider trading after trading on information received from financial analysts who were not themselves the insiders (or tippers), but who had received the information from others. The issues in Newman focused on the legal standard for individuals like Newman and Chiasson who were tippees “several steps removed from the corporate insiders” who had initially disclosed the material, nonpublic information.

The government argued at trial and on appeal that for tippees to be liable they must only know that the insider had “breach[ed] a duty of confidentiality” in disclosing the information, and that they did not need to know that the insider had received a personal benefit for disclosing the information.

The Second Circuit disagreed, holding that this standard failed to consider important and necessary elements of a fraud claim against a tippee. According to the Second Circuit, a tippee’s liability for insider trading does not result solely from trading on material, nonpublic information. Instead, it “derives only from the tipper’s [or insider’s] breach of a fiduciary duty.” Therefore, to be liable, the tipper must have breached a fiduciary duty and the tippee must know of the tipper’s breach. And contrary to the government’s argument, merely disclosing confidential information does not qualify as a breach for a tipper. There must be an “exchange of confidential information for personal benefit.” Therefore, the Second Circuit held that to be liable for insider trading, a tippee must “know of the personal benefit received by the [tipper] in exchange for the disclosure.” The court concluded that the district court’s jury instructions failed to accurately advise the jury on these elements and the required knowledge of the tippee.
The Second Circuit did not stop there, however. It went on to evaluate the sufficiency of the evidence on the question of the personal benefit to the tipper in *Newman*. While acknowledging that personal benefit is “broadly defined,” the “mere fact of friendship, particularly of a casual or social nature” is not enough. Instead, to establish a personal benefit, there must be “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.” The court concluded that the circumstantial evidence in *Newman* was “too thin to warrant the inference” that the tippers received any personal benefit.

The *Newman* decision firmly rejects the government’s recent efforts to broaden the scope of who could be charged with insider trading. As the court stated, “[t]he Government’s overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders.” *Newman* will likely lead to renewed challenges by many defendants who were convicted of insider trading based on this “doctrinal novelty.” The decision will also likely increase the burden on the government in future insider trading cases to define the personal benefit received by the insider—an element that under the previous standard in the Second Circuit often proved to be no more than a formality.

Notably, as the Second Circuit pointed out, the actual tippers had not been charged “administratively, civilly, or criminally for insider trading or any other wrongdoing.” Without sufficient evidence of a personal benefit to the tipper, there could be no breach by the tipper and no liability for the defendant tippees.

“The Government’s overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders.”

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**RECENT SEC STAFF CHANGES**

- **On October 20, 2014**, the SEC named **Marc Wyatt** as Deputy Director of the Office of Compliance Inspections and Examinations (“OCIE”).
- **On October 21, 2014**, the SEC announced that the Director of the Office of Municipal Securities, **John J. Cross III**, would leave the agency in November. Mr. Cross was the first Director of the Office of Municipal Securities, a position that was established under the Dodd-Frank Act to oversee the municipal securities market.
- **On October 28, 2014**, the SEC announced that **Steven J. Levine** had been named the Associate Director for the Investment Adviser/Investment Company (“IA/IC”) examination program in its Chicago office, where he will oversee the IA/IC examination program in nine Midwestern states.
- **On November 26, 2014**, the SEC named **Kevin M. Kelcourse** as the Associate Director for OCIE in Boston, where he will oversee the SEC’s exam program in six New England states.
- **On December 10, 2014**, the SEC announced that **Karol L.K. Pollock** had been named the Associate Director of the examination program in the Los Angeles Regional Office, where she will oversee the staff responsible for examining firms in Southern California, Nevada, Arizona, Hawaii, and Guam.
- **On December 17, 2014**, the SEC announced that **Gary Barnett** and **Gary Goldsholle** had been named Deputy Directors in the Division of Trading and Markets. Mr. Barnett will have responsibility for the Office of Broker-Dealer Finances and the Office of Derivatives Policy and Trading Practices. Mr. Goldsholle will oversee the offices of the Chief Counsel, Clearance and Settlement, and Market Supervision.
THIRD CIRCUIT HOLDS THAT PREDISPUTE ARBITRATION AGREEMENTS ARE NOT BARRED IN DODD-FRANK WHISTLEBLOWER RETALIATION CLAIMS

On December 8, 2014, the United States Court of Appeals for the Third Circuit held in *Khazin v. TD Ameritrade Holding Corp.* that the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or the “Act”) does not bar arbitration pursuant to predispute agreements when a whistleblower brings a retaliation claim under the Act.

Khazin alleged that his employers, TD Ameritrade, Inc. and Amerivest Investment Management Company (collectively, “TD”), fired him after he reported to his supervisor that one of TD’s products was priced in a manner that did not comply with the securities laws. He sued TD in federal district court under the portion of Section 922 of Dodd-Frank that created a whistleblower retaliation private right of action. TD sought to compel arbitration pursuant to Khazin’s employment agreement, arguing that Dodd-Frank’s prohibition on arbitration pursuant to predispute agreement does not apply to claims under Dodd-Frank itself and, in any event, because Khazin’s employment agreement pre-dated Dodd-Frank, the Act could not retroactively apply to bar arbitration. Khazin resisted and cited the portion of Section 922 of Dodd-Frank which provides that “[n]o predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section.” The district court adopted TD’s retroactivity argument and compelled arbitration.

On appeal, the Third Circuit avoided the retroactivity issue and affirmed on the alternate ground advanced by TD—that the predispute arbitration provision does not apply to retaliation claims brought under the retaliation right of action created by Dodd-Frank. In reaching its decision, the Third Circuit relied on the plain language of the Act. While Section 922 of Dodd-Frank contains both the Dodd-Frank retaliation cause-of-action provision and the anti-arbitration provision relied on by Khazin, those provisions were codified in entirely separate parts of the United States Code. The Dodd-Frank cause-of-action was codified as part of the Security Exchange Act of 1934 (15 U.S.C. § 78u-6(h)) while the anti-arbitration provision was codified at 18 U.S.C. § 1514A(e)(2), related to the Sarbanes-Oxley Act of 2002. Thus, the Third Circuit had little trouble holding that the anti-arbitration provision applies only to Sarbanes-Oxley retaliation claims, reasoning that the provision “is expressly limited to a single category of disputes: those arising under this section, meaning Section 1514A…[which] contains the Sarbanes-Oxley cause of action.” The court noted that the Dodd-Frank retaliation cause of action “is not located in the same title of the United States Code, let alone the same section.”

The court further concluded that nothing in the structure or history of Dodd-Frank supported judicially recognizing an arbitration bar that does not appear in the text, and that no administrative interpretation supported such a reading. The court noted that, in addition to the Sarbanes-Oxley provision, Dodd-Frank also appended similar anti-arbitration provisions to the whistleblower retaliation sections of the Commodity Exchange Act and Consumer Financial Protection Act. The court reasoned that “[t]he fact that Congress did not append an anti-arbitration provision to the Dodd-Frank cause of action while contemporaneously adding such provisions elsewhere suggests…that the omission was deliberate,” rather than an oversight that ought to be remedied, as urged by Khazin.

Two federal district courts (the Southern District of New York and the Central District of California) have previously considered this same issue and reached the same conclusion. The *Khazin* decision again highlights the important distinctions between the retaliation rights of action available to whistleblowers under different acts, including Dodd-Frank and Sarbanes-Oxley. As the Third Circuit noted, each cause of action is “substantively different, and each has its own prohibited conduct, statute of limitations, and remedies.”
On December 15, 2014, in a 3-2 decision, the SEC announced an extremely broad test for primary liability under the antifraud provisions of the federal securities laws by adopting a new, narrow interpretation of the United States Supreme Court’s holding in \textit{Janus Capital Group v. First Derivative Traders}. In the recent enforcement action, \textit{In re: John P. Flannery and James D. Hopkins}, the SEC opined that the \textit{Janus} holding regarding who can be held primarily liable for “making” a misstatement under Rule 10b-5(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) does not apply to Rule 10b-5(a) or (c), and that one does not have to “make” a misstatement or engage in deceptive or manipulative conduct at all to be liable under any provision of Section 17(a) of the Securities Act of 1933 (the “Securities Act”). The ruling has important implications not only for SEC enforcement actions under the antifraud provisions, but potentially for private damages actions under Rule 10b-5.

The decision, led by SEC Chair Mary Jo White and joined by the Commission’s two Democratic members, overturned the Chief Administrative Law Judge’s dismissal of charges against John Flannery, the chief investment officer of a fund complex, and James Hopkins, a fund product engineer. The SEC Enforcement Division alleged that the two had misled investors about the makeup of a collective trust fund that invested in asset-backed securities leading up to the financial crisis.

In \textit{Janus}, the Supreme Court limited primary liability under Rule 10b-5 to those who had “ultimate authority” over the alleged misstatements, i.e., those who had “made” the statements. The holding in \textit{Janus} meant that an investment adviser who drafted misstatements that were later incorporated into a separate mutual fund’s prospectus could not be found liable under Rule 10b-5 because it did not “make” the misstatement. Several district courts have since interpreted \textit{Janus} to limit primary liability based on other antifraud provisions of the Exchange Act and the Securities Act. In \textit{Flannery}, the SEC outright rejected these interpretations, concluding that the limitation established in \textit{Janus} applied only to Rule 10b-5(b), pointing out that the Supreme Court never suggested that a defendant’s failure to “make” a misstatement for purposes of 10b-5(b) precluded primary liability under any other provision because the language of those provisions does not include the verb “to make.” The SEC went on to explain that one could be primarily liable under Rules 10b-5(a) or (c) for drafting or using a misstatement even if one does not “make” the misstatement (or did not engage in any
additional deceptive conduct). The SEC further ruled that Janus does not apply to any provision of Section 17(a) of the Securities Act, which means that one could be primarily liable if one makes, drafts, or devises a misstatement or contributes to a fraud; negligently “uses” a misstatement (even if one has not made it); or if one’s negligent conduct, even when not deceptive or manipulative itself, causes investors to receive misleading information. The SEC defended this interpretation as being supported by its “long-held position that the securities laws should not be construed technically and restrictively, but flexibly to effectuate” their remedial purposes.

In applying this new interpretation of Janus, the SEC found that Hopkins and Flannery had understated the degree to which the collective trust fund had been invested in asset-backed securities by using presentations in investor meetings that described the fund’s “typical” portfolio as concentrated 55% in ABS, when in fact that percentage had become higher as the financial crisis progressed. The SEC determined that these presentations had become misleading given the magnitude of the difference between the represented “typical” versus then-current exposure levels. Because Hopkins was involved in drafting, approving, and delivering the presentations, the SEC determined that Hopkins had “made” a misstatement in violation of Rule 10b-5(b), and that he had therefore also employed a “device” or “artifice to defraud” under Rule 10b-5(a) and Section 17(a)(1), as well as a deceptive “act” under Rule 10b-5(c). With respect to Flannery, the SEC found that he negligently contributed to and approved two client letters that misleadingly downplayed the fund’s risk, and that he was liable under Section 17(a)(3) because these two letters constituted a “course of business” that operated as a fraud on the fund’s investors.

Counsel for Flannery and Hopkins have stated that they will appeal the ruling, which should result in an important court of appeals decision on the extent of primary liability after Janus. The SEC likely will argue that its interpretation is entitled to Chevron deference. However, the extent of judicial deference that will be granted on a question of law remains to be seen, where the SEC reversed, by a 3-2 partisan vote, the findings of the actual trier of fact on a statute and rule subject to criminal enforcement. The decision also represents a level of hindsight second-guessing about disclosure, at a time of rapidly changing facts during the financial crisis, that should concern anyone in the financial services industry.

SUPREME COURT JUSTICES EXPRESS SKEPTICISM ABOUT DEFERENCE OWED TO GOVERNMENT IN SECTION 10(B) CRIMINAL PROSECUTIONS

In the course of the United States Supreme Court’s recent denial of a petition for certiorari in a criminal insider-trading case under Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”), Justice Scalia (joined by Justice Thomas) expressed skepticism about whether courts owed deference to an executive agency’s interpretation of a statute that can be enforced in both civil and criminal proceedings.

The petition in question, Whitman v. United States, requested review of the Second Circuit’s decision upholding an August 2012 conviction for insider trading. The Supreme Court denied the petition, but in an unusual move, Scalia attached a three-page statement to what is usually a perfunctory one-sentence petition denial. In the statement, Scalia acknowledged that the procedural history of Whitman made it a poor setting in which to reach the question of interpretive deference.
This was because the Second Circuit’s holding in *Whitman* did not rely on any agency interpretation and was instead based on court precedent that pre-dated the relevant SEC rulemaking on insider trading. Thus, any consideration of agency interpretation would not have changed the Second Circuit’s holding. Still, in the statement, Scalia discussed the interpretive deference question and made clear that he would be receptive to granting a future petition concerning the question when a petition properly presenting it reached the Court.

In the context of civil enforcement actions, courts routinely defer to an administrative agency’s interpretation of the statute that is being construed—granting what is known as *Chevron* deference. In contrast, as Scalia notes, criminal statutes are for the courts and not the government to construe and “the rule of lenity requires interpreters to resolve ambiguity in criminal laws in favor of defendants.”

Yet Congress frequently drafts laws that may be enforced either civilly or criminally. For example, the SEC frequently brings civil cases alleging violations of Section 10(b) of the Exchange Act, while the Department of Justice brings its own cases alleging criminal violations of 10(b). When courts are tasked with interpreting these kind of dual-use statutes in criminal cases, the government, perhaps unsurprisingly, often argues that the courts should defer to an agency’s interpretation of the statute, especially when the agency entrusted by Congress with administering the statute is the one doing the interpreting. In these situations, based on the principles of *Chevron*, courts often conclude that the government’s position is owed a degree of deference.

Justice Scalia questioned the appropriateness of that approach. His skepticism echoes comments by other circuit judges, who have noted that a single statute can only have one meaning—even if it is used in both civil and criminal proceedings. What is seemingly required is for courts to choose a consistent approach. And Justice Scalia, although not deciding the issue, hinted rather strongly that he believed the rule of lenity must trump *Chevron* deference.

Were the Supreme Court to ultimately resolve the issue in favor of lenity and against deference, it would likely cabin the reach of certain federal securities laws. Section 10(b), for instance, has been noted for its ambiguous language and the SEC has capitalized on that ambiguity by seeking to apply the statute to a broad range of conduct. The Supreme Court and other courts have usually deferred to the Commission in these cases, noting that “the statute should be construed not technically and restrictively, but flexibly to effectuate its remedial purpose.” Replacing that flexibility with the rule of lenity could foreclose the SEC’s efforts to expand the reach of the statute.

Ultimately, while Justice Scalia was only speaking for himself and Justice Thomas, it seems likely that now that the question has been raised, the entire Court will soon be given an opportunity to provide an answer.

**JUDGE RAKOFF CRITICIZES THE SEC’S INCREASED USE OF ADMINISTRATIVE PROCEEDINGS**

United States District Court Judge Jed Rakoff recently delivered a key note speech at the Practising Law Institute’s (“PLI’s”) Annual Securities Regulation Institute directly criticizing the SEC Enforcement Division’s move towards bringing cases in its in-house administrative forum rather than federal courts. According to SEC statistics, between 2009 and 2013, the percentage of the enforcement cases initiated in administrative proceedings increased from 53% to 69%. In 2014, the percentage was approximately 80%. The SEC’s Enforcement staff has publicly stated their expectation that this trend will continue and the Commission has recently doubled its administrative law staff in an apparent attempt to meet this new demand.

According to Judge Rakoff, while the SEC is “one of the jewels of the federal regulatory regime,” the Commission’s preference for bringing cases before ALJs instead of the federal courts “impinge[s] on the courts” and undermines the balanced and impartial development of securities law. This was certainly not Judge Rakoff’s first time rebuking the SEC’s administrative proceeding policy. In his August 2014 opinion in the *Citigroup* case, Judge Rakoff questioned the due process implications of the Commission’s in-house adjudications, commenting that “the Court of Appeals invites the SEC to avoid even the extremely modest review it leaves to the district court by proceeding on a solely
SEC’S INCREASED USE OF ADMINISTRATIVE PROCEEDINGS CRITICIZED

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administrative basis,” leaving the Commission “free to eschew the involvement of the courts and employ its own arsenal of remedies instead.”

In his PLI speech, Judge Rakoff asserted that the Commission’s present stance on administrative proceedings was heralded by the statutory expansion of the SEC’s administrative jurisdiction and powers that was part of a “long-term trend that has accelerated in recent years.” Among other things, he cited the growth throughout the years of the SEC’s arsenal of remedies and sanctions available through administrative proceedings, including injunctive powers, cease-and-desist orders, and disgorgement. Those administrative powers had always been connected to “the agency’s oversight of regulated entities or those representing entities before the Commission” but had previously been “largely ancillary to the broader remedies and sanctions [the Commission] could obtain by going to federal court.” According to Judge Rakoff, the “final, and largest expansion of the SEC’s administrative enforcement power” came with the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) which for the first time granted the SEC “the power through internal administrative proceedings to impose substantial monetary penalties against any person or entity whatsoever if that person or entity has violated the federal securities laws, even if the violation was unintentional.” For Judge Rakoff, the “net result” of Dodd-Frank was that the SEC could now “obtain through internal administrative proceedings nearly everything it might obtain by going to court.”

According to Judge Rakoff, among the problems with administrative proceedings are the limitations under the SEC’s Rules of Practice on traditional civil discovery mechanisms, the inapplicability of the Federal Rules of Evidence during hearings, and the loss of the jury as fact finder. In Judge Rakoff’s estimation, any purported efficiencies gained by administrative proceedings seemed to benefit the Enforcement Division rather than the adjudicative process itself: “It is hardly surprising in these circumstances that the SEC won 100% of its internal administrative hearings in the fiscal year ending September 30, 2014, whereas it won only 61% of its trials in federal court during the same period.”

Moreover, in Judge Rakoff’s view, any proclaimed justifications fail to outweigh the costs. The “[m]ost significant SEC enforcement actions, especially those involving complicated or novel questions of fact or law, are brought under the general anti-fraud provisions of the federal securities laws,” such as Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act. The development of law under these provisions, Judge Rakoff claimed, is attributable to judges. But the SEC’s more recent practices have turned this process on its head: “[L]aw in such cases would effectively be made, not by neutral federal courts, but by SEC administrative judges.” Moreover, Judge Rakoff noted, administrative proceedings impact the quality of appellate review as well. Questions of law no longer would be subject to de novo appellate review, but would rather be entitled to Chevron deference, a more limited and deferential standard. The outcome, Judge Rakoff claimed, is “unlikely…to lead to as balanced, careful, and impartial interpretations as would result from having those cases brought in federal court.”

Judge Rakoff warned that this system is not only unfair to litigants in the short-run but also detrimental to the SEC’s reputation for fairness in the long-run. The cumulative effect, Judge Rakoff urged, was that the SEC would “become, in effect, a law unto itself,” which was not in the SEC’s interest, “in the interest of the securities markets, nor in the interest of the public as a whole.”

In remarks to the American Bar Association’s Business Law Section Fall Meeting in November 2014, SEC Director of Enforcement Andrew J. Ceresney sought to justify the Commission’s preference for administrative proceedings. While not citing Judge Rakoff’s speech explicitly, Director Ceresney’s remarks clearly seemed directed at Rakoff’s critique and the SEC’s fundamental disagreement with it. Ceresney argued that “using the administrative forum furthers the balanced and informed development of the federal securities laws, just as it does in other specialized legal areas in which administrative agencies function.”

Ceresney emphasized that the policy is not new and that the Commission has always had the ability to bring, and has brought, administrative cases against both registered and unregistered persons. He acknowledged that before Dodd-Frank, “penalties against unregulated entities or individuals were only available in district court,” but he contended that the SEC’s policy is now “simply making use of administrative forum in cases where we previously could only obtain penalties in district court.” While settlements will “often” be filed in administrative proceedings in order to expeditiously...
end matters where the parties have agreed to settlement, he claimed that the forum in which cases will be brought are subject to case-by-case determinations. As evidence that the Commission is not shying away from federal courts, he noted that of the cases the Enforcement Division “filed last year on at least a partially litigated basis, approximately 57% were filed in district court, and around 43% were filed in the administrative forum.” These numbers did not include certain types of actions including delinquent filings cases or follow-on administrative proceedings.

Ceresney has also attempted to counter certain of Judge Rakoff’s procedural critiques of the administrative proceedings. For Ceresney, the expedited hearing schedule under which ALJs operate prevents evidence from becoming stale, protects the public interest by obtaining industry bars more expeditiously, and promotes deterrence and investor protection. Furthermore, the SEC’s Rules of Practice on evidence allow for ALJs to be “guided by, but not obligated to strictly apply, the Federal Rules of Evidence” and to freely weigh evidentiary relevance within their discretion. For Ceresney, these procedural features equally benefit the Enforcement Division and respondents. Indeed, he highlighted that the Enforcement Division has “lost some significant proceedings before ALJs in the last few years” and that the Commission has not upheld ALJ decisions that erroneously ruled for the Division. He added that ALJs’ intimate knowledge of securities cases are assets in these proceedings as ALJs are “specialized factfinders” with “expert knowledge of the securities laws, and the types of entities, instruments, and practices that frequently appear in [Enforcement] cases.”

Moreover, Ceresney pointed out that the SEC’s rules afford “extensive procedural protections” that enable respondents to be aware of the Division’s theory of the case and proof by requiring, for example, the Enforcement Division to provide the entire investigative file within seven days of filing allegations, and by permitting respondents to serve third-party subpoenas for witnesses and documents. Additionally, the rules impose “Brady obligations to disclose material, exculpatory information and Jencks Act obligations to turn over statements of [Commission] witnesses”—obligations not required in district court civil cases. As for jury trials, he noted that the United States Supreme Court has rejected a constitutional right to a jury trial in government enforcement “claims based on statutes like the federal securities laws.”

As both Judge Rakoff’s and Director Ceresney’s arguments illustrate, there are strong opinions on both sides of the issue. As the SEC continues to press forward in increasing its use of administrative proceedings, particularly for insider trading cases, the practice will continue to be scrutinized closely for its impact on fairness, efficiency, and the development of securities laws.

SEC TARGETS PUBLIC COMPANY DISCLOSURE VIOLATIONS IN RECENT “BROKEN WINDOWS” ENFORCEMENT ACTION

On November 5, 2014, the SEC announced administrative actions against 10 companies for failing to make required disclosures about financing deals and other unregistered sales that diluted shares of their common stock. The companies agreed to settle the SEC charges and to pay penalties ranging from $25,000 to $50,000 each.

The SEC charged the companies with failing to make required disclosures on Form 8-K. Under SEC rules, public companies must disclose major events to shareholders by filing a Form 8-K with the SEC. Under Item 1.01 of Form 8-K, registrants must disclose within four business days the entry into a material definitive financing agreement outside the ordinary course of business. Item 3.2 of Form 8-K requires smaller reporting companies to disclose within four business days the unregistered sales of equity securities unless they constitute less than 5% of the number of last reported shares outstanding of the class of equity securities sold. According to the SEC release, the companies in question failed to make disclosures related to transactions that diluted shares of their common stock as required by Items 1.01 and 3.2 of Form 8-K.

The SEC also charged three of the companies with failing to use accurate numbers in their Forms 10-Q and 10-K. Forms 10-Q and 10-K require issuers to disclose, among other things, the number of outstanding shares of their common stock as of the latest practicable date, and the information must be true, correct, and complete. According to the SEC, the three companies failed to use accurate numbers when reporting the dilution of their common stock.
In announcing the charges, Enforcement Director Andrew J. Ceresney emphasized that “public issuers must ensure that their SEC filings contain all required information so that investors can base decisions on current and accurate information” and acknowledged that “these enforcement actions reinforce the ongoing need for full disclosure to shareholders concerning an issuer’s entry into highly dilutive financing agreements.”

These disclosure actions appear to be yet another chapter in the SEC’s ongoing efforts to police what SEC Chair Mary Jo White called “broken windows.” As was discussed in a prior edition of the SEC Enforcement Quarterly, in an October 2013 speech announcing this campaign, Chair White stated her belief that “it is important to pursue even the smallest infractions” and announced her desire to pursue “violations such as control failures, negligence-based offenses and even violations of prophylactic rules with no intent requirement.” She also emphasized that the SEC was using “data analytics and related technology to...streamline our investigative efforts.” Although the “broken windows” campaign is not without its critics, these recent actions suggest that the SEC will continue to aggressively pursue such actions.

SEC CONTINUES ITS “GATEKEEPER” ENFORCEMENT INITIATIVE IN CHARGING CHIEF COMPLIANCE OFFICER FOR FIRM’S CUSTODY RULE VIOLATIONS

On October 29, 2014, the SEC announced charges against an investment adviser, Sands Brothers Asset Management LLC (“Sands Brothers”), its two principals, and its Chief Compliance Officer (“CCO”) for violating the “custody rule” under Section 206(4) of the Investment Advisers Act. Among other things, the custody rule requires that advisers make certain disclosures to clients when the advisers have control or have access to client money or securities. Advisers with “custody” of private fund assets can comply with the custody rule by distributing audited financial statements to fund investors within 120 days of the end of the fiscal year.

In 2010, Sands Brothers and its two principals consented to an order finding, among other things, that Sands Brothers had willfully violated the custody rule by failing to distribute its financial statements in a timely manner. However, according to the SEC’s new cease-and-desist order, Sands Brothers continued to violate the custody rule from 2010 through 2012 because it distributed audited financial statements to clients anywhere from 40 days to eight months late.

In addition to the charges against the principals, the SEC’s order also alleged that the CCO willfully aided and abetted these continued violations. The SEC alleged that the CCO was aware of, and actually executed, the 2010 order for the firm yet did not implement policies or procedures to ensure the firm’s future compliance with the custody rule. In addition, the CCO was also the point of contact for the firm’s auditors and knew that the audited financial statements were not being distributed on time.

Although the fact of the prior order in 2010 may have led to the more severe treatment for the CCO in this case, the action is consistent with the SEC’s continued focus on “gatekeepers” in its enforcement efforts. Indeed, in a recent speech, SEC Chair Mary Jo White highlighted the importance of “gatekeepers,” which she defined to include “auditors, lawyers and others who have professional obligations to spot and prevent potential misconduct.” According to Chair White, corporate directors are “the essential gatekeepers upon whom investors and, frankly, the SEC rely.” Similarly, SEC Enforcement Director Andrew J. Ceresney said, during a May 2014 address, that the SEC has brought “and will continue to bring actions against legal and compliance officers when appropriate” and especially “when they have clear responsibility to implement compliance programs or policies and wholly failed to carry out that responsibility.”
The Foreign Corrupt Practices Act continues to be a high enforcement priority of the SEC. Here are some highlights of FCPA enforcement from the past quarter. For more information on the FCPA, please see Sidley’s Anti-Corruption Quarterly.

**9/29/2014:** Agilent Technologies, Inc., a company that makes testing and measurement equipment for the medical industry, disclosed in its Form 8-K that an investigation regarding sales practices in China by third-party intermediaries and company employees ended without prosecution by the SEC and DOJ.

**10/1/2014:** Ben Aissa, SNC-Lavalin’s former head of construction, accepted a plea deal from the Swiss authorities for time served, which was 29 months. Aissa had been named in connection with $22 million in bribes allegedly paid by SNC-Lavalin employees. Subsequently, Aissa was extradited to Canada and charged with 16 counts, including fraud and bribery charges, in connection with $160 million in alleged bribes paid to the son of Muammar Gaddafi. In November, Aissa was granted bail set at $250,000 and was ordered to wear an electronic bracelet pending his next court appearance. In this case, SNC-Lavalin is referred to as an injured party in the indictment.

**10/6/2014:** The United States Supreme Court denied a petition to review whether employees of state-owned enterprises are considered “instrumentalities” thereby falling within the definition of “foreign officials” under the FCPA in Esquenazi et al. v. United States. The Supreme Court has, to date, never heard an FCPA case.

**10/8/2014:** GlaxoSmithKline, the UK’s largest pharmaceutical company, announced an investigation into allegations of improper payments in the United Arab Emirates following receipt of a whistleblower email from a GSK sales manager in the UAE.

**11/5/2014:** The United Kingdom High Court of Justice issued a decision in UBS (AG) v. UBS Limited addressing numerous important questions regarding bribery. The court held that, “[w]here the agent of one party to a contract pays a bribe to the agent of the other party, the party whose agent was bribed is entitled to avoid the contract (and claim damages from the principal of the agent who paid the bribe).” The Court found this to be the case even when the principal neither authorized nor was aware of the agent’s bribery, holding that “[n]o honest principal authorizes its agent to pay a bribe, but…a principal may nevertheless be responsible in law for the consequences of a bribe paid by its agent within the course of the agent’s employment or authority.”

**11/12/2014:** SBM Offshore, the Dutch-based offshore oil and gas industry company, agreed to pay $240 million to Dutch authorities to settle bribery allegations in Angola, Brazil, and Equatorial Guinea. Prosecutors had alleged that SBM paid sales agents $200 million in illegal commissions between 2007 and 2011. SBM also announced that the DOJ has closed its parallel investigation into the company.

**11/17/2014:** The DOJ’s second FCPA opinion procedure of 2014 clarified certain questions on successor liability. DOJ stated that if the Requestor, a multinational company headquartered in the U.S., planned to acquire a foreign company riddled with suspected illegal payments to foreign officials, the acquisition did not create successor liability for the Requestor unless the foreign company had been subject to U.S. criminal jurisdiction.

**12/2/2014:** The OECD released a report on foreign bribery, analyzing more than 400 cases worldwide between 1999 and 2014, and concluded that “most international bribes are paid by large companies, usually with the knowledge of senior management.”

**12/3/2014:** In October, China announced that the Ministry of Public Security had captured at least 88 fugitives wanted on charges of corruption and other economic crimes. Forty additional individuals are reported to be in discussions to surrender and return to China. Foreign countries that assist with the capture of the fugitives can share up to 80% of the fugitives’ forfeited assets. Most recently, China announced its desire to use U.S. courts to sue fugitives, despite the lack of an extradition treaty between China and the U.S.

**12/5/2014:** Former Bechtel Corporation senior executive, Asem Elgawhary, pleaded guilty for taking $5.2 million in kickbacks in exchange for rigging bids for state-run power contracts in Egypt. Elgawhary is set to be sentenced on March 23, 2015.

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12/11/14: Dallas Airmotive Inc., a Texas-based aircraft engine maintenance, repair, and overhaul firm, admitted that it bribed Latin American officials to win government contracts. The company agreed to pay $14 million to resolve the FCPA charges with the DOJ as part of a Deferred Prosecution Agreement.

12/15/14: Siemens’ former CFO, Heinz-Joachim Neubürger, agreed to pay the company $3.1 million to settle a civil recovery claim connected to the global bribery scandal Siemens resolved with U.S. and German authorities in 2008. Before Neubürger agreed to the settlement, Siemens already had reached agreements with 10 executives, including its former chairman and chief executive, totaling approximately $25 million.

12/16/14: Bruker Corporation settled an FCPA investigation with the SEC, agreeing to pay $2.4 million. The SEC alleged that Bruker violated the FCPA’s internal controls and books and records provisions by paying for sightseeing trips and shopping expenses for Chinese government officials. The SEC, however, credited Bruker for self-reporting its misconduct and providing extensive cooperation during the investigation.

12/22/14: Alstom S.A., a French power and transportation company, pleaded guilty to charges that it violated the FCPA’s books and records and internal controls provisions through a bribery scheme spanning several countries, including Indonesia, Saudi Arabia, Egypt and the Bahamas. Alstom agreed to pay over $772 million to resolve the enforcement action with the DOJ. This represents the largest criminal penalty ever paid in an FCPA case. The plea agreement cites many factors considered by the DOJ in seeking such a significant penalty, including Alstom’s failure to voluntarily disclose the misconduct even though it was aware of related misconduct at a U.S. subsidiary; Alstom’s refusal to fully cooperate with DOJ’s investigation for several years; and Alstom’s lack of an effective compliance and ethics program at the time of the conduct. Alstom’s Swiss and American subsidiaries have entered into Deferred Prosecution Agreements and admitted that they conspired to violate the FCPA. The DOJ has also announced charges against five individuals to date, including four corporate executives of Alstom and its subsidiaries.
SECUIRITIES & DERIVATIVES ENFORCEMENT AND REGULATORY PRACTICE OF SIDLEY AUSTIN LLP

Sidley’s Securities & Derivatives Enforcement and Regulatory group advises and defends clients in a wide range of securities- and derivatives-related matters. With more than 150 lawyers in 10 offices worldwide, we provide comprehensive regulatory, enforcement, and litigation solutions in matters involving the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), self-regulatory organizations (SROs), state attorneys general, and state securities regulators. Our team is distinctive in that it combines the strength of nationally recognized enforcement lawyers with the skills of equally prominent counseling lawyers. We work collaboratively to provide our clients with informed, efficient, and effective representation.

Our team features many prominent practitioners and former officials from the SEC, FINRA, and CFTC, as well as state regulators. Our lawyers include a former associate director of the SEC’s Division of Enforcement, a former co-head of enforcement and associate regional director of the SEC’s Northeast Regional Office, a former deputy director of the SEC’s Division of Trading and Markets, a former SEC senior trial counsel, the former head of enforcement for FINRA, and the former chief of the Massachusetts Securities Division. We also understand the “inside” perspective. Our team includes former general counsels of Charles Schwab and UBS Financial (Paine Webber), as well as the former global head of compliance at J.P. Morgan.

Our team has earned acknowledgement in numerous industry publications, including being named in the 2011 U.S. News – Best Lawyers “Law Firm of the Year” for Securities Regulation. In its 2013 edition, Chambers USA ranked us among the best U.S. law firms for Securities. In a recent edition, that publication noted the firm’s “well-regarded enforcement practice with a considerable depth of resources.” Sources told that publication that our practice “is highly thought of for public company representations and advisory work.”

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