HIGHLIGHTS FROM THE SEC SPEAKS — 2016 ENFORCEMENT PRIORITIES

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Government Enforcement Alert

By: Stephen G. Topetzes, R. James Mitchell, Krista Consiglio, Nicole A Baker, Curtis Kowalk

Senior members of the Securities and Exchange Commission's ("SEC" or "Commission") Division of Enforcement ("Division") addressed the defense bar on February 19, 2016, during the Practising Law Institute's annual "SEC Speaks" conference in Washington, D.C., summarizing recent SEC Enforcement activity and articulating the Division's priorities for 2016.[1]

I. FOCUS ON MARKET STRUCTURE

Consistent with Chair White's opening remarks, which focused on the SEC's plans to move "beyond disclosure" in its enforcement efforts, panelists Robert Cohen and Stephanie Avakian discussed some market structure concerns that do not involve allegedly fraudulent activity but have attracted the attention of the Division.[2] These include so-called "Dark Pools," cybersecurity concerns, and spoofing.

- **Dark Pools:** Dark pools are the most prominent types of alternative trading systems ("ATS"). Mr. Cohen noted that the SEC brought six cases involving dark pools in recent years.[3] In each case, the SEC alleged that the respondent failed to adequately monitor the ATS with the tools that the respondent advertised to its subscribers. Cohen stated that other common issues involving dark pools include allegedly unequal distribution of material information by the firm to its subscribers in the dark pool, and general violations of Regulation ATS (e.g., failure to comply with firm confidentiality requirements by giving confidential subscriber information to firm employees who should not receive the data).
- **Cybersecurity:** Ms. Avakian divided cybersecurity cases into three groups: (1) cases involving the alleged failure of the registrant to protect customer information, (2) cases alleging that material nonpublic information was stolen to gain a market advantage, and (3) cases involving purported failures to disclose cyber-related breaches. While the SEC has been active in bringing cases from the first two categories,[4] it has not yet brought cases in the third category. As a general matter, the Commission considers companies that have experienced data security breaches to be victims rather than violators. Ms. Avakian addressed the potential reluctance to self-report cybersecurity breaches — which could potentially result in an enforcement action — by emphasizing that the Division does not intend to bring actions that merely second-guess good faith actions by companies. She also stated that the Commission may give significant credit to companies that self-report cybersecurity failures.
- **Spoofing:** Mr. Cohen identified spoofing, a type of manipulative trading involving the placing of non-bona fide orders designed to prompt specific market reactions, as a significant area of focus for the Commission.[5] He noted that the SEC brought three spoofing cases in 2015 and will continue to prioritize the issue going forward.

II. INSIDER TRADING POST-NEWMAN

Insider trading continues to be a major focus for the Division. In the last six years, over 650 defendants have been charged with insider trading. Ms. Avakian addressed the U.S. Supreme Court's grant of certiorari in the Salman case.[6] She commented that, from the Division's perspective, the case has "good facts" with respect to the "personal benefit" element. Mr. Cohen confirmed that the Market Abuse Unit is increasingly relying on its "Analysis and Detection Center" to generate insider trading cases, originating five such cases in the last twelve months.

III. LITIGATED CASES

In an effort to debunk the notion that the SEC enjoys home turf advantage in litigated Administrative Proceedings, Matt Solomon stated that for FY2015, the SEC lost two Administrative Proceedings, but was undefeated in U.S. District Court. The SEC litigated 27 trials nationwide, slightly below its ten-year high-water mark of 30 trials in 2014. Mr. Solomon also emphasized that many administrative cases are settled actions rather than contested cases. And, Mr. Solomon addressed the "fairness" issues that continue to be a frequent complaint of the defense bar, noting that the Commission has published a guide detailing its approach to forum selection in contested actions.

IV. GATEKEEPERS

Joe Brenner stated that the Division is continuing to focus on the role of gatekeepers by bringing cases against individuals and firms. He divided gatekeeper cases into two categories: (1) alleged failures related to the nature of the gatekeeper's gatekeeping function and (2) purportedly misleading or false representations made to the public. Mr. Brenner explained that the first category includes cases where the SEC found that auditors identified red flags during a financial audit, but nonetheless issued an unqualified audit opinion without reporting any of the red flags.[7] The second category covers a variety of matters, including cases involving (1) an attorney who incorrectly claimed to have conducted due diligence and (2) a ratings agency that allegedly failed to follow its own rating standards.[8]

V. WHISTLEBLOWER PROGRAM

In 2015, the SEC's Whistleblower Program received over 4,000 tips. Ms. Binger highlighted a recent award of $700,000 dollars to a company outsider, commenting that the SEC is prepared to investigate information from any source, including company outsiders who conduct independent analyses that lead to "successful" SEC actions. She also commented that the SEC continues to focus on problematic confidentiality agreements to ensure that there are no impediments to employee whistleblowing.[9]

VI. BROKER-DEALER TASK FORCE

The SEC created the Broker-Dealer Task Force ("B-D Task Force") in 2014. The B-D Task Force coordinates with resources in the Division of Enforcement, Office of Compliance Inspections and Examinations ("OCIE"), and Financial Industry Regulatory Authority to identify targeted enforcement initiatives in the Broker-Dealer space. The current focus of the B-D Task Force includes: (i) the AML Compliance initiative, (ii) the Alternative Products Due Diligence initiative, and (iii) the Excessive Trading or "churning" initiative.

The AML Compliance initiative has leveraged previous Bank Secrecy Act enforcement efforts, which revealed that a large number of broker-dealers had not filed any Suspicious Activity Reports ("SAR") during 2013. The B-D Task Force used data analytics and risk metrics to further evaluate the SAR filings of broker-dealers, which resulted in "dozens" of referrals to the exam and enforcement staff. The enforcement investigations remain on-going.

The Alternative Products Due Diligence initiative is focused on the sale of alternative products to retail investors and firms' procedures and due diligence relating thereto. The initiative has used data mining to identify potential subjects of enforcement investigations. In particular the SEC has focused on introducing firms that derive a significant portion of revenue from the sale of alternative products to retail investors. Several referrals have been made to enforcement staff as a result.

The B-D Task Force will continue focusing on its churning initiative, which has long been a top priority for OCIE. The B-D Task Force leverages the SEC Quantitative Analytics Unit to analyze clearing data and identify firms that may require investigation for churning. In particular, the SEC focuses on the "Turnover" and "Cost-to-Equity" ratios of a portfolio. Turnover ratios measure how often the securities in a customer's portfolio are traded in a year. The Divisions views six or more turnovers in a year as indicia of churning. The Cost-to-Equity ratio measures the cost of trading as a percentage of the customer's investments, which reflects the amount that would need to be earned in order to break even on the cost of the trades. The SEC views a Cost-to-Equity ratio of 20% or more as indicative of churning.

VII. FOREIGN CORRUPT PRACTICES ACT ("FCPA")

Kara N. Brockmeyer highlighted the fourteen FCPA-related cases brought in 2015, totaling over $215 million of recovery. Recently, the SEC worked with Dutch authorities, along with thirteen other jurisdictions, to obtain a global settlement with VimpelCom. The company was charged with paying more than $114 million in bribes to gain entry to the telecom market in Uzbekistan. This effort, which involved the assistance of multiple countries, may pave the way for similar cooperation in the future and more global settlements.

The FCPA unit obtained several recent "firsts," including: (i) the first case against a financial services firm related to internships allegedly provided to unqualified students who were family members of foreign government officials;[10] (ii) the first case solely involving an allegedly improper payment to a political party;[11] and (iii) the first Deferred Prosecution Agreement ("DPA") with a foreign national.[12] Ms. Brockmeyer stated that there are more cases involving student internships in the pipeline for 2016 and that individual liability will continue to be a focus. She cautioned that individuals and companies seeking to take advantage of a DPA or Non-Prosecution Agreement must self-report and engage in remediation.

Ms. Brockmeyer predicted that 2016 will be a busy year for the FCPA Unit, having already brought six cases and recovering $250 million, only three of which involved parallel DOJ proceedings. Ms. Brockmeyer commented on the trend of "SEC-only" cases involving conduct other than bribery or smaller, less egregious conduct that focus on public companies keeping accurate books and records and effective internal controls. Ms. Brockmeyer stated that the FCPA Unit will continue to focus on industries that have historically been problematic, such as the pharmaceutical industry and financial services sector and noted that the Unit has several cases in the pipeline.

VIII. ASSET MANAGEMENT UNIT

Marshall Sprung highlighted several significant cases brought in 2015 by the Asset Management Unit ("AMU") and summarized the AMU's 2016 priorities relating to (i) registered investment companies,[13] (ii) private funds (hedge funds and private equity),[14] and (iii) retail accounts.[15] With respect to registered funds, in 2016 the AMU will continue to focus on valuation, conflicts of interest, and compliance failures. Similarly in the private fund space, in 2016 the AMU expects to bring additional cases based on undisclosed conflicts of interest, valuation, allocation of fees and expenses, as well as cases derived from the AMU's aberrational performance risk analytic initiative, which uses data mining to identify and further inspect suspicious performance outliers. With respect to retail accounts, the AMU will focus on conflicts of interest, fee arrangements, advertising, performance reporting, and client communications.

IX. FINANCIAL REPORTING AND AUDIT GROUP

The Financial Reporting and Audit Group ("FRAud Group") evaluates financial reporting, auditing, and disclosure matters to identify potential subjects for enforcement investigations. In 2015, the FRAud Group brought 135 cases, a noteworthy increase from the 96 cases brought in 2014. The cases focus on financial reporting issues such as revenue recognition, expense recognition, valuation matters, earnings management, and internal controls deficiencies.

The FRAud Group seeks to identify potential financial reporting issues as early as possible. Toward that end, the FRAud Group launched an Issuer Review and Monitoring initiative, which uses technology to identify issuers that may be of interest for further review. In particular the FRAud Group makes use of a proprietary tool called the Corporate Issuer Risk Assessment ("CIRA"), which allows staff to evaluate an issuer's financial statements in a multiple ways. For example, CIRA enables the FRAud Group to compare a company's financial reporting with that of its peers. Ms. McGuire stated that although CIRA analyzes anomalous financial results, the FRAud Group also focuses on financial results that are not necessarily anomalous, but might nonetheless merit further analysis. Through its use of CIRA, the FRAud Group has identified 270 issuers of interest for further review.

Notes:

[1] The participants of the various enforcement-related panels included, among others: Andrew J. Ceresney (Director of the Division of Enforcement), Stephanie Avakian (Deputy Director of the Division of Enforcement), Joseph K. Brenner (Chief Counsel of the Division of Enforcement), Matthew C. Solomon (Chief Litigation Counsel), Michael J. Osnato, Jr. (Chief, Complex Financial Instruments Unit), Robert Cohen (Co-Chief, Market Abuse Unit), Sharon B. Binger (Regional Director, Philadelphia Regional Office), Marshall Sprung (Co-Chief of the Asset Management Unit), Andrew Calamari (Regional Director of the New York Regional Office), Antonia Chion (Associate Director), Kara N. Brockmeyer (Chief of the FCPA Unit), and Margaret McGuire (Chief of the FRAud Group).

[2] Mary Jo White, S.E.C. Chair, Chairman's Address at SEC Speaks - Beyond Disclosure at the SEC in 2016; *See also* Andrew Ceresney, Director, S.E.C. Div. of Enforcement, Market Structure Enforcement: Looking Back and Forward (Nov. 2, 2015).

[3] See Exchange Act Release No. 77001 (Jan. 31, 2016); *see also* Exchange Act Release No. 77002 (Jan. 31, 2016).

[4] *S.E.C. v. Dubovoy, et al.,* No. 2:15-cv-06076-MCA-MAH (D.N.J., Aug. 10, 2015) (charging 32 defendants with trading on stolen, non-public corporate earnings announcements); *S.E.C. v. Zavodchiko, et al.*, No. 2:16-cv-00845-MCA-LDW (D.N.J., Feb. 17, 2016) (charging an additional nine defendants with involvement in the stolen corporate earnings scheme identified in the *Dubovoy* case).

[5] Exchange Act Release No. 76546 (Dec. 3, 2015) (charging two brothers with spoofing in connection with "All-Or-None" orders in the options markets); Exchange Act Release No. 76104 (Oct. 8, 2015) (involving the placement of allegedly non-bona fide orders prior to the opening of the market, only to cancel these orders and place bona fide orders on the other side of the market after news of the non-bona fide orders had been disseminated); *S.E.C. v. Aleksandr Milrud*, No. 15-cv-00237-KM-SCM (D.N.J. Jan. 12, 2015) (alleging a manipulative layering scheme involving coordination between traders in Canada, China, and Korea; a parallel criminal case is being pursued by the U.S. Attorney for the District of New Jersey).

[6] *See United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015) *cert. granted in part,* No. 15-628, 2016 WL 207256 (U.S. Jan. 19, 2016).

[7] *See* Exchange Act Release No. 75862 (Sept. 9, 2015). Other highlighted cases involving gatekeepers include Exchange Act Release No. 75843 (Sept. 4, 2015) (alleging that an inaccurate audit caused the private investment fund to materially overstate its asset values); Investment Company Act Release No. 31678 (June 17, 2015) (alleging that board members failed to fulfill their Section 15(c) obligations); Investment Company Act Release No. 31586 (Apr. 29, 2015) (concerning allegations that the firm's principal and general counsel improperly used assets to pay for operational expenses); Exchange Act Release No. 74827, Investment Company Act Release No. 31585 (Apr. 29, 2015) (alleging that an outside auditor approved audit reports containing unqualified opinions, despite its knowledge that a firm improperly used certain assets).

[8] *See, e.g.,* Exchange Act Release No. 74104 (Jan. 21, 2015) (involving allegedly misleading public disclosures regarding the agency's methodology for rating conduit fusion CMBS transactions); *see also* Exchange Act Release No. 76261 (Oct. 26, 2015) (involving the alleged misrepresentation of a rating agency's surveillance methodology for the rating of certain financial products).

[9] *E.g.*, Exchange Act Release No. 74619 (Apr. 1, 2015).

[10] Exchange Act Release No. 75720 (Aug. 18, 2015).

[11] *See* 2015 WL 5680060 (D.D.C. Sept. 28, 2015).

[12] Exchange Act Release No. 77145 (Feb. 16, 2016).

[13] In 2015, the AMU brought noteworthy cases against registered investment companies. *See* Investment Company Act Release No. 31558 (Apr. 20, 2015) (alleging failure to disclose conflicts of interest posed by portfolio manager's outside business interests and failure to adopt written policies and procedures related to same); Investment Company Act Release No. 31678 (June 17, 2015) (charging the advisor and board members with failing to fulfill section 15(c) obligations in connection with mutual fund advisory contracts); Investment Company Act Release No. 31832 (Sept. 21, 2015) (charging an improper use of mutual fund assets to pay for the marketing and distribution of fund shares).

[14] Significant 2015 hedge fund cases included Investment Company Act Release No. 31700 (July 1, 2015) (pertaining to the allegedly false, inflated valuations of thinly-traded residential mortgage-backed securities

causing the funds to pay higher management and performance fees);Investment Company Act Release No. 31586 (Apr. 29, 2015) (alleging that the firm's principal and general counsel used fund assets to pay undisclosed operating expenses). The AMU's Significant 2015 private equity cases included Investment Advisers Act Release No. 4131 (June 29, 2015) (concerning an alleged breach of fiduciary duty via the misallocation of expenses from unsuccessful buyout opportunities to private equity funds, instead of to the co-investors); Investment Advisers Act Release No. 4219 (Oct. 7, 2015) (charging firm with failing to inform investors about benefits obtained from accelerated monitoring fees and discounts on legal services); Investment Advisers Act Release No. 4253 (Nov. 3, 2015) (alleging a failure to disclose conflicts of interest arising from over $20 million in payments to a company's former firm employees who performed services while still working at the company).

[15] Significant cases included Investment Company Act Release No. 31688 (June 23, 2015) (alleging a failure to conduct annual compliance program reviews leading to undetected compliance violations and alleging a failure to convert eligible clients' investments into a lower cost institutional share class); Exchange Act Release No. 76897 (Jan. 14, 2016) (charging firm with an improper collection of 12b-1 fees, which created an alleged conflict of interest that was not adequately disclosed to clients, among other alleged compliance failures); Investment Advisers Act Release No. 4204 (Sept. 22, 2015) (alleging a failure to establish required cybersecurity policies and procedures, leading to a breach that compromised the personally identifiable information of 100,000 individuals and clients); Securities Act Release No. 9992, Exchange Act Release No. 76694 (Dec. 18, 2015) (pertaining to the alleged failure to disclose the firm's preference for investing clients in the firm's own proprietary investment products).

KEY CONTACTS

STEPHEN G. TOPETZES
PARTNER

WASHINGTON DC
+1.202.778.9328
STEPHEN.TOPETZES@KLGATES.COM

