Navigating Risks in the New Enforcement Environment

Schulte Roth & Zabel

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Harry focuses his practice on complex commercial litigation and regulatory matters for financial services industry clients, including hedge funds, funds of funds and private equity funds, prime and clearing brokers, introducing brokers and interdealer brokers, and auditors and administrators. He has substantial experience in both securities regulatory matters and private litigation, including investigations by the SEC, U.S. Attorneys' offices, DOJ, CFTC, FTC, state attorneys general, state securities regulators and self-regulatory organizations. Harry has litigated numerous cases in federal and state courts throughout the United States, including his recent victory for an inter-dealer broker in an arbitration brought by one of its competitors for alleged misappropriation of trade secrets as well as in a 4-1/2 month jury trial in a raiding case, and his successful representation of a prime broker in a high-profile jury trial brought by the bankruptcy trustee of a failed hedge fund. Over the course of a career spanning more than 25 years, Harry has represented clients in investigations and litigations involving allegations of insider trading, market manipulation, market timing and late trading, misconduct involving PIPEs, short-swing profits, securities and common law fraud, advertising, breach of fiduciary duty, employee raiding and other employment issues, misappropriation of trade secrets and other business torts, and breach of contract, among other claims.

Harry is recognized as a leading lawyer by *The Legal 500 United States* and by *New York Super Lawyers*. He is a member of the American Bar Association, the New York State Bar Association, the New York County Lawyer's Association, the New York City Bar Association, the Federal Bar Council, the Federalist Society and Securities Industry and Financial Markets Association's Compliance and Legal Division, and he is the former chair, co-chair and vice chair of the Trade Regulation Committee. A prolific author and speaker, Harry is the editor of and author of several chapters in *Insider Trading Law and Compliance Answer Book* (Practising Law Institute), a definitive treatise written in question and answer format and designed to help educate and protect clients from regulatory exposure. He is also the author of a chapter in *Private Fund Dispute Resolution*, which serves as a primer regarding U.S. and U.K. regulatory inquiries, investigations and examinations of private investment funds, and he recently published an article concerning short selling under Rule 105. He has presented about a wide range of topics, including how hedge funds can protect themselves against insider trading, limiting liability for compliance officers, and civil litigation relating to securities enforcement.

Harry holds a J.D., *magna cum laude*, from Cornell Law School, where he was Order of the Coif, and a B.A. from Johns Hopkins University.

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Adam serves as co-chair of Schulte Roth & Zabel's White Collar Defense & Government Investigations Group. He focuses his practice on complex civil and white collar criminal matters, including securities, health care, False Claims Act ("qui tam"), the Foreign Corrupt Practices Act (FCPA), export sanctions, criminal tax, money laundering, antitrust and bankruptcy. He counsels corporations and individuals in compliance matters, internal investigations, and Congressional and regulatory matters. He also represents corporations and individuals in high-stakes civil litigation. Adam has defended numerous high-ranking executives and general counsel from some of the world's largest companies, as well as high-profile staff and members of the Senate, Congress, White House and various government agencies, faced with federal and state criminal investigations and indictments. He is a Fellow of the American College of Trial Lawyers and has successfully tried cases throughout the country.

Adam has been recognized in *Chambers USA* for his "immense talent as a trial lawyer" and "strong advocacy skills," in *The Legal 500 United States* as "an aggressive trial advocate," and in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys* as a "celebrated government investigations practitioner." He has also been recognized in *The Best Lawyers in America*, *Expert Guide to the World's Leading White Collar Crime Lawyers*, *International Who's Who of Business Crimes Defense Lawyers*, *Global Investigations Review*, *Washingtonian Magazine* and *Washington DC Super Lawyers*. Adam was named "Government Investigations Attorney of the Year" for 2015 and "Life Sciences Star" from 2013 to 2015 in *LMG Life Sciences*. In addition, he was recognized in the *National Law Journal*'s "Hot Defense List" for his jury trial victory on behalf of a former pharmaceutical executive in a criminal case charging conspiracy and violations of the federal Anti-Kickback Statute. Adam is a former Assistant U.S. Attorney for the Southern District of New York, and he received the Director's Award for Superior Performance from the U.S. Department of Justice in 1990. He is an adjunct professor at The George Washington University Law School and has been an instructor at Georgetown University Law Center's National Institute of Trial Advocacy (NITA) since 1992. He also serves on the alumni board of the Fordham University School of Law. Adam frequently speaks about topics of interest to the private funds industry, including, most recently, audit committee investigations, recovery of assets, and obtaining and negotiating corporate deferred and non-prosecution agreeements.

Adam received his J.D. from Fordham University School of Law and his B.A. from Trinity College.

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David's practice focuses on corporate, securities and bank regulatory matters. He primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their businesses. He structures investment management and financial services firms as well as hedge, private equity, credit, distressed investing and hybrid funds, energy funds, co-investments, funds of funds and scalable platforms for fund sponsors. David provides legal and business advice on fund structuring, fundraising, management company partnerships, compensation plans, succession plans, seed and strategic investments and spinoffs of investment teams. His work also includes counseling clients on finding practical solutions to regulatory and compliance requirements, including the Volcker Rule, and managing conflicts of interest with an emphasis on reducing legal risk to the business.

David has been named a leader in his field by *Chambers Global* and *Chambers USA* and has been recognized by *The International Who's Who of Private Funds Lawyers*, *PLC Cross-border Private Equity Handbook*, *The Legal 500 United States* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. A member of the Advisory Board of The Financial Executives Alliance and past member of the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker. Works he has authored or co-authored include the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), "Hedge Fund Names: What a Hedge Fund Manager Should Do Before It Starts Using a Name" in *The Hedge Fund Law Report* and "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*. He has addressed topics at conferences and seminars including co-investment vehicles, investing in the oil and gas sector, liquidity events, exits and succession planning.

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Jen has a diverse practice focusing on complex commercial litigation, bankruptcy-related litigation, and regulatory investigations and counseling. She has represented clients in state and federal courts and before regulatory bodies, and has also counseled clients on anti-money laundering and anti-corruption and sanctions rules and regulations. Her class action litigation experience includes defending various parties in Madoff-related litigation, including defendants in a putative class action alleging violations of federal securities laws, successfully settling an ADR securities class action for a Brazilian company, and prevailing on a motion to dismiss a consumer fraud class action. Jen's complex commercial cases have involved defending a major bank in lawsuits brought by investors in a credit facility, successfully defending against RICO claims and settling common law tort claims; representing hedge fund advisory board members in connection with opposing third-party subpoenas served on them, obtaining orders that quashed the subpoenas; and counseling an investor in a company in connection with litigation in which the shareholder plaintiffs alleged that the company's directors breached their fiduciary duties by entering into a merger agreement that resulted in an acquisition of the company, and various investors aided and abetted those violations and were unjustly enriched. Jen has also represented funds in connection with disputes arising from an investment in a company that sought Chapter 11 protection, and hedge fund traders in joint SEC, CFTC and FERC investigations in which no action was taken against the traders.

Recognized as a "Rising Star" by *New York Super Lawyers*, Jen is also the recipient of the Lisa Beth Deutsch Pro Bono Award and a member of the New York State Bar. She is the co-author of "Federal and State Regulators Target Compliance Officers" in *The Banking Law Journal* and has written on recent developments in Delaware business and securities law in *Computer Law Reporter, Inc.* She contributed to the article "Corporate Cooperation," published in the *National Law Journal*, which was the winner of a Burton Award for Distinguished Legal Writing.

Jen holds a J.D., *magna cum laude*, from the University of Minnesota Law School, where she was Order of the Coif, and a B.A., *summa cum laude*, from Hillsdale College, where she was awarded departmental honors in philosophy. After law school, she clerked for a federal district court judge in Minnesota.

Navigating Risks in the New Enforcement Environment

I. Inter-Relationship Between SEC Examinations and Enforcement Actions, As Well As Between Civil and Criminal Liability

A. Cooperation Between the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") and the Enforcement Division: Following the investigation and prosecution of Bernard Madoff's $17.3-billion Ponzi scheme, the SEC modified the National Exam Program ("NEP") run by OCIE.

1. This has led to increased cooperation between OCIE and staff members from the Division of Enforcement when conducting inspections and examinations, as well as an increase in enforcement actions resulting from OCIE examinations.

2. As a result of this increased cooperation, more and more OCIE examinations include someone from the Enforcement Division as part of the staff conducting an OCIE examination. The mere fact that members of the Enforcement Division participate in a firm's examination does not necessarily mean that the examination will result in a referral to the Enforcement Division, but it does increase the possibility that that will happen.

3. The SEC's approach to enforcement has been increasingly aggressive. After a record-breaking 2014 in which the SEC filed 755 enforcement actions and recovered $4.16 billion in disgorgement and penalties, the Commission managed to go even further the following year, bringing 807 enforcement actions and recovering approximately $4.19 billion by the end of fiscal year 2015.

4. Particularly for hedge funds and private equity funds, since the creation of the Enforcement Division's Asset Management Unit, there has been an emphasis on increasing examiner expertise in those industries,[1] and OCIE has increased its focus on investment advisers of all varieties.[2]

5. Fund managers need to be prepared and should expect that their policies, procedures and practices will be scrutinized carefully during OCIE examinations.[3]

6. Increased cooperation between OCIE and the Division of Enforcement has meant that violations that may have previously been ignored as immaterial may now result in deficiency letters and that matters which previously were the subject of deficiency letters might result in an investigation by the Enforcement Division and/or an enforcement action.

B. Potential Exposure to Criminal Liability/Cooperation Between the SEC and Criminal Prosecutors

1. Regulators have adopted increasingly prosecutorial mindsets in an effort to drive their respective Enforcement Divisions in a more aggressive direction. This has been accomplished by hiring an increased number of former prosecutors into enforcement roles.[4]

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[1] Hazel Bradford, "SEC Management Enforcement Unit Evolves into Respected Watchdog," *Pensions & Investments* (Nov. 30, 2015), *available at* www.pionline.com/article/20151130/PRINT/311309984/sec-management-enforcement-unit-evolves-into-respected-watchdog.

[2] National Examination Program: Office of Compliance Inspections and Examination, *Examination Priorities for 2015*, Securities and Exchange Commission (2015).

[3] Marc E. Elovitz, "SEC Examinations of Private Fund Advisers," *The Review of Securities & Commodities Regulation* (June 17, 2015), *available at* www.srz.com/files/News/4d8f612d-6b91-4ce0-9fa3-fa16b9d51770/Presentation/NewsAttachment/f29ce315-5f8c-44e2-b7bf-006192c396e8/The_Review_of_Securities_and_Commodities_Regulation_SEC_Examinations_of_Private_Fund_Advisers_Jul.pdf.

2. The current Directors of Enforcement at both the SEC and the CFTC are former federal prosecutors, and an increasing number of senior enforcement lawyers at both agencies have backgrounds as criminal prosecutors.

3. Increasingly, financial regulators and prosecutors are cooperating with each other for the purpose of building stronger cases against white collar defendants. The Department of Justice notes that as many cases now feature parallel proceedings (criminal and regulatory) and/or the presence of multi-agency task forces, prosecution teams have expanded accordingly to facilitate cooperation with these regulators.[5]

4. These developments force potential defendants to reconsider whether to cooperate with regulators in exchange for reduced penalties, as such cooperation can lead to eventual criminal charges down the road.

II. Enforcement by the CFTC and Commodities and Futures Exchanges

A. Enforcement by the CFTC

1. The CFTC brought 69 enforcement actions and collected $3.14 billion in civil penalties in fiscal year 2015. This is the largest amount the CFTC has collected in its history and is not far behind the amount collected by the much larger SEC.[6]

2. The CFTC has adopted a more aggressively prosecutorial stance, bringing in a former federal prosecutor to serve as head of its Enforcement Division last year.[7]

B. Recent Major Enforcement of Commodities Laws and Regulations

1. Michael Coscia: Coscia was prosecuted criminally and convicted for entering orders that he had no intention to execute (i.e., spoofing) for the purpose of impacting commodities prices. Coscia took advantage of these price fluctuations in order to generate a profit; using this strategy he earned $1.4 million in less than three months.[8] This case was jointly investigated and litigated by the U.S. Attorney's Office and the CFTC.

2. Navinder Singh Sarao and Nav Sarao Futures Limited PLC: The CFTC has charged Sarao and his firm with spoofing and unlawful manipulation of commodities markets. According to the CFTC's complaint, Sarao's firm was layering large sell orders at different price levels, ensuring that they were seen by other traders, and then canceling the trades. The CFTC is seeking disgorgement, civil penalties, and a trading suspension or ban against Sarao.[9]

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[4] Aruna Viswanatha and Christopher Matthews, "Regulators Tap Prosecutors for Key Jobs," *The Wall Street Journal* (April 6, 2015), *available at* www.wsj.com/articles/regulators-tap-prosecutors-for-key-jobs-1428361038.

[5] David Ogden, *Guidance for Prosecutors Regarding Criminal Discovery*, Department of Justice (Jan. 4, 2010), *available at* www.justice.gov/dag/memorandum-department-prosecutors.

[6] Press Release, Commodities Futures Trading Commission, CFTC Releases Annual Enforcement Results for Fiscal Year 2015 (Nov. 6, 2015), *available at* www.cftc.gov/PressRoom/PressReleases/pr7274-15.

[7] Ben Protess, "Commodities Regulator Names New Enforcement Chief," *The New York Times* (June 10, 2014), *available at* http://dealbook.nytimes.com/2014/06/10/c-f-t-c-hires-new-enforcement-director/?_r=0.

[8] "US High Frequency Trader Convicted in First US Spoofing Case," *The Guardian* (Nov. 4, 2015), *available at* www.theguardian.com/us-news/2015/nov/04/us-high-frequency-trader-convicted-first-spoofing-case-michael-coscia.

[9] Press Release, Commodity Futures Trading Commission, CFTC Charges U.K. Resident Navinder Singh Sarao and His Company Nav Sarao Futures Limited PLC with Price Manipulation and Spoofing (April 21, 2015), *available at* www.cftc.gov/PressRoom/PressReleases/pr7156-15.

3. Arya Motazedi: In the first-ever insider-trading case brought by the CFTC, the Commission found that Motazedi had misappropriated material, nonpublic information for the purpose of making fraudulent transactions between his employer and an account he owned. These trades, which involved oil and gas futures, were designed to generate profits for himself and losses for his employer.[10]

C. Enforcement by Commodities and Futures Exchanges

1. Between April 1, 2012 and March 31, 2013 (the last period reviewed by the CFTC), the Commodities and Futures Exchanges (which include the Chicago Board of Trade (CBOT), Chicago Mercantile Exchange (CME), the Commodity Exchange, Inc. (COMEX) and the New York Mercantile Exchange (NYMEX), collectively referred to as "the Exchanges") brought 93 enforcement actions in their capacity as self-regulatory organizations ("SROs").[11]

(a) During this period, the Exchanges assessed a total of $6.3 million in fines (ranging from $5,000 to $1 million), and $2,023,900 in disgorgement (ranging from $6,000 to $1.1 million).[12]

(b) Additionally, the Exchanges issued suspensions for 51 individuals (ranging from five days to 25 years), and imposed permanent bars on membership against 10 respondents.[13]

(c) The Exchanges have focused their enforcement efforts on highly technical rule violations:

(i) Exchange for Related Positions ("EFRP"): EFRP transactions allow investors to exchange futures contracts for their related physical instruments, derivative positions or options (or other OTC contracts with similar characteristics).[14]

(1) The rules governing the circumstances in which EFRPs are permissible are highly technical and have recently been the focus of regulatory action by the Exchanges. The Exchanges often refer to these rules as essentially imposing strict liability.

(2) Toronto Dominion Bank ("TD"): In a settlement between TD and NYMEX, TD neither admitted nor denied a violation of NYMEX Rule 538.C.[15] TD was alleged to have entered into an EFRP which did not involve the transfer of the cash commodity underlying the Exchange contract, or a by-product, related product or OTC instrument, between TD and its counterparty.[16] TD paid a fine of $15,000.[17]

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[10] Arya Motazedi, CFTC Docket No. 16-02 (Dec. 2, 2015).

[11] U.S. Commodities Futures Trading Commission, Division of Market Oversight, *Disciplinary Program Rule Enforcement Review of the CBOT, CME, COMEX, and NYMEX* (Nov. 21, 2014), *available at* www.cftc.gov/idc/groups/public/@iodcms/documents/file/rerdisciplinaryprogram112114.pdf.

[12] *Id.*

[13] *Id.*

[14] CME Group, *Exchange for Related Positions ("EFRPs")*, *available at* www.cmegroup.com/clearing/trading-practices/efp-efr-eoo-trades.html.

[15] Notice of Disciplinary Action – Toronto Dominion Bank, NYMEX 15-0130-BC-2 (Nov. 25, 2015), *available at* www.cmegroup.com/tools-information/lookups/advisories/disciplinary/NYMEX-15-0130-BC-2-TORONTO-DOMINION-BANK.html.

[16] *Id.*

[17] *Id.*

(ii) Position Limit Violations: CME Rule 562 stipulates, "Any positions … in excess of those permitted under the rules of the Exchange shall be deemed position limit violations."[18]

Pacific Investment Management Company LLC ("PIMCO"): In a settlement agreement between PIMCO and CBOT, PIMCO neither admitted nor denied a violation of CBOT Rule 562.[19] PIMCO was alleged to have violated Rule 562 by having held end-of-day net short positions in excess of both single-month and all-month position limits.[20] PIMCO paid a fine of $35,000.[21]

(d) The CFTC's most recent review found that the Exchanges' practice of sending warning letters was effective for the purpose of deterring violations and that the Exchanges had a reasonable basis for bringing all 93 of the enforcement actions that they filed. However, the CFTC also found that staffing shortages at the Exchanges led to several matters not being enforced promptly.[22]

III. Conflicts of Interest: Recent Enforcement Actions

A. BlackRock Advisors LLC (April 2015)

1. In a settlement with the SEC, BlackRock agreed to pay $12 million and to engage an independent compliance consultant to conduct an internal review for failing to disclose a conflict of interest created by the outside business activity of a top-performing portfolio manager.[23]

2. According to the SEC, the portfolio manager at issue was also the founder of, and a general partner and investor (in the sum of approximately $50 million) in an outside fund participating in a joint venture that eventually became the largest holding in a BlackRock fund.[24]

3. Also according to the SEC, BlackRock knew and approved the portfolio manager's investment and involvement with Rice Energy as well as the joint venture, but failed to disclose the conflict of interest to either the boards of the BlackRock registered funds or its advisory clients.

4. Significantly, BlackRock's then-chief compliance officer ("CCO") agreed to pay a $60,000 penalty to settle the charges against him, which included failure to report a material compliance matter to the funds' boards of directors and causing a failure to adopt and implement policies and procedures for outside activities of employees.[25]

B. Guggenheim Partners Investment Management LLC (August 2015)

1. Guggenheim paid $20 million to the SEC to settle, among other things, charges that it breached its fiduciary duty to disclose a $50-million loan that one of its senior executives received from an

[18] CME Rulebook, *562. Position Limit Violations*, *available at* www.cmegroup.com/rulebook/CME/I/5/5.pdf.

[19] Notice of Disciplinary Action – Pacific Investment Management Company LLC, CBOT 14-0035-BC (July 24, 2015), *available at* www.cmegroup.com/tools-information/lookups/advisories/disciplinary/CBOT-14-0035-BC-PACIFI-INVESTMENT-MANAGEMENT-COMPANY-LLC.html.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] BlackRock Advisors, LLC and Bartholomew A. Battista, Investment Advisers Act Release No. 4065 (April 20, 2015).

[24] *Id.*

[25] *Id.*

advisory client, which the SEC alleged created a potential conflict of interest that might cause Guggenheim to place that client's interests over those of other clients.[26]

2. According to the SEC, after the executive received the loan, the executive then facilitated the investment by the client that issued the loan to him into certain transactions. Later, the same executive facilitated an investment into the same transactions by other Guggenheim clients, which received different terms than the client that had made the loan had received.[27]

3. On these facts, the SEC alleged, among other things, that the failure to disclose the existence of the loan to its other clients was a breach of Guggenheim's fiduciary duties to its clients.[28]

C. JP Morgan Chase Bank N.A. and J.P. Morgan Securities LLC (December 2015)

1. JP Morgan Chase Bank N.A. and J.P. Morgan Securities LLC ("JPM") agreed to pay a total of $307 million to settle charges by the SEC[29] and CFTC[30] that JPM failed to disclose conflicts of interest relating to preferences for (i) JP Morgan-managed mutual funds, (ii) JP Morgan-managed private hedge funds, and (iii) third-party-managed private hedge funds that shared client fees with a JP Morgan affiliate.

2. As part of the settlement, JPM paid $267 million to the SEC[31] and $40 million to the CFTC[32] and had to admit the SEC's factual allegations.

IV. Expense and Fee Allocations

A. "By far the most common deficiencies noted by our examiners in private equity relate to expenses and expense allocation. Many managers still seem to take the position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty … . This practice can be difficult for investors to detect but easy for our examiners to test," said Marc Wyatt, director of OCIE.[33]

B. Kohlberg Kravis Robert & Co. ("KKR"): The SEC entered into a settlement with KKR, alleging that KKR charged its clients approximately $338 million in fees over a six-year period related to broken deal or diligence expenses.[34]

1. The SEC alleged that KKR had not been allocating these expenses to co-investors (including some of the firm's executives) and had failed to disclose this practice.[35]

2. KKR agreed to pay over $14 million in disgorgement and a $10-million penalty.[36]

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[26] Guggenheim Partners Investment Management, LLC, Investment Advisers Act of 1940 Release No. 4163 (Aug. 10, 2015).

[27] *Id.*

[28] *Id.*

[29] JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC, Investment Advisers Act of 1940 Release No. 4295 (Dec. 18, 2015).

[30] JPMorgan Chase Bank, N.A., CFTC Docket No. 16-05 (Dec. 18, 2015).

[31] JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC, Investment Advisers Act of 1940 Release No. 4295 (Dec. 18, 2015).

[32] JPMorgan Chase Bank, N.A., CFTC Docket No. 16-05 (Dec. 18, 2015).

[33] Securities and Exchange Commission, Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), *available at* www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[34] Securities and Exchange Commission, SEC Charges KKR with Misallocating Broken Deal Expenses, Release No. 2015-131 (2015).

[35] *Id.*

3. "This is the first SEC case to charge a private equity adviser with misallocating broken deal expenses," said Andrew Ceresney, director of the SEC Division of Enforcement.[37]

C. The Blackstone Group: The SEC charged Blackstone with failing to disclose the acceleration of monitoring fees paid by fund-owned portfolio companies prior to their sale or initial public offering. The SEC alleged that these accelerating fees had the effect of reducing the value of the portfolio companies prior to their sale.[38] The SEC's investigation also found that Blackstone had failed to disclose to investors the existence of a separate fee arrangement with an outside law firm that provided Blackstone with a much greater discount than the same law firm provided to the relevant funds.[39]

1. Blackstone agreed to pay over $26 million in disgorgement and a $10-million penalty in order to settle the charges.[40]

2. "Full transparency of fees and conflicts of interest is critical in the private equity industry and we will continue taking action against advisers that do not adequately disclose their fees and expenses, as Blackstone did here," said Andrew Ceresney, director of the SEC Division of Enforcement.[41]

V. Individual Responsibility

A. Chief Compliance Officer Liability

1. In a series of recent actions, the SEC has sought to hold CCOs liable for compliance failures at their firms. This has caused concern — including a public dissent from approval of two settlements by an SEC Commissioner who subsequently left the Commission[42] — as the claim in these cases is that the CCO failed to implement an effective compliance program despite the fact that the relevant SEC Rule places that obligation to "implement" an effective compliance program on the investment adviser and not on the CCO.[43]

2. Recent Enforcement Actions Against CCOs

(a) BlackRock Advisors Inc. and Bartholomew Battista

(i) One of BlackRock's portfolio managers was also engaged in managing an outside fund. This fund engaged in a joint venture, which BlackRock then had several clients invest in without disclosing the interest that its portfolio manager had in the venture.[44]

(ii) The SEC alleged that this conflict of interest occurred because BlackRock failed to have adequate compliance policies in place, and that Bartholomew Battista, its CCO, was

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[36] *Id.*

[37] *Id.*

[38] Securities and Exchange Commission, Blackstone Charged with Disclosure Failures, Release No. 2015-235 (2015).

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] Commissioner Daniel M. Gallagher, Securities and Exchange Commission, Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), *available at* www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html.

[43] Ben DiPietro, "SEC Actions Stir Concerns over Compliance Officer Liability," *The Wall Street Journal* (June 24, 2015), *available at* http://blogs.wsj.com/riskandcompliance/2015/06/24/sec-actions-stir-concerns-over-compliance-officer-liability/.

[44] BlackRock Advisors, LLC and Bartholomew A. Battista, Investment Advisers Act Release No. 4065 (April 20, 2015).

responsible for this failure. The Commission's view was driven by the fact that Battista knew about the outside activity of several BlackRock managers and still allegedly failed to implement compliance policies designed to monitor and disclose this activity.[45]

(iii) Part of the SEC's criticism of Battista was a claim that BlackRock's compliance procedures were too generic and were not specifically tailored to the actual conflict that arose.

(b) SFX Financial Management Enterprises Inc. and Eugene Mason

(i) An SFX executive was found to have misappropriated client funds by writing checks from their bank accounts to himself over a period of eight years, during which he served as a vice president of SFX and then as its president. When SFX's CCO, Eugene Mason, discovered this, the firm hired outside counsel, conducted an internal investigation, terminated the firm's then-president and reported his misconduct to prosecutors. SFX then cooperated in the ensuing criminal prosecution of its former president.[46]

(ii) In spite of efforts by SFX, and Mason in his capacity as CCO, to work with criminal authorities, the SEC alleged that Mason was responsible for the implementation of SFX's policies and procedures and had failed in this task.[47] Specifically, the Commission alleged that Mason did not effectively implement a provision of SFX's compliance policy providing for the review of cash flows in client accounts; the SEC viewed this as particularly troubling because SFX's Form ADV stipulated that such review was to be done by senior management.[48] The SEC was also troubled by what it alleged was Mason's failure to conduct an annual review of SFX's compliance program (in spite of the fact that this review was delayed because SFX, and Mason particularly, were actively involved in an internal investigation relating to the misappropriation at issue).[49]

(c) In a noteworthy written dissent regarding both the BlackRock and SFX settlements, SEC Commissioner Daniel Gallagher (who resigned from the Commission towards the end of last year) expressed concern that the SEC had effectively taken the position that CCOs are strictly liable for the failure to implement their firms' compliance policies and procedures.[50]

(i) Commissioner Gallagher was concerned that these recent settlements were "undoubtedly sending a troubling message that CCOs should not take ownership of their firm's compliance policies and procedures, lest they be held accountable for conduct that, under Rule 206(4)-7, is the responsibility of the adviser itself. Or worse, that CCOs should opt for less comprehensive policies and procedures with fewer specified compliance duties and responsibilities to avoid liability when the government plays Monday morning quarterback."[51]

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[45] *Id.*

[46] SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason, Investment Advisers Act Release No. 4116 (June 15, 2015).

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] Commissioner Daniel M. Gallagher, Securities and Exchange Commission, Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), *available at* www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html.

[51] *Id.*

(ii) In response, the SEC has sought to reassure the compliance community in the wake of these cases, noting that it continues to bring an extremely small number of enforcement actions against CCOs and that the vast majority of these cases involve CCOs who "wore more than one hat," or were otherwise personally involved in the misconduct.[52]

(d) Sands Brothers Asset Management LLC and Christopher Kelly

(i) In October 2014, the SEC instituted cease-and-desist proceedings against Sands Brothers and its CCO, Christopher Kelly, for an alleged violation of Section 206(4)-2 of the Advisers Act and Rule 206(4)-2 thereunder.[53]

(ii) Sands Brothers had consented to a settlement of cease-and-desist proceedings brought against the firm in 2010 related to an earlier alleged violation of Rule 206(4)-2.[54] The SEC alleged that the firm had continued to fail to comply with the rule by failing to distribute audited financial statements to 10 funds within a 120-day window, imposed by the rule, at the end of each fiscal year.[55]

(iii) The SEC further alleged that Kelly, as CCO (but also serving as chief operating officer and as a partner of Sands Brothers), knew or was reckless in not knowing of, and substantially assisted, Sands Brothers' violations of Rule 206(4)-2. As such, the SEC alleged that Kelly had willfully aided and abetted Sands Brothers' in its alleged violations of Section 206(4)-2 and Rule 206(4)-2.[56]

(iv) While acknowledging that Kelly "reminded people of the custody rule deadline,"[57] the SEC alleged that more substantial action was required of Kelly as CCO. Specifically, the SEC alleged that because Sands Brothers' compliance manual tasked Kelly with "ensuring compliance with … Rule 206(4)-2," and because such compliance was not occurring, Kelly had failed to implement policies or procedures to ensure compliance with the rule.[58]

B. The Yates Memo

1. This memo broadly outlines the intent of the DOJ to increase its focus on bringing criminal charges against individuals bearing responsibility for corporate misconduct.[59]

The memo makes clear that its guidance should also be taken into consideration by regulators responsible for bringing civil actions in response to allegations of corporate misconduct, but the memo only applies to the DOJ and not to the SEC, CFTC or other regulators.[60]

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[52] Commissioner Luis A. Aguilar, Securities and Exchange Commission, The Role of Chief Compliance Officers Must Be Supported (June 29, 2015), *available at* www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html. Like Commissioner Gallagher, Commissioner Aguilar also resigned from the Commission at the end of last year.

[53] Sands Brothers Asset Management, LLC, Steven Sands, Martin Sands, and Christopher Kelly, Investment Advisers Act Release No. 3960 (Oct. 29, 2014).

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] Sally Quillian Yates, Department of Justice, *Individual Accountability for Corporate Wrongdoing* (Sept. 9, 2015).

[60] *Id.* at 2-3, 6.

2. Recommendations for Corporations

(a) Provide all relevant facts regarding individual involvement in corporate misconduct.[61] The Yates memo takes the position that corporations must turn over absolutely all evidence related to individual misconduct, and corporations may not pick and choose what to turn over, before they will be considered for any kind of cooperation credit.

(b) Focus on individual wrongdoing from the outset of an investigation.

(c) Increase cooperation between criminal and civil attorneys. The goal is that increased dialogue between criminal and civil government attorneys would lead to more thorough investigations and a full range of potentially viable claims being brought against alleged wrongdoers.[62]

(d) Settlements with corporations should not release alleged individual wrongdoers from liability.[63]

(e) Always resolve cases of corporate misconduct with a plan to deal with allegedly culpable individuals before the relevant statute of limitations expires.

(f) Civil attorneys for the government should also focus on individuals and look beyond a party's ability to pay a judgment when considering whether to bring suit.[64]

VI. Insider Trading Post-*Newman*

A. Significance of *U.S. v. Newman*

1. In *Newman*, the U.S. Court of Appeals for the Second Circuit reversed two insider-trading convictions, finding that the government had not sufficiently proved that the defendants had been aware that the insiders responsible for passing on information had done so in exchange for a personal benefit and thus in violation of their fiduciary duties.[65]

2. The *Newman* court also held that the government had failed to adequately prove that the insiders obtained a personal benefit that was sufficiently concrete and of a pecuniary or pecuniary-like nature, finding that such a benefit is an essential element of a breach of fiduciary duty by the insider necessary to give rise to insider-trading liability.[66]

(a) The government had argued that the receipt of career advice by the tipper qualified as a personal benefit given in exchange for the tip at issue, but the Second Circuit rejected that this was sufficient to allow a rational fact finder to conclude beyond a reasonable doubt that a personal benefit that was sufficiently concrete and pecuniary in nature had been given in exchange for the tip.[67]

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[61] *Id.* at 3.

[62] *Id.* at 4-5.

[63] *Id.* at 5.

[64] *Id.* at 6-7.

[65] *United States v. Newman*, 773 F.3d 438, 450-51 (2nd Cir. 2014).

[66] *Id.* at 452-53.

[67] *Id.* at 452.

(b) In rejecting the government's argument, the Second Circuit held: "To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of the profits to the recipient,' … we hold that such an inference is 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."[68]

(c) The court did not clarify what types of personal benefit would satisfy this test, leaving it to future case-by-case evaluation by the courts. It did note, however, that entrance to an investment club, receiving client referrals, or entering into commission-splitting arrangements in exchange for a tip would suffice.[69]

B. Insider-Trading Decisions after *Newman*

1. It must be emphasized that *Newman*'s reach is limited to the Second Circuit (which consists of federal courts sitting in New York, Connecticut and Vermont). Several courts outside the Second Circuit have already decided not to follow *Newman*.

(a) *U.S. v. Salman*: The Ninth Circuit declined to follow *Newman*, holding that the U.S. Supreme Court's insider-trading jurisprudence had established that liability for a tippee could be established when an "insider makes a gift of confidential information to a trading relative or friend."[70]

(i) Of particular importance in *Salman* was the close familial relationship between the tipper and tippee (they were brothers); the tipper testified that he had given his brother information in order to "benefit him" and to "fulfill whatever needs he had."[71] In one instance, the tipper gave the tippee information in lieu of a loan.[72]

(ii) The defendant in *Salman* was the brother-in-law of the tipper and tippee, and the court found that he was aware of both the source of the tip as well as the close fraternal relationship between the tipper and tippee.[73]

(b) *U.S. v. Melvin*: A Georgia federal district court declined to follow *Newman*, noting that it was not binding authority. In rejecting the holding of *Newman*, the *Melvin* court focused on both the gift language of the U.S. Supreme Court's decision in *Dirks* in addition to the fact that pecuniary gain is not necessary to prove a personal benefit.[74]

(i) The *Melvin* court found that the defendant had a close personal friendship with those to whom he had provided confidential inside information.[75]

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[68] *Id.*

[69] *Id.* at 453-54.

[70] 792 F.3d 1087, 1093-94 (9th Cir. 2015) (citing *Dirks v. SEC*, 463 U.S. 646, 664 (1983)).

[71] *Id.* at 1089.

[72] *Id.*

[73] *Id.* at 1090.

[74] 2015 WL 7077258, at *15 (N.D. Ga. 2015).

[75] *Id.* at *1.

(ii) Important to the court's analysis was that the U.S. Court of Appeals for the Eleventh Circuit "has interpreted [*Dirks*] to define '"benefit" in very expansive terms,' indicating that in *Dirks*, 'the Court declared that not only does an actual pecuniary gain, such as a kickback or an expectation of a reciprocal tip in the future, suffice to create a "benefit," but also cases where the tipper sought to enhance his reputation (which would translate into future earnings) or to make a gift to a trading relative or friend.'"[76]

(c) It is also worth noting that the SEC's own administrative courts — in which the SEC has brought an increasing number of enforcement actions in recent years — are not bound by *Newman*.

VII. Anti-Money Laundering Rules, Cases and Implications for Fund Managers

A. Proposed FinCEN Rulemaking

1. On Sept. 1, 2015, the Financial Crimes Enforcement Network ("FinCEN") issued a notice of proposed rulemaking to prescribe, among other things, minimum standards for anti-money laundering ("AML") programs to be established by registered investment advisers. The proposed rule would also require the registered investment advisers to report suspicious transactions that are conducted or attempted by, at or through an investment adviser, and involve or aggregate at least $5,000 in funds or assets.[77]

(a) The proposed rule would apply to investment advisers who are registered or required to be registered with the SEC.

(b) AML programs must include:

(i) Development of internal policies, procedures and controls reasonably designed to prevent the investment adviser from being used for money laundering or the financing of terrorist activities, and to achieve and monitor compliance with the BSA and FinCEN's implementing regulations.

(ii) The designation of an AML compliance officer. This person should be an officer of the investment adviser.

(iii) An ongoing employee training program.

(iv) An independent audit function to test the programs.

(c) Under the proposed rule, investment advisers may contractually delegate some duties of their compliance program to other entities, including agents or third-party service providers, such as administrators. However, any entity that does so will remain fully responsible for the effectiveness of the program, as well as for ensuring that FinCEN and the SEC are able to obtain information and records relating to the AML program.

(d) The SEC will act as the designated examiner of investment advisers for compliance with the rules.

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[76] *Id.* at *15 (quoting *SEC v. Yun*, 327 F.3d 1263, 1276 (11th Cir. 2003)).

[77] Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 169 (proposed Sept. 1, 2015) (to be codified at 31 C.F.R. Ch. X).

B. Recent AML Enforcement Actions

1. Oppenheimer (January 2015)

(a) The SEC charged Oppenheimer with, among other things, aiding and abetting illegal unregistered broker-dealer activity by a customer, an off-shore broker-dealer.

(b) According to the settlement document, Oppenheimer knew, suspected or had reason to suspect that one of its clients was using its Oppenheimer account to facilitate unlawful activity, but did not file Suspicious Activity Reports ("SARs").

(c) Oppenheimer agreed to admit wrongdoing and pay $10 million to settle the SEC's charges[78] and an additional $10 million to settle a parallel action by FinCEN.[79] Oppenheimer also agreed to retain an independent compliance consultant.

2. First National Community Bank (February 2015)

(a) FinCEN assessed a civil money penalty against First National Community Bank ("FNCB") for violations of the Bank Secrecy Act ("BSA"), and FNCB admitted such violations.

(b) According to the Assessment of Civil Money Penalty, FNCB failed to "detect or adequately report suspicious transactions involving millions of dollars in illicit proceeds from a judicial corruption scheme perpetrated by a former Pennsylvania state judge, among others."[80]

(c) FNCB agreed to pay a penalty of $1.5 million, of which $500,000 was concurrent with a penalty imposed by the Office of the Comptroller of the Currency. In connection with the settlement, FinCEN expressly reserved the right to bring claims against parties other than FNCB, including any current or former partner, director, officer or employee of FNCB.[81]

3. Commerzbank (March 2015)

(a) Commerzbank entered into a Deferred Prosecution Agreement with the DOJ, as well as settlements with OFAC and the Federal Reserve.[82] Commerzbank paid $563 million in disgorgement and $79 million in penalties.[83] It paid $300 million in forfeiture in connection with BSA violations. In total, Commerzbank agreed to pay a total of $1.45 billion in penalties.

(b) The DOJ alleged that one of its clients used Commerzbank to perpetuate a massive accounting fraud designed to conceal from the clients' auditors and investors hundreds of millions of dollars in losses from the late 1990s to 2011, and that Commerzbank had failed to thoroughly conduct investigations of transactions that triggered alerts in the bank's automated AML software. Moreover, the bank failed to report this suspicious activity to regulators and failed to monitor billions of dollars in correspondent banking transactions.[84]

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[78] Oppenheimer & Co. Inc., Securities Act Release No. 9711 (Jan. 27, 2015).

[79] Oppenheimer & Co., Inc., FinCEN No. 2015-01 (Jan. 26, 2015).

[80] First National Community Bank Dunmore Pennsylvania, FinCEN No. 2015-03 at *2 (Feb. 27, 2015).

[81] *Id.*

[82] *United States v. Commerzbank*, Deferred Prosecution Agreement (March 11, 2015).

[83] *Id.*

[84] *Id.*

(c) Recent actions to enforce AML laws and regulations make it clear that simply having a compliance program in place is not sufficient. Among other things, regulators expect firms to have procedures in place that take into account the particular risks presented by the firm's business activities, and to have qualified AML officers. It is likely that investment advisers will find themselves subjected to these same requirements in the near future.

4. LPL Financial LLC (May 2015)

(a) In May 2015, LPL Financial LLC ("LPL") and FINRA entered into a Letter of Acceptance, Waiver and Consent ("AWC").[85] According to the AWC, LPL had in place a surveillance system that suffered from coding errors and therefore failed to generate alerts based on risk-based scenarios for customer ATM withdrawals. After the coding error was detected, LPL was unable to correct the coding promptly. According to FINRA, as a result, LPL failed to have a system reasonably designed to monitor for suspicious activity relating to customer ATM use.[86]

(b) In connection with settling these and other allegations, LPL consented to the imposition of a censure and a fine in the amount of $10 million. In addition, in connection with its surveillance system AML scenarios, LPL was required to conduct transactional look-backs for the periods during which the surveillance system was not fully functional.[87]

5. Halcyon Cabot Partners Ltd. (October 2015)

(a) In July 2015, FINRA filed a disciplinary proceeding against Halcyon Cabot Partners, Ltd. ("HCP"), Michael Trent Morris and Ronald Mark Heineman. On Oct. 6, 2015, FINRA entered an order accepting an offer of settlement from HCP, as well as Morris and Heineman, who were the firm's CCOs and AML officers during the relevant period.[88]

(b) FINRA alleged, among other things, that between 2010 and 2013, HCP, Morris and Heineman engaged in a scheme to defraud investors by causing HCP to serve as a bogus placement agent to conceal a kickback of a private placement fee, and caused the firm to serve as a false sales agent so that a now-expelled broker-dealer could charge commissions to both buyers and sellers in certain private sales of securities.[89]

(c) FINRA claimed that these and other violations were enabled by HCP's culture of non-compliance, which manifested itself in numerous supervisory violations and an inoperable AML program. Specifically, with respect to the AML program, FINRA alleged, among other things, that: (i) HCP had inadequate supervisory procedures because those procedures did not accurately reflected the risks posed by HCP's business model and the controls necessary to mitigate those risks; (ii) HCP failed to implement its AML program; (iii) HCP failed to detect and investigate red flags related to potentially suspicious securities transactions; and (iv) HCP did not have a qualified AML officer.[90]

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85 LPL Financial LLC, Letter of Acceptance, Waiver and Consent, No. 2013035109701 (May 6, 2015).

86 *Id.*

87 *Id.*

88 Halcyon Cabot Partners, Ltd., Michael Trent Morris, and Ronald Mark Heineman, FINRA Disciplinary Proceeding No. 2012033877802 (Oct. 6, 2015).

89 *Id.*

90 *Id.*

(d) As a sanction, HCP was expelled from FINRA, and Morris and Heineman were barred from association with any FINRA member in any capacity.[91]

VIII. Whistleblowers Post-*KBR*

A. As part of a settled action, the SEC imposed a cease-and-desist order on engineering company KBR Inc., alleging that the company violated SEC Rule 21F-17 by forcing its employees to sign confidentiality statements related to its internal compliance investigations.[92]

1. Rule 21F-17(a) states: "No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement … with respect to such communications."[93]

2. The SEC was not aware of any instance in which a KBR employee either had been prevented from revealing information to federal regulators, or had been subjected to discipline as a result of bringing any matter covered by the confidentiality statement to federal regulators. Nonetheless, the Commission alleged that "the language found in the form confidentiality statement impedes such communications by prohibiting employees from discussing the substance of their interview without clearance from KBR's law department under penalty of disciplinary action including termination of employment."[94]

B. The result of the settlement was that KBR paid a $130,000 fine and, most significantly, agreed to amend its confidentiality statement "to make clear that its current and former employees will not have to fear termination or retribution or seek approval from company lawyers before contacting [the SEC]," according to Sean McKessy of the SEC Office of the Whistleblower.[95] It is likely that the SEC will continue to bring actions against registered employers that have not reformed their confidentiality agreements in line with the SEC's view as expressed in *KBR* of what such confidentiality agreements may and may not contain.

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[91] *Id.*

[92] KBR, Inc., Exchange Act Release No. 74619, 2015 WL 1456619 (April 1, 2015).

[93] 17 C.F.R. § 240.21F-17(a).

[94] KBR, Inc., Exchange Act Release No. 74619, 2015 WL 1456619 (April 1, 2015).

[95] Scott Hingham, "SEC Finds That KBR Confidentiality Agreements 'Stifled' Whistleblowers," *The Washington Post* (April 1, 2015), *available at* www.washingtonpost.com/investigations/sec-finds-that-kbr-confidentiality-agreements-stifled-whistleblowers/2015/04/01/c78f6708-d884-11e4-8103-fa84725dbf9d_story.html.

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