Enforcement

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27TH ANNUAL PIF

PRIVATE INVESTMENT FUNDS SEMINAR

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Harry S. Davis

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 four-and-a-half month jury trial in a raiding case, and his successful representation of a prime broker in a hotly contested and 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 US* 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 co-authored an article titled "Second Circuit, in Split Decision, Overrules Limitation on Insider Trading Liability Established in *U.S. v. Newman*," published in *The Hedge Fund Journal*. He has presented on a wide range of topics, including SEC examinations and enforcement actions, 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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Douglas I. Koff

Doug represents clients in high-profile civil and criminal proceedings, as well as investigative matters. He is best known for supervising these types of matters for financial institutions and broker-dealers as well as representing executives in the crosshairs of the government regulators and criminal authorities. Doug has been actively engaged in cases involving financial service institutions, broker-dealers and corporate executives relating to securities, derivative products and other complex financial instruments. In this regard, he has advised and defended companies and corporate executives in virtually all types of inquiries by civil and criminal authorities (as well as SROs) into business practices on Wall Street, including a wide array of matters involving the financial crisis. He has also handled major civil litigations and arbitrations involving a broad spectrum of substantive legal issues, including fraud, breach of contract, antitrust, breach of fiduciary duty, reinsurance, piercing the corporate veil, mergers and acquisitions and money laundering, as well as federal securities law.

Doug has been recognized as a leading lawyer by *Chambers USA* and *The Legal 500 US*. A highly sought-after thought leader, he has spoken and written widely on key industry topics, including current trends in financial regulation and enforcement and securities laws violations. Most recently, he was quoted in the article “Execution Enforcement Actions Escalate,” published in *The Hedge Fund Journal*.

Doug received his J.D. from Columbia Law School, where he was managing editor of *Columbia Human Rights Law Review*, and his B.A. from Earlham College.

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David focuses on complex commercial litigation and regulatory matters primarily for financial services industry clients, including hedge funds, funds of funds and private equity funds. He has substantial experience in both private securities litigation and securities regulatory matters, investigations by the U.S. Securities and Exchange Commission, the New York Stock Exchange, the Financial Industry Regulatory Authority and state attorneys general offices, investor disputes and class action litigation. David also provides day-to-day counseling for financial services companies on these issues. His significant engagements include successfully representing investment managers in connection with regulatory investigations into trading activities; an interdealer broker in various arbitrations and related civil actions arising from the hiring of brokers by a competitor; an investment manager in connection with the wind-up of funds and related U.S.- and Cayman Island-based litigation, as well as related state and federal regulatory investigations; and a group of investment managers and related entities in fraudulent conveyance actions arising from leveraged buyout transactions.

David has written extensively on securities regulation and has spoken at industry events covering insider trading and other regulatory compliance and enforcement issues for private investment funds. Most recently, he co-authored "Second Circuit, in Split Decision, Overrules Limitation on Insider Trading Liability Established in *U.S. v. Newman*," published in *The Hedge Fund Journal* and the "Market Manipulation" chapter in the leading treatise *Federal Securities Exchange Act of 1934* (Matthew Bender). In addition, he authored the "Big Boy Letters" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and "Managing and Resolving Hedge Fund and Private Equity Fund Disputes," in *Corporate Disputes*.

David earned his J.D. from Boston University School of Law, where he was a G. Joseph Tauro Scholar and an Edward F. Hennessey Scholar, and his B.A. from Boston University.

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Seetha focuses her practice on anti-money laundering and OFAC compliance, regulatory investigations and enforcement actions, white-collar criminal defense and criminal and civil forfeiture matters. She has represented companies and individuals in criminal and regulatory investigations by the DOJ, New York Attorney General, CFTC and SEC, as well as conducted internal investigations. She has counseled a range of companies, including hedge funds, private equity funds, banks, broker-dealers and money services businesses on AML and OFAC compliance, and other regulatory issues. As a federal prosecutor for nearly a decade, Seetha spearheaded and oversaw the DOJ's first major AML prosecutions, including those of HSBC, MoneyGram, Standard Chartered Bank and ING. Much of her work developing and charging criminal cases under the Bank Secrecy Act (BSA) formed the model for AML enforcement that regulators and prosecutors apply today, making her uniquely well-positioned to advise clients in this area. She also has deep experience negotiating the penalty phase of AML and forfeiture matters large and small, ranging from those involving global financial institutions to individual defendants. Seetha is a former Deputy Chief in the Asset Forfeiture and Money Laundering Section (AFMLS), Criminal Division, U.S. Department of Justice, where she was the first head of the Money Laundering & Bank Integrity Unit — DOJ's criminal litigation unit focused on AML and sanctions enforcement. In this role, she supervised BSA cases against traditional financial institutions like banks, as well as those involving emerging areas of BSA enforcement, such as casino gambling, online payment systems and virtual currencies. Seetha also worked closely with state and federal banking regulators and U.S. Attorneys' offices nationwide, providing expert advice on cases involving the BSA, complex money laundering and financial institutions. Prior to her appointment at AFMLS, Seetha served as an Assistant U.S. Attorney for the Southern District of New York for nearly six years, where she worked in the Complex Frauds, Major Crimes and Asset Forfeiture units.

The Legal 500 US has recognized Seetha as a leading lawyer. An accomplished public speaker, she has presented on topics that include enforcement trends in the financial services industry, effective AML programs and asset forfeiture. Seetha was recently interviewed by *Financier Worldwide* on tackling fraud and money laundering within financial institutions and for that magazine, she co-authored "Should Lawyers be Required to Investigate Their Own Clients?" In addition, Seetha co-authored "Sanctions Update: Russia, Iran, North Korea and Venezuela" and "Sanctions and AML Update: North Korea and Venezuela," both published in *The Hedge Fund Journal*.

Seetha earned her J.D. from Columbia Law School and her B.A., *magna cum laude*, from Brown University.

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Craig is co-chair of the Broker-Dealer Regulatory & Enforcement Group. His practice focuses on securities enforcement and regulatory matters for broker-dealers, private funds, financial institutions, companies and individuals. Drawing on his experience both as a former enforcement attorney with the U.S. Securities and Exchange Commission and as a Special Assistant U.S. Attorney, Craig advises clients on securities trading matters and, when necessary, represents them in regulatory investigations and enforcement actions by the SEC, DOJ, FINRA and other self-regulatory organizations and state regulators. Craig leads training sessions for clients on complying with insider trading and market manipulation laws and assists hedge funds and private equity funds in connection with SEC examinations. Craig also has experience representing entities and individuals under investigation for, or charged with, securities fraud, mail/wire fraud, accounting fraud, money laundering, Foreign Corrupt Practices Act (FCPA) violations and tax offenses. In his previous roles in the U.S. Attorney's Office for the Eastern District of New York and the SEC, Craig prosecuted numerous complex and high-profile securities fraud, accounting fraud and insider trading cases.

Craig is recognized as a leading litigation lawyer in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers*. He is a former law clerk to the Honorable Lawrence M. McKenna of the U.S. District Court for the Southern District of New York. Craig has written about enforcement actions against hedge funds and other industry-related topics, and has spoken on attorney-client privilege. Most recently, he was interviewed for the article "Execution Enforcement Actions Escalate," published in *The Hedge Fund Journal*.

Craig received his J.D., *cum laude*, from Benjamin N. Cardozo School of Law and his B.A. from the University of Michigan.

Enforcement

I. Key Personnel Changes

A. New SEC Chairman: Jay Clayton

Mr. Clayton is a former partner at Sullivan & Cromwell, where he specialized in merger and acquisition transactions and capital market offerings.

B. New CFTC Chairman: J. Christopher Giancarlo

Mr. Giancarlo served as acting chair from January 2017 until his confirmation in August 2017. He is the former executive vice president of GFI Group, a financial services firm, and a former partner at Brown Raysman Millstein Felder & Steiner.

C. New SEC Division of Enforcement Directors: Stephanie Avakian and Steven Peikin

1. Ms. Avakian was named co-director of the SEC's Division of Enforcement in June 2017 after serving as acting director since December 2016, and deputy director since 2014. She is a former partner at Wilmer Cutler Pickering Hale and Dorr.

2. Mr. Peikin worked from 1996 to 2004 as an assistant U.S. attorney for the Southern District of New York. He is also the former managing partner of Sullivan & Cromwell's Criminal Defense and Investigations Group.

D. New CFTC Division of Enforcement Director: James McDonald

Mr. McDonald assumed his new role in April 2017 after serving as an assistant U.S. attorney for the Southern District of New York.

E. New SEC New York Regional Office Director: Marc Berger

Mr. Berger is the former global co-head of Ropes & Gray's Securities and Futures Enforcement Practice. Prior to his work at Ropes & Gray, Mr. Berger spent 12 years as an assistant U.S. attorney for the Southern District of New York.

II. Enforcement Priorities

A. Enforcement and Investigation Statistics

1. SEC Enforcement Division Statistics

(a) In 2017, the SEC Enforcement Division initiated a total of 754 actions, compared with 868 in 2016.[1]

(i) This drop-off is not as precipitous as it initially looks. As the SEC report notes, an operation targeted at municipal bond offerings was concluded in FY 2016. Excluding these initiatives, there were 784 total actions initiated in 2016.

(ii) Actions against private funds have decreased, but only slightly. While there were 98 such actions in 2016, there were 91 in 2017.

(b) Actions involving investment advisory issues, securities offerings and issuer reporting/accounting and auditing accounted for roughly 60 percent of the total in 2017. Market manipulation and insider trading were about 20 percent of all actions.

(c) Broker-dealer actions actually increased from 2016 to 2017, accounting for roughly 10 percent of SEC Enforcement actions in 2017.[2]

[1] *See* SEC, Division of Enforcement, Annual Report 2017, *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

2. CFTC Enforcement Statistics

   In FY 2017 the CFTC brought 49 actions,[3] as compared with FY 2016's 68.[4] Forty percent of FY 2017's actions focused on retail fraud.[5]

3. FINRA Statistics

   No complete report has been issued yet comparing 2017 statistics with 2016 statistics. However, based on reports of disciplinary and other FINRA actions, rates decreased slightly, on average, in 2017.[6]

B. Budgetary Constraints

1. The SEC budget allocation for FY 2017 was identical to that of FY 2016. This was the first time the budget was not increased since 2013, when a sequester was in place.

2. For FY 2018, the SEC budget is likely to decrease. This will be the first decrease since 2007, when the total budget was half of its current size.[7]

3. The CFTC's budget remained the same from FY 2016 to FY 2017.[8]

C. Pullback from "Broken Windows" Strategy

In October of 2017, co-director of the SEC Enforcement Division Peikin indicated the SEC would drop the "broken windows" strategy of pursuing many cases over even the smallest legal violations.

1. Speaking at a securities conference, Peikin said, "[I]t may be the case that we have to be selective and bring a few cases to send a broader message rather than sweep the entire field."[9]

2. He also noted that, "I think when people resolve cases with the commission [and] neither admit nor deny but agree to all the points of relief, I don't think most people in the world say, 'Boy, they really got away with that.'"

   In contrast, under former SEC Chair Mary Jo White, an Obama appointee, the SEC sought admissions of fault by firms and individuals in select cases, rather than allowing defendants to resolve probes by paying penalties while neither admitting nor denying the allegations.

D. Foreign Corrupt Practices Act

FCPA Cases

1. There has been speculation, since this time last year, that FCPA enforcement actions would decrease in 2017. That speculation proved to be correct, with only eight FCPA actions commenced in FY 2017 compared with the record high of 27 in FY 2016. However, the SEC and DOJ have continued to indicate that FCPA enforcement remains a top priority. SEC Chairman Clayton recently said that he views "combatting corruption" as "an important governmental mission."[10] At the DOJ, acting assistant attorney general Kenneth Blanco said in a speech in April 2017 that the DOJ "remains committed to enforcing the

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[2] *Id*.

[3] *See* CFTC Releases Annual Enforcement Results for Fiscal Year 2017, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7650-17.

[4] *See* CFTC Releases Annual Enforcement Results for Fiscal Year 2016, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7488-16.

[5] *See* CFTC Releases Annual Enforcement Results for Fiscal Year 2017, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7650-17.

[6] *See* FINRA, Enforcement Department, Monthly and Quarterly Disciplinary Actions, *available at* http://www.finra.org/industry/disciplinary-actions.

[7] *Id.*

[8] *See* CFTC, Budget Request 2018, *available at* http://www.cftc.gov/reports/presbudget/2018/.

[9] Dave Michaels, "SEC Signals Pullback from Prosecutorial Approach to Enforcement," *The Wall Street Journal*, Oct. 26, 2017, *available at* https://www.wsj.com/articles/sec-signals-pullback-from-prosecutorial-approach-to-enforcement-1509055200.

[10] United States House of Representatives Committee on Banking, Housing, and Urban Affairs, Nomination of Mr. Jay Clayton, March 23, 2017.

FCPA and to prosecuting fraud and corruption more generally."[11] Attorney general Jeff Sessions has delivered the same message, stating that the DOJ "will continue to strongly enforce the FCPA . . . ."[12]

2. Last year, we saw the DOJ institute a "Pilot Program" that was meant to reward voluntary self-disclosures with decreased fines. But even after the initial one year trial (and after a change in administration) the program remains in effect today.

3. It is widely debated whether the Pilot Program truly rewards cooperation, but one important takeaway is that even where the DOJ has declined to bring a case, the SEC has sought disgorgement. Disgorgement is specifically contemplated as a condition of declination, under the Pilot Program.

E. Focus on Main Street Investors

As a guiding principal, SEC Chairman Clayton has frequently emphasized ensuring protections for retail investors.

1. SEC Chairman Clayton's testimony on "Oversight of the U.S. Securities and Exchange Commission," Washington D.C., Sept. 26, 2017:

   (a) "In particular, I have asked the Division of Enforcement to evaluate regularly whether we are focusing appropriately on retail investor fraud and investment professional misconduct, insider trading, market manipulation, accounting fraud and cyber matters. I believe our Main Street investors would want us to focus on these areas."

   (b) "[Due to] advancements in OCIE's use of technology and other efficiencies, the SEC is on track to deliver a 30 percent increase in the number of investment adviser examinations this fiscal year — to approximately 15 percent of all investment advisers."

2. SEC Chairman Clayton's remarks at PLI's 49th Annual Institute on Securities Regulation, New York, NY, Nov. 8, 2017:

   (a) "[I]t is not clear whether in our rulemaking process, the views and fundamental interests of long-term retail investors are being advocated fully and clearly, either by individual investors or groups that represent them."

   (b) "I expect that our Enforcement Division will continue to be active in pursuing cases where hidden or inappropriate fees are at issue, but we also are exploring whether more can be done to clarify fee disclosures made to retail investors and, thereby, deter and reduce the opportunities for misbehavior."

3. The Retail Strategy Task Force[13]

   (a) Dedicated to developing effective strategies and methods to identify potential harm to retail investors.

   (b) Fraud aimed at retail investors has been under particular scrutiny, and with the implementation of the Task Force this is likely to continue throughout 2018.

   (c) Examples of 2017 enforcement actions with a direct impact on retail investors.

      (i) Thirteen individuals allegedly involved in two Long Island-based cold calling scams that bilked more than 100 victims out of more than $10 million through high-pressure sales tactics and lies about penny stocks.[14]

[11] Speech, Acting Assistant Attorney General Kenneth A. Blanco Speaks at the Atlantic Council Inter-American Dialogue Event on Lessons From Brazil: Crisis, Corruption and Global Cooperation, July 19, 2017.

[12] Speech, Attorney General Jeff Sessions Delivers Remarks at Ethics and Compliance Initiative Annual Conference, April 24, 2017.

[13] *See* SEC, Division of Enforcement, Annual Report 2017, *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

(ii) Twenty-seven individuals and entities behind various alleged stock promotion schemes that left investors with the impression they were reading independent, unbiased analyses on investing websites while writers actually were being secretly compensated for touting company stock.[15]

(iii) Barclays Capital for charging improper advisory fees and mutual fund sales charges to clients, who were overcharged by nearly $50 million. The firm agreed to pay more than $97 million in disgorgement and penalties to settle the Commission's claims.[16]

(iv) Three New York-based brokers for allegedly making unsuitable recommendations that resulted in substantial losses to customers and hefty commissions for the brokers. One of the brokers agreed to pay more than $400,000 to settle the charges.[17]

F. Insider Trading

1. Insider trading remained a main focus of SEC enforcement actions in 2017.

(a) A partner at a Hong Kong-based private equity firm who allegedly amassed more than $29 million in illegal profits by insider trading in advance of the April 2016 acquisition of DreamWorks Animation SKG by Comcast.[18]

(b) A former government employee turned political intelligence consultant and three others for engaging in an alleged insider trading scheme involving tips of nonpublic information about government plans to cut Medicare reimbursement rates, which affected the stock prices of certain publicly traded medical providers or suppliers.[19]

(c) The SEC announced that it used data analysis to uncover a wide-reaching insider-trading scheme involving seven individuals — even though the traders allegedly used shell companies, code words and encrypted messaging to evade detection. Specifically, the SEC claimed that it was able to detect improbably successful trading across different securities over time, and thereby discovered the scheme.[20]

2. Major case law development in 2017: *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017).

(a) The Second Circuit held that "an insider or tipper personally benefits from a disclosure of inside information whenever [1] the information was disclosed 'with the expectation that [the recipient] would trade on it' . . . and [2] the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . whether or not there was a 'meaningfully close personal relationship' between the tipper and the tippee."

(b) The majority rejected adopting a categorical rule that an insider can never personally benefit from disclosing inside information as a gift without a "meaningfully close personal relationship." In doing

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[14] *See* SEC Announces Charges in Massive Telemarketing Boiler Room Scheme Targeting Seniors, July 12, 2017, *available at* https://www.sec.gov/news/press-release/2017-124.

[15] *See* SEC: Payments for Bullish Articles on Stocks Must Be Disclosed to Investors, April 10, 2017, *available at* https://www.sec.gov/news/press-release/2017-79.

[16] *See* Barclays to Pay $97 Million for Overcharging Clients, May 10, 2017, *available at* https://www.sec.gov/news/press-release/2017-98.

[17] *See* SEC Detects Brokers Defrauding Customers, Sept. 28, 2017, *available at* https://www.sec.gov/news/press-release/2017-180.

[18] *See* SEC Charges Chinese Citizens Who Reaped Massive Profits From Insider Trading on Comcast-Dreamworks Acquisition, Feb. 10, 2017, *available at* https://www.sec.gov/news/pressrelease/2017-44.html.

[19] *See* SEC Files Charges in Trading Scheme Involving Confidential Government Information, May 24, 2017, *available at* https://www.sec.gov/news/press-release/2017-109.

[20] *See* SEC Uncovers Wide-Reaching Insider Trading Scheme, Aug. 16, 2017, *available at* https://www.sec.gov/news/press-release/2017-143.

so, the Second Circuit panel in *Martoma* expressly overruled another panel's decision on this point in *United States v. Newman.*[21]

(c) Nothing in *Martoma* undercuts the requirement that a tippee must know or have reason to know that the tipper received a legally cognizable personal benefit (whatever that benefit might be) in exchange for the tip, one of the core holdings in *Newman*.

(d) However, regulators and prosecutors are still relying on the "conscious avoidance" doctrine to establish liability.

(i) *United States v. Goffer*, Nos. 10-cr-56-1 (RJS), 10-cr-56-2 (RJS), 2017 WL 203229 (S.D.N.Y. Jan. 17, 2017).

(1) Conscious avoidance was proven on the basis that defendant "was aware of the characteristics of the conspiracy's sources, namely, that they were attorneys or similarly situated insiders." The Court noted that defendant was familiar with usage of many merger and deal-related terms because he explained them to clients. The Court used recorded conversations in which defendant refused to talk about certain topics on the phone against him, and that he took many in-person meetings with the parties involved.

(2) "The nature of the information Kimelman received, the frequency with which he received it, and his clandestine behavior when discussing or trading on this information completely undermine the hypothetical suggestions set forth in Kimelman's briefs of possible nonculpable sources for the tips, such as 'a fellow subway passenger who was unguardedly reviewing deal documents on his morning commute,' 'a neighbor who carelessly discarded confidential documents in their building's trash,' or a lawyer friend 'commiserating about work.' More to the point, a reasonable juror would have inferred from this evidence that Kimelman did not believe he was receiving inadvertently disclosed information, but rather that he knew he was receiving inside information from a lawyer or similarly situated professional who would face grave consequences if caught breaching a duty of confidentiality."

(ii) *United States v. Flom*, 256 F. Supp. 3d 253 (E.D.N.Y. Jun. 13, 2017).

This case articulates clearly that a conscious avoidance charge is appropriate where (i) the defendant asserts the lack of knowledge required for conviction; and (ii) there is a sufficient factual predicate for the charge. To prove that a sufficient factual predicate exists, the government must provide enough evidence for a rational juror to conclude beyond a reasonable doubt that (i) defendant was aware of a high probability that the securities involved in the UC Scheme were fraudulent (the "probability requirement"); and (ii) defendant consciously avoided confirming that fact (the "conscious avoidance requirement").

3. Big Data and Web Scraping

(a) Analysis of big data, some gathered through web scraping, to assist in investment decisions is an increasingly common practice for fund managers.

(b) Potential issues under federal and state law

(i) First, fund managers who obtain or receive data collected as a result of web scraping might come into possession of MNPI, or information that, when aggregated, could be considered MNPI. Risks arise if the information was provided in violation of a confidentiality obligation. Trading while in possession of such information could conceivably lead to liability under the "misappropriation theory" of insider trading, which holds that a person commits fraud in connection with a securities transaction — and thereby violates Section 10(b) of the Exchange

[21] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

Act and SEC Rule 10b-5 — when he, she or it misappropriates confidential information for securities-trading purposes in breach of a duty owed to the source of the information. The source need not be an insider of the issuer whose securities are being traded.

(ii) Second, if the data were collected in a manner considered "deceptive," then there is a risk that trading on that information may be considered part of a fraudulent scheme in violation of the antifraud provisions under the securities laws. Behavior in violation of a duty not to mislead may violate these provisions even when the trader is under no duty to the source of the information. For example, if a manager or its agent circumvents security protocols, disguises or fails to reveal a scraper's identity on a site (where required), or otherwise deceives a website into allowing access to the site, these might be viewed as affirmative misrepresentations constituting a "deceptive device" under Section 10(b) and Rule 10b-5, which could form the basis for such a fraud claim.

(iii) Finally, even where data collectors fully comply with the terms of a site's agreements and its security protocols, state attorneys general may raise concerns under state laws about practices that take "unfair advantage" of access to information and practices that are against public policy generally.

4. "Material Fact" vs. "Guessing": Is There a Difference?

There is a legal distinction between guessing or speculating, on the one hand, and a material fact, on the other hand, although the distinction often does not deter regulators from investigating or pursuing an insider trading charge.

(a) *SEC v. Carroll*, 9 F. Supp. 3d 761 (W.D.K.Y. 2014) (summary judgment denied; defendant argued that tipper had communicated his "hunch" that the acquisition would occur).

(b) *SEC v. Steffes*, Case No. 1:10-cv-06266 (N.D. Ill. Jan. 27, 2014) (verdict entered for defendant; defendant argued that he pieced together for himself what was occurring regarding a corporate transaction based on what was available to him as an employee of the company).

(c) David Sokol Matter (2013) (SEC announced that it would not pursue insider trading charges; unclear whether corporate executive, in fact, had knowledge of the deal-making process).

5. The *Deerfield* Matter

(a) On May 24, 2017, the U.S. Attorney's Office for the Southern District of New York and the SEC announced insider trading charges relating to a scheme in which a federal government employee is alleged to have provided confidential information involving Medicare and Medicaid reimbursement rate decisions to a political intelligence consultant, who in turn relayed the information to a hedge fund, Deerfield Management Company, that allegedly reaped $3.9 million in gains from trades made on the basis of the illicit information.[22]

(b) The SEC's order found that Deerfield was on notice that the political intelligence analyst might be conveying MNPI. An email from the analyst said that he "heard from a reliable CMS source" that CMS was about to issue a regulation, and an internal Deerfield email noted that the analyst "has a guy" at a "closed-door" government meeting. From at least May 2012 to November 2013, Deerfield generated more than $3.9 million in trading profits based on MNPI from the political intelligence analyst. Through its management agreements with the hedge funds, including performance-based compensation, Deerfield received approximately $714,110 due to these trades.

[22] *See* Four Charged in Scheme to Commit Insider Trading Based on Confidential Government Information, DOJ, May 24, 2017, *available at* https://www.justice.gov/usao-sdny/pr/four-charged-scheme-commit-insider-trading-based-confidential-government-information.

(c) Deerfield Management agreed to pay $4.8 million to settle the charges without admitting or denying the findings.[23]

G. Electronic Communication and Cybersecurity

1. In September 2017, the SEC announced the establishment of the Cyber Unit, which targets cyber-related misconduct including:[24] [25]

(a) Hacking to obtain MNPI.

(b) Violations involving distributed ledger technology and initial coin offerings.

(c) Cyber-related threats to trading platforms and other market infrastructure.

(d) Market manipulation schemes involving false information spread through electronic media.

(e) Misconduct perpetrated using the dark web.

(f) Intrusions into brokerage accounts.

(g) 2017 SEC actions relating to cyber misconduct:

(i) Three Chinese traders for allegedly trading on hacked, nonpublic, market-moving information stolen from two prominent law firms, making almost $3 million in illegal profits; and[26]

(ii) A Virginia-based mechanical engineer for allegedly scheming to manipulate the price of Fitbit stock by making a phony regulatory filing.[27]

2. Electronic Communications

A recent "Information Request List" being used by OCIE focusing on the use of electronic communications by advisers and their employees recently became public. The list asks an adviser for: descriptions of how the adviser and its employees used electronic messaging services and through which devices; adviser's policies and procedures related to electronic messaging, including how an adviser monitors electronic messaging (e.g., exception/activity reports); the identities and responsibilities of those who oversee those policies and procedures; documentation as to any instances of unauthorized use of electronic messaging and adviser's actions in connection therewith; and summaries of any internal audits or compliance reviews in connection with electronic messaging. Information Request List items in broader examinations will overlap with many of these requests, even if electronic communications are not the sole focus of those examinations.

H. Cross Trades

1. In the current climate emphasizing complete, accurate and effective disclosure, principal trades and agency cross trades are under particular scrutiny.

Example Cases

(a) *Calvert Investment Management, Inc. ("Calvert")*, Admin. Proc. File No. 3-17630 (Oct. 18, 2016).

[23] *See* Hedge Fund Adviser Charged for Inadequate Controls to Prevent Insider Trading, Aug. 21, 2017, *available at* https://www.sec.gov/news/press-release/2017-146.

[24] *See* SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors, Sept. 25, 2017, *available at* https://www.sec.gov/news/press-release/2017-176.

[25] *See* SEC, Division of Enforcement, Annual Report 2017, *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

[26] *See* Chinese Traders Charged with Trading on Hacked Nonpublic Information Stolen from Two Law Firms (Dec. 27, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-280.html.

[27] *See* SEC Charges Fake Filer with Manipulating Fitbit Stock (May 19, 2017), *available at* https://www.sec.gov/news/press-release/2017-107.

(i) Administrative order and settlement concerning Calvert, a registered investment adviser that caused RIC advisory clients to cross trade bond instruments (in addition to unrelated failures to accurately value bond instruments that resulted in Calvert being overpaid inflated asset-based fees or to properly remediate issues arising out of valuation problems for investors).

(ii) Cross trade issue was third and least significant aspect of the order.

(iii) Calvert caused the advised funds to violate Section 17(a) of the Investment Company Act by engaging in cross trades without complying with Rule 17a-7(e), which requires, among other things, that cross trade transactions be reported to and evaluated by a Fund's board of directors.

(iv) Calvert was also found to have violated Section 206(2) and (4) of the Advisers Act, and Rule 206(4)-8 thereunder, as well as Section 34(b) of the Investment Company Act, although each of those violation findings seems to have been in connection with the unrelated issues concerning the firm's NAV determinations.

(v) Calvert paid a $3.9-million monetary penalty and agreed to undertakings related to NAV reprocessing and distributions to accountholders as a result of NAV reprocessing.

(b) Aviva Investors Americas, successor to Aviva Investors North America ("AINA"), Admin. Proc. File No. 3-17567 (Sept. 3, 2016).

(i) Administrative order and settlement concerning AINA, a registered investment adviser that arranged cross trade transactions between RIC advisory client accounts, using broker-dealer as intermediary.

(ii) AINA caused registered investment company clients to conduct trades with affiliates in violation of Section 17(a) of Investment Company Act and conducted principal trades in violation of Section 206(3) of Advisers Act.

(iii) AINA interposed third-party broker-dealers into sale and repurchase transactions, which were completed overnight. The sale/repurchase transactions involved the same security, same quantity and the same price, but with a 1/8 tick markup collected by the broker-dealer. An agreement or understanding was formed between AINA and the non-affiliated broker whereby AINA agreed to repurchase the securities prior to the sale to the broker.

(1) Transactions did not qualify for Rule 17a-7 exemption because the affiliation between the clients did not arise solely due to having a common investment adviser, because the sole shareholder of the registered investment company whose clients traded was under common control with AINA. AINA's internal cross trading policy prohibited transactions under these circumstances.

(2) Even if the transactions were eligible under Rule 17a-7, they did not comply with Rule 17a-7 because they were not at the rule's mandated price (the sale/buybacks were at the same price, and independent bids were not evaluated to find the market price under the rule), and because they were made through broker-dealers that received remuneration for the transactions.

(3) Principal trades were between AINA advisory clients and insurance clients owned by Aviva plc, AINA's parent company. Because no written notification and consent were obtained from investors on a per-transaction basis for the principal trades, AINA violated Section 206 of the Advisers Act. AINA's internal policies permitted principal transactions only if the clients consented and the CCO of AINA approved it.

(iv) AINA failed to adopt and implement adequate policies and procedures to prevent unlawful cross and principal trading.

(v) AINA's compliance policy required that sale/buyback trades within a three-day period would be reviewed to ensure no violations occurred. AINA failed to detect/prevent these transactions because the review function had been delegated to a low-level administrative assistant without proper training, who looked only for same-day sale/buybacks. A trader also asked if a cross trade was permissible using a broker-dealer as intermediary, and was told that the trades were permitted as long as there was "best execution" and "pricing documentation."

(vi) AINA paid a $250,000 civil monetary penalty. AINA also was required to retain a compliance consultant to enhance detection and understanding for cross trading and principal transactions.

2. Principal trades and agency cross trades are generally prohibited in the absence of disclosure and prior client consent.

3. A sale coupled with an agreement to repurchase may constitute a cross trade.

4. SEC's Division of Enforcement is currently conducting non-public inquiries regarding cross trading of a number of different investment managers. Those inquiries are being conducted jointly by the asset management unit and the complex financial products unit.

I. Expense Allocation Policies

1. These policies have been an area of focus in 2017 and this trend will continue in 2018.

2. Misallocated "broken-deal" expenses

Platinum Equity Advisors[28]

(a) Settled action against investment adviser for charging three of its private equity fund clients with about $1.8 million in undisclosed fees.

(b) From 2004 to 2015, three private equity funds invested in 85 companies, in which co-investors connected with Platinum also invested. During this time, Platinum incurred expenses related to potential fund investments that were not ultimately made. While the co-investors participated in Platinum's successful transactions and benefited from Platinum's sourcing of private equity transactions, Platinum did not allocate any of the broken-deal expenses to the co-investors. Instead, it allocated all broken-deal expenses to the private equity funds even though the agreements governing the funds did not disclose that the funds would be responsible for anything other than their own expenses.

(c) The Commission found that from Q2 2012 to 2015, the private equity funds were allocated over $1.8 million in broken-deal expenses that were not disclosed in the fund agreements. In addition, Platinum did not adopt and implement a written compliance policy or procedure governing its broken-deal expense allocation practices.

J. "Cherry-Picking": allocating favorable trades to accounts where an adviser receives higher fees.

Licht & Howarth and Howarth Financial Services Orders[29]

1. Settled charges against two investment advisers who agreed to be banned from the securities industry and were ordered to collectively pay more than $480,000 after the agency uncovered their separate illegal cherry-picking schemes through data analysis.

2. Jeremy Licht, a California registered investment adviser doing business as JL Capital Management, and Gary Howarth, the owner and sole employee of his Oregon-based advisory firm, Howarth Financial

[28] *See* Platinum Equity Advisors, LLC, Inv. Advisers Act Release No. 4772, Sept. 21, 2017, *available at* https://www.sec.gov/litigation/admin/2017/ia-4772.pdf.

[29] *See* Investment Advisers Cheated Their Clients By Cherry-Picking Trades, Sept. 12, 2017, *available at* https://www.sec.gov/litigation/admin/2017/34-81584-s.pdf.

Services, cherry-picked profitable trades for their personal accounts to the detriment of their clients' accounts. The SEC's analysis showed that for a certain time there was less than a one-in-a-trillion chance that the outsized performance of Licht's personal account, compared to that of his clients' accounts, was due to chance, and that there was less than a one-in-a-billion chance that the difference between Howarth's returns and those of his clients was due to chance. The SEC also found that Licht falsely represented in his Forms ADV that no account would be favored over another as a result of the allocation of orders placed in the omnibus account, and that Howarth admitted in testimony to breaching his fiduciary duty to his clients when making preferential allocations of certain trades.

3. Data analytics being used to identify cherry-picking schemes.

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