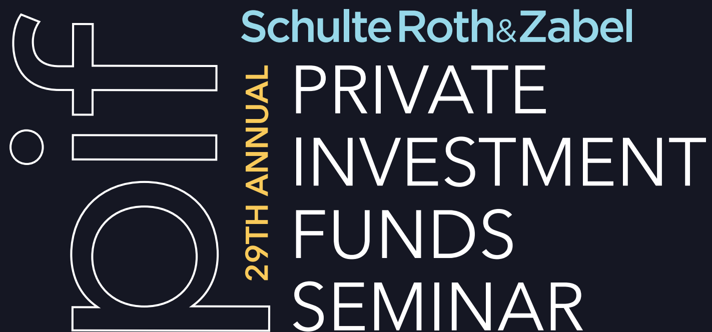

JANUARY 21, 2020

Partner
Washington, DC Office
+1 202.729.7480

New York Office
+1 212.756.2046

charles.clark@srz.com

Practices

Litigation

Complex Commercial Litigation

Regulatory & Compliance

Securities Enforcement

Securities Litigation

White Collar Defense & Government Investigations

Blockchain Technology & Digital Assets

Charles J. Clark

Charles J. Clark is a nationally acclaimed securities lawyer. Initially recognized for his work leading the investigation of Enron Corporation while serving as a senior member of the SEC's Division of Enforcement, Charles continues to represent his clients in their most important matters, drawing from his unique combination of government, in-house and private practice experience. Charles represents financial institutions, public companies and accounting firms, and their senior executives, in securities-related enforcement proceedings before the SEC, DOJ, FINRA, PCAOB, and other federal and state law enforcement and regulatory authorities. In particular, he counsels hedge funds, private equity firms, venture capital funds and other asset managers through regulatory scrutiny, including in routine and risk-based inspections and examinations and in enforcement proceedings. He defends investigations involving a broad spectrum of issues, including accounting and disclosure fraud, insider trading, foreign corruption, offering fraud, market manipulation, breach of fiduciary duty and conflicts of interest. In addition, Charles represents boards of directors and associated committees in internal investigations, and he provides guidance on corporate governance and trading practices for public companies and private funds. Prior to entering private practice, Charles served for nine years in the SEC's Division of Enforcement, most recently as assistant director supervising the investigation and prosecution of some of the SEC's most significant matters.

Charles has been recognized as a leading litigator by *Chambers USA, The Legal 500 US* and *Benchmark Litigation*. A frequent speaker and panelist, Charles has addressed a wide variety of topics of interest to the white collar defense community, including, most recently, the Wells and settlement process at the SEC and responding to the DOJ and SEC's focus on individual accountability. He also serves as a resource for numerous media publications, including *Bloomberg News, Financial Times, The Wall Street Journal* and *The Washington Post*. Charles received his J.D. from NYU School of Law and his B.A., with high distinction, from the University of Virginia.

©2020 Schulte Roth & Zabel LLP

Partner
New York Office
+1 212.756.2227
david.nissenbaum@srz.com

Practices

Investment Management
Energy
Financial Institutions
Hedge Funds
Private Equity

David Nissenbaum

David Nissenbaum is co-head of the Investment Management Group. 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 along with credit, hedge, private equity, hybrid, distressed investing, activist and energy funds, co-investments, funds of funds and scalable platforms for fund sponsors. David also advises on fundraising, management company partnerships, compensation plans, succession plans, seed and strategic investments and spinoffs of investment teams. His work 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.

Clients often seek David's advice on business matters and strategy and to assist on difficult negotiations. For many years, he 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 US* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. A past member of the Advisory Board of The Financial Executives Alliance and 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*, published by *ALM Law Journal Press*; "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*; and "Succession Planning," published by SRZ. He has spoken at conferences and seminars on a range of topics, including fundraising, merchant bank structures, liquidity events, credit and lending funds and co-investment vehicles. David received his J.D. from Brooklyn Law School and his B.A. from the State University of New York at Albany.

© 2020 Schulte Roth & Zabel LLP

Special Counsel
New York Office
+1 212.756.2084
jennifer.opheim@srz.com

Practices

Litigation

Bankruptcy & Creditors' Rights Litligation

Complex Commercial Litigation

Securities Enforcement

Securities Litigation

Jennifer M. Opheim

Jennifer M. Opheim has a diverse practice focusing on complex commercial litigation and regulatory investigations and counseling. She has represented clients in state and federal courts and before regulatory bodies. Jennifer has also counseled clients on anti-money laundering, anti-corruption, and sanctions laws, rules and regulations. Jennifer earned her J.D., *magna cum laude*, from the University of Minnesota Law School and her B.A., *summa cum laude*, from Hillsdale College.

 ©2020 Schulte Roth & Zabel LLP

Partner
New York Office
+1 212.756.2471
michael.swartz@srz.com

Practices

Litigation

Shareholder Activism

Blockchain Technology & Digital Assets

Complex Commercial Litigation

Regulatory & Compliance

Securities Enforcement

Securities Litigation

Antitrust

Michael E. Swartz

Michael E. Swartz, co-chair of the Litigation Group and head of the shareholder activism litigation practice, focuses on complex commercial litigation and antitrust, particularly as it relates to mergers and acquisitions. His litigation practice includes shareholder activist litigation, private investment fund disputes, M&A litigation, corporate control disputes and securities litigation. Michael has particular expertise with litigation involving Sections 10(b), 13(d), 14(a), 14(e),16(b) and 20(a) of the Securities Exchange Act and in arbitration proceedings. He represented Trian Fund Management in its proxy contest at Procter & Gamble, and achieved a series of victories on behalf of venBio Select Advisor in its proxy campaign at Immunomedics. Among other things, for venBio, Michael obtained a TRO blocking the closing of a global license agreement, which effectively would have amounted to a sale of the company. Michael's other recent litigation experience includes activist litigation; cryptocurrency investment fund disputes, representations of several boards and companies in M&A- and proxy-related litigation; and obtaining dismissal of several Section 16(b) actions brought against investment advisers and the funds they manage, seeking disgorgement of alleged short-swing trading profits. Michael served as trial counsel to the former Vivendi Universal CFO in a four-month securities class action jury trial. The jury returned a verdict of no liability for SRZ's client for securities fraud. He also represented The Children's Investment Fund in a trial involving proxy litigation commenced by CSX Corporation and served as trial counsel to the former chief legal officer of media giant Hollinger in a four-month criminal trial. Michael represented Cerberus Capital Management in its $9.2-billion acquisition of Safeway.

Michael has been recognized by his peers and clients in *Benchmark Litigation: The Definitive Guide to America's Leading Litigation Firms and Attorneys*, *The Legal 500 US* and *New York Super Lawyers* in the area of business litigation. His litigation victories have been featured in *The Hedge Fund Journal*, *Hedge Fund Legal and Compliance Digest* and, recently, the Litigation Group, co-chaired by Michael, won *Law360's* "Asset Management Practice Group of the Year" for its representations of leading private investment funds. Michael's recent publications include contributing to *The Activist Investing Annual Review 2019* and co-authoring the "Information Sharing with Market Professionals" chapter in the *Insider Trading Law and Compliance Answer Book 2019* (Practicing Law Institute). Michael is a member of the Executive Committee of the Board of the Lawyers' Committee for Civil Rights Under Law. He is also a former law clerk to the Hon. Irving R. Kaufman, Circuit Judge for the U.S. Court of Appeals for the Second Circuit. Michael received his J.D. from Columbia Law School, where he was editor of the *Columbia Law Review*, and received his B.A., *magna cum laude*, from the University of California, Los Angeles.

©2020 Schulte Roth & Zabel LLP

Partner
Washington, DC Office
+1 202.729.7476

New York Office
+1 212.756.2413

pete.white@srz.com

Practices

Litigation
Financial Institutions
Regulatory & Compliance
Securities Enforcement
Securities Litigation
White Collar Defense & Government Investigations
Cybersecurity
Antitrust

Peter H. White

Peter H. White is co-chair of the Litigation Group and a member of the firm's Executive Committee. One of the nation's leading white collar lawyers, Pete represents corporations and executives in managing crisis situations, including grand jury investigations, internal investigations, SEC enforcement proceedings, False Claims Act and qui tam lawsuits, and shareholder class actions. He achieved acquittals on all counts in multiple federal fraud trials, including allegations of accounting and securities fraud, government program fraud, false claims and public corruption. He served as lead counsel in over 80 federal and local jury trials and many more bench trials.

Pete is a fellow of the American College of Trial Lawyers. A recipient of the Department of Justice Director's Award for Superior Performance as an Assistant U.S. Attorney, Pete has performed with comparable skill as a private practitioner. Among the many publications that have recognized him as a leading litigator are: *The Best Lawyers in America* (corporate compliance law, criminal defense: white collar, and litigation securities), *Chambers USA*, *Ethisphere: Attorneys Who Matter*, *The Legal 500 United States*, *Washington DC Super Lawyers*, *Washingtonian's* "Washington's Top Lawyers" (criminal defense, white collar) and *The Washington Post* ("Their Own Defense," June 18, 2007). Pete obtained his J.D. from the University of Virginia School of Law, where he was Order of the Coif and on the management board of the *Virginia Law Review* and his B.A., with high honors, from University of Notre Dame. Upon graduation, he had the distinction of serving as a law clerk to the Hon. Richard L. Williams of the Eastern District of Virginia.

©2020 Schulte Roth & Zabel LLP

Litigation and Enforcement

I. Introduction

This outline summarizes enforcement actions, priorities and trends exhibited by the SEC, DOJ and other regulatory and enforcement authorities who administer the federal securities laws and related statutes, with a focus on issues affecting private funds. It also discusses private securities and M&A litigation relevant to private funds.

First, this outline recaps guidance for investment advisers and companies from the SEC's Office of Compliance Inspections and Examinations ("OCIE") before reviewing SEC enforcement statistics for 2019 and SEC enforcement priorities for 2020. Next, it provides updates on a change and a court challenge to different SEC policies regarding settlements, as well as on the consequences of four recent appellate decisions. After that, this outline analyzes the actions brought by the Enforcement Division in 2019 relevant to private funds. This outline then summarizes enforcement actions and other developments in the areas of insider trading, foreign bribery, sanctions and anti-money laundering. Finally, this outline examines significant court decisions affecting private securities and M&A litigation before ending with a discussion of the litigation risk to which private funds may be exposed through their portfolio companies.

II. OCIE

A. Examination Statistics for FY2019

1. OCIE completed 3,089 examinations in FY2019, a 2.7% decrease from FY2018.
2. OCIE completed 2,180 examinations of registered investment advisers ("RIAs") in FY2019, covering 15% of the population.
3. Examinations of investment companies increased in FY2019 by approximately 12% to over 150.
4. OCIE completed over 350 examinations of broker-dealers, 110 examinations of national securities exchanges and over 90 examinations of municipal advisers and transfer agents.
5. OCIE so far has made more than 150 enforcement referrals from FY2019 examinations.
   (a) OCIE reports that its examinations and referrals to the Enforcement Division have resulted in "dozens of settled actions against advisers to private funds."
6. Examinations closed in FY2019 have resulted in firms returning more than $70 million to investors.

B. OCIE's Examination Priority Relating to Private Funds for 2020[1]

OCIE will continue to focus on RIAs to private funds that have a greater impact on retail investors, such as firms that provide management to separately managed accounts side-by-side with private funds. Moreover, OCIE will review RIAs to private funds to assess compliance risks, including controls to prevent the misuse of material, non-public information and conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses and the use of RIA affiliates to provide services to clients.

C. OCIE's Other Examination Priorities for 2020[2]

1. Protection of retail investors, including seniors and those saving for retirement, with a focus on:
   (a) Intermediaries that serve retail investors (e.g., RIAs, broker-dealers and dually-registered firms), including proper procedures and disclosures related to fees, expenses and conflicts of interest;

[1] 2020 Examination Priorities, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (Jan. 7, 2020), available here.

[2] *Id.*

 ©2020 Schulte Roth & Zabel LLP

(b) Investments marketed to, or designed for, retail investors, such as mutual funds, exchange-traded funds, municipal securities and other fixed-income securities, and microcap securities (securities of companies with a market cap of <$250 million).

2. Information security, with areas of focus including (1) governance and risk management, (2) access controls, (3) data loss prevention, (4) vendor management, (5) training and (6) incident response and resiliency;

3. Financial technology (fintech) and innovation, including digital assets and electronic investment advice;

4. Additional focus areas involving registered investment advisers and investment companies:

(a) RIA compliance programs;

(b) Never-before and not recently examined RIAs;

(c) Mutual funds and ETFs; and

(d) RIAs to private funds (see above description).

5. With respect to broker-dealers and municipal advisers, the safety of customer cash and securities, risk management, certain types of trading activity, the effects of evolving commissions and other cost structures, best execution and payment for order-flow arrangements;

6. Anti-money laundering programs;

7. Market infrastructure; and

8. FINRA and MSRB.

D. Investment Adviser Issues Identified by OCIE in 2019 Risk Alerts

1. Issues Related to Principal and Agency Cross Trading[3]:

(a) Failure to satisfy the requirement of Advisers Act Section 206(3)[4] (i.e., failing to obtain appropriate prior client consent for each principal trade and failing to provide sufficient disclosure regarding the potential conflicts of interest and terms of the transaction).

(b) Failure to comply with Section 206(3) for principal trades involving a pooled investment vehicle that either is significantly owned by the adviser or is a client of the adviser.

(c) Engaging in agency cross transactions even though the adviser had stated to clients that it would not engage in such transactions.

(d) Failure to comply with the requirements of Rule 206(3)-2, which permits certain agency cross transactions without requiring transaction-by-transaction disclosure and consent.

(e) Failure to adopt and implement policies and procedures relating to Section 206(3).

---

[3] OCIE Risk Alert, Investment Adviser Principal and Agency Cross Trading Compliance Issues (Sept. 4, 2019), available here.

[4] Section 206(3) makes it unlawful for any investment adviser, directly or indirectly, acting as principal for his own account knowingly to (a) sell any security to a client or (b) purchase any security from a client ("principal trades"), without disclosing to such client in writing before the completion of such transaction the capacity in which the adviser is acting and obtaining the consent of the client to such transaction. Section 206(3) requires an adviser entering into a principal trade with a client to satisfy these disclosure and consent requirements on a transaction-by-transaction basis — blanket disclosure and consent are not permitted. Section 206(3) also prohibits an adviser, directly or indirectly, acting as broker for a person other than the advisory client, from knowingly effecting any sale or purchase of any security for the account of that client ("agency cross transactions"), without disclosing to that client in writing before the completion of the sale or purchase the capacity in which the adviser is acting and obtaining the consent of the client to the sale or purchase.

2. Compliance Issues Regarding Disciplinary Events[5]:

   (a) Failure to fully disclose information regarding disciplinary events of supervised persons or the adviser itself.[6]

   (b) Failure to adopt and implement compliance policies and procedures addressing the risks associated with employing individuals with prior disciplinary histories.

3. Failure to supervise persons with oversight and compliance responsibilities.[7]

4. Failure to Implement Compliance Policies and Procedures:[8]

   (a) Areas of inconsistent compliance practices most frequently cited by the staff: solicitation fees, management fees, compensation related to hiring personnel and oversight of firm compensation practices.

5. Failure to perform or adequately document annual compliance reviews.[9]

6. Disclosure of conflicts of interest, especially those related to compensation arrangements.[10]

7. Compliance issues related to regulation S-P[11]:

   (a) Failure to provide accurate privacy and opt-out notices to customers.

   (b) Failure to adopt and implement written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information as required by Regulation S-P's Safeguards Rule.

E. Investment Company Issues Identified by OCIE in 2019 Risk Alerts[12]:

1. Fund Compliance Rule[13] Issues:

   (a) Failure of compliance programs to take into account the nature of funds' business activities.

   (b) Failure to follow or enforce policies and procedures.

   (c) Inadequate oversight of service providers (e.g., investment adviser, underwriter).

---

[5] OCIE Risk Alert, Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019), available here.

[6] All registered advisers must promptly disclose in Form ADV certain legal or disciplinary events that would be material to a client's or a prospective client's evaluation of the adviser's integrity or its ability to meet its commitments to clients. *See* Amendments to Form ADV, Advisers Act Release No. 3060 (July 28, 2010).

[7] OCIE Risk Alert, Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019).

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] OCIE Risk Alert, Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies (April 16, 2019), available here.

[12] OCIE Risk Alert, Top Compliance Topics Observed in Examinations of Investment Companies and Observations from Money Market Fund and Target Date Fund Initiatives (Nov. 7, 2019), available here.

[13] The fund compliance rule requires a fund to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance for each investment adviser, principal underwriter, administrator and transfer agent of the fund (collectively, "service providers"). In addition, the fund board must approve the policies and procedures of the fund's service providers. The rule also requires that each fund annually review the adequacy and effectiveness of the policies and procedures of the fund and its service providers and the effectiveness of their implementation. The fund's chief compliance officer must also annually provide a written report to the fund board that addresses, among other things, the operation of the policies and procedures and material changes to those policies and procedures.

(d) Failure to perform annual reviews or address the adequacy of funds' policies and procedures

2. Issues related to disclosure to investors (e.g., failing to disclose the payment of fees to service providers or a change to an investment strategy).

3. Issues with the section 15(c) process[14]:

   (a) Failure to request or consider information reasonably necessary to evaluate a fund's investment advisory agreement.

   (b) Failure to adequately discuss or document the material factors and conclusions forming the basis for the board's approval of an investment advisory agreement.

4. Issues related to the fund code of ethics[15]:

   (a) Failure to implement the code of ethics through procedures designed to prevent violations (e.g., no procedures adequate to prevent access persons from misusing material non-public information).

   (b) Failure to follow or enforce the code of ethics (e.g., failing to collect or review personal securities holdings and transactions reports of the fund's access persons).

   (c) Failure of board to approve code of ethics.

   (d) Failure to provide board with required annual report regarding code of ethics violations and sanctions.

III. SEC Enforcement Overview

A. Actions

1. The SEC filed 526 standalone enforcement actions in FY2019, the most since FY2016; but 95 were self-reported by companies under the Share Class Selection Disclosure Initiative ("SCSD") (see § II.A). Without these self-reported cases, the number of standalone actions would have been the SEC's lowest of the last five years, which is not surprising given the 35-day government shutdown early in the year.[16]

2. The largest portion of the Enforcement Division's actions involved investment advisers and investment companies (36%), though that figure includes SCSD Initiative cases. Excluding SCSD cases, the most numerous type of action was those involving securities offerings, a large portion of which involved some form of pyramid or Ponzi scheme directed at retail investors (21%). Issuer reporting/accounting and auditing matters were the third most common type of enforcement action in FY2019 (17%).[17]

---

[14] Section 15(c) of the 1940 Act requires a majority of the fund's independent directors to approve the fund initially entering into, or renewing, a contract or agreement with a person who undertakes regularly to serve or act as an investment adviser of or a principal underwriter for such fund. As part of this approval process, all board members of the fund have a duty to request and evaluate information that may be reasonably necessary for the board to evaluate the terms of the adviser's contract. In addition, the fund is required to preserve any documents or other written information its board considered in approving the terms or renewal of the contract or agreement between the fund and the adviser. Following a board's approval or renewal of an advisory contract, a fund's next shareholder report must discuss in reasonable detail the material factors and conclusions that formed the basis for the board's approval or renewal.

[15] The fund code of ethics rule requires funds, in addition to other entities, to adopt a written code of ethics containing provisions reasonably necessary to prevent their "access persons" from engaging in any fraudulent, deceptive or manipulative acts in connection with the purchase and sale of securities held or to be acquired by the fund. The rule also generally requires access persons to report their personal securities holdings and transactions in "covered securities" to the fund. 1940 Act Rule 17j-1.

[16] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 14, available here.

[17] *Id.* at 15.

 ©2020 Schulte Roth & Zabel LLP

3. There was a marked decline in insider trading enforcement actions: 30 standalone cases (compared to 51 in FY2018).[18]

B. Remedies

1. The median amount of total combined monetary sanctions ordered in FY2019 was over $550,000, the highest in the last five years. The median penalty amount was $200,000 and the median disgorgement amount was $694,663.[19]

2. The 5% of cases that involved the largest financial remedies accounted for 70% of the financial remedies obtained by the SEC, which is in line with the previous five years.[20]

3. 69% of standalone actions, excluding actions brought as part of the SCSD Initiative (which applied only to entities), involved charges against one or more individuals, which is in line with the percentage from the last several fiscal years.[21]

4. Enforcement actions resulted in 595 bars and suspensions of wrongdoers in FY2019, an increase from FY2018.[22] Trading suspensions held steady from last year (271 in FY2019 versus 280 in FY2018).[23]

IV. SEC Enforcement Areas of Focus

A. Protecting Retail Investors

1. Share Class Selection Disclosure Initiative

The SCSD Initiative targets failure by mutual funds to disclose conflicts of interest associated with the receipt of certain fees by the adviser for placing retail advisory clients in a 12b-1 fee paying share class when a lower-cost or no-cost share class of the same mutual fund was available for the clients. Investment advisers who self-report such disclosure failures receive standardized settlement terms, requiring disgorgement but no civil penalty. Since February 2018, the SEC has ordered 95 investment advisory firms to return more than $135 million to investors.[24]

B. Cryptocurrency and Other Cyber-Related Issues

1. The SEC has continued to emphasize cryptocurrency and other cyber-related enforcement through its interdisciplinary Cyber Unit, which focuses on "violations involving distributed ledger technology, cyber intrusions, and hacking to obtain material, nonpublic information," as well as electronic market manipulation and unlawful trading schemes.[25]

2. This year saw an increase in enforcement actions involving cryptocurrencies, including actions targeting ICOs in violation of Securities Act registration requirements in addition to fraud cases.

---

[18] *Id.* at 28.

[19] *Id.* at 16.

[20] *Id.* at 17.

[21] *Id.*

[22] "Bars and suspensions" refers to SEC orders prohibiting wrongdoers from serving as officers or directors of public companies, dealing in penny stocks, associating with registered entities such as broker-dealers and investment advisers, or appearing or practicing before the Commission as accountants or attorneys. *Id.* at 19.

[23] "The federal securities laws allow the SEC to suspend trading in any stock for up to ten trading days when the SEC determines that a trading suspension is required in the public interest and for the protection of investors." *Id.*

[24] Press Release 2019-28, "SEC Share Class Initiative Returning More Than $125 Million to Investors" (March 11, 2019), available here; Press Release 2019-200, "SEC Orders an Additional 16 Self-Reporting Advisory Firms to Pay Nearly $10 Million to Investors" (Sept. 30, 2019), available here.

[25] Press Release 2017-176, "SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors" (Sept. 25, 2017), available here.

 ©2020 Schulte Roth & Zabel LLP

Settlements with some of these ICO issuers establish a framework for future resolutions,[26] with remedies including:

(a) Establishing claims processes for harmed ICO investors, including notifying investors of their right to file claims;

(b) Registering the issuer's tokens with the SEC under Section 12(g) of the Exchange Act;

(c) Complying with applicable registration and reporting requirements; and

(d) No civil penalty for self-reporting unregistered offering to SEC.

3. The SEC has also brought a number of enforcement actions against third-party participants in digital asset offerings for violations of the anti-touting, broker-dealer registration and exchange registration provisions of the securities laws.[27]

C. Coordination with Law Enforcement[28]

1. The SEC has worked with federal and state criminal authorities to punish and deter certain types of securities law violators, including recidivists, microcap fraudsters, insider traders, Ponzi schemers and others who act with a high degree of scienter.

2. Other regulators and law enforcement offices requested and obtained access to SEC investigative files pertaining to more than 400 SEC investigations.

D. Accelerating the Pace of Investigations

1. In FY2019, the SEC took an average of just under 24 months to file an enforcement action after opening an investigation, slightly faster than last year. The SEC is striving to accelerate investigations and file enforcement actions sooner.[29]

2. The SEC was subjected to increased scrutiny by the D.C. Circuit for its delay in bringing an enforcement action against Volkswagen. The action was filed in March 2019, years after Volkswagen had resolved actions brought by other federal and state authorities and related civil actions. The D.C. Circuit ordered the SEC to file a declaration stating when it learned of each fact alleged in its complaint.[30]

E. Whistleblower Program

1. Since the program began in 2012, the SEC has awarded $387 million to 66 whistleblowers in actions resulting in more than $2 billion in financial remedies.[31]

2. The SEC received a record number of whistleblower claims in FY2019 and is working to streamline the process for evaluating claims for whistleblower awards.

3. Whistleblower awards can range from 10% to 30% of the money collected when the monetary sanctions exceed $1 million, providing a powerful incentive to potential whistleblowers to report

[26] Press Release 2019-15, "Company Settles Unregistered ICO Charges After Self-Reporting to SEC" (Feb. 20, 2019), available here.

[27] Press Release 2018-268, Two Celebrities Charged with Unlawfully Touting Coin Offerings (Nov. 29, 2018), available here; Press Release 2019-181, SEC Charges ICO Incubator and Founder for Unregistered Offering and Unregistered Broker Activity (Sept. 18, 2019), available here; Press Release 2018-258, SEC Charges EtherDelta Founder with Operating an Unregistered Exchange (Nov. 8, 2018), available here.

[28] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 7.

[29] *Id.*

[30] David Shepardson, "U.S. judge questions SEC on delay in filing Volkswagen suit," Reuters (May 10, 2019), available here.

[31] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 8.

©2020 Schulte Roth & Zabel LLP

suspicions of misconduct and thus to regulated parties to implement effective, proactive compliance programs.[32]

4. In May, the SEC awarded more than $4.5 million to a whistleblower whose tip triggered the company to review the allegations as part of an internal investigation and subsequently report the whistleblower's allegations to the SEC. It was the first time the SEC made an award to a claimant under a provision of the whistleblower rules permitting claims by whistleblowers who first report a tip to a company if the whistleblower also reports the same tip to the SEC within 120 days.[33]
5. Last year in *Digital Realty Trust, Inc. v. Somers*, the Supreme Court held that Dodd-Frank's anti-retaliation provision applies only to whistleblowers who report misconduct to the SEC and not those who report misconduct internally. This ruling ultimately may harm companies by incentivizing prospective whistleblowers to report misconduct to the SEC before, or instead of, reporting it internally, thereby depriving companies of the opportunity to "get ahead of" an SEC investigation.
6. In July, the House passed H.R. 2515, the Whistleblower Protection Reform Act of 2019, which would extend the anti-retaliation provision to employees who report misconduct internally. The Senate has yet to take action on the bill.

V. Significant Developments Regarding Settlements with the SEC

A. Simultaneous Consideration of Settlement Offers with Waiver Requests

Some types of relief prescribed by settlements, such as an injunction against future violations of the securities laws or requiring an entity to retain an independent compliance consultant, can trigger regulatory disqualifications.[34] In many cases, the SEC has the authority to grant a waiver from these regulatory disqualifications. Parties seeking settlements often make waiver requests with their settlement offers.

During the previous administration, the SEC revoked the authority previously delegated to the regulatory divisions to decide waiver requests and required a party to make an unconditional offer of settlement without assurance that the Commission would grant the waiver. Because a potentially critical term of the settlement could not be negotiated, a party settling with the SEC was forced to accept the risk that the Commission would reject its waiver request and, as a result, the party would be bound by a settlement triggering a disqualification.

In July, the SEC announced a change in policy allowing prospective defendants negotiating a settlement that would trigger a regulatory disqualification to seek a waiver from such disqualification as part of settlement negotiations with the Commission.[35]

> "An offer of settlement that includes a simultaneous waiver request negotiated with all relevant divisions . . . will be presented to, and considered by, the Commission as a single recommendation from the staff."[36] Chairman Jay Clayton

---

[32] SEC Press Release, "SEC Awards $4.5 Million to Whistleblower Whose Internal Reporting Led to Successful SEC Case and Related Action," (May 24, 2019), available here.

[33] SEC Press Release, "SEC Awards $4.5 Million to Whistleblower Whose Internal Reporting Led to Successful SEC Case and Related Action," (May 24, 2019), available here.

[34] These regulatory disqualifications may include loss of well-known seasoned issuer (WKSI) status for the purposes of securities offerings; loss of statutory safe harbors under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), for forward-looking statements, which were added by the Private Securities Litigation Reform Act of 1995 (PSLRA); loss of private offering exemptions provided by Regulations A, D and Crowdfunding under the Securities Act; loss of the exemption from registration under the Securities Act for securities issued by certain small business investment companies and business development companies provided by Regulation E; and the prohibition on a registered investment adviser from receiving cash fees for solicitation under Rule 206(4)-3 of the Investment Advisers Act of 1940 (Advisers Act).

[35] Statement by Chairman Jay Clayton Regarding Offers of Settlement (July 3, 2019), available here.

[36] *Id.*

 ©2020 Schulte Roth & Zabel LLP

Though the staff now may negotiate a settlement that includes a waiver from a regulatory disqualification, the Commission still may approve the settlement but not the waiver request. In those cases, however, the settlement would not be executed unless the prospective defendant decides to move forward with the part of the settlement offer that was accepted. If the prospective defendant does not so notify the staff, the settlement offer effectively would be deemed withdrawn and the party would not be bound by its terms.

B. Challenge to the "Neither-Admit-Nor-Deny" Settlement

Typically, a prospective defendant settles an enforcement action without admitting or denying the findings or allegations contained in a Commission order or complaint.

> "Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, **and without admitting or denying the findings herein**, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings . . . ." SEC Cease-and-Desist Order

In January, the Cato Institute filed a lawsuit challenging the constitutionality of this policy as a violation of a settlement defendant's First Amendment right to free speech. The Cato Institute's standing to bring the suit is premised on its desire to publish a manuscript in which the author accuses the SEC of coercing him into a settlement despite his belief that the charges against him were baseless.[37]

The SEC filed a motion to dismiss in May arguing, in part, that the Cato Institute failed to state a First Amendment claim because the no-deny provisions are freely negotiated and not imposed against a defendant's free will. The district court has not yet ruled on the SEC's motion to dismiss.

VI. Significant Appellate Rulings

A. Fallout from the Supreme Court's *Kokesh* Decision Continues[38]

In 2017, the Supreme Court unanimously held that a five-year statute of limitations applies to the SEC's authority to order disgorgement of ill-gotten gains from defendants in *Kokesh v. SEC*.[39] The SEC estimates this ruling has caused the Commission to forgo about $1.1 billion in disgorgement in filed cases.[40] More significantly, *Kokesh* has prompted the Enforcement Division to shift focus and resources to investigations of more recent misconduct, prioritizing actions with the greatest potential to return funds to investors.

In an ominous footnote to the *Kokesh* opinion, however, the Court hinted that it may welcome a challenge to the SEC's authority to obtain disgorgement at all, stating that its decision was limited to the applicability of the statute of limitations and did not reach the issue of "whether courts possess authority to order disgorgement in SEC enforcement proceedings . . . ."[41] So far, the Second Circuit has upheld disgorgement awards post-*Kokesh*.[42] But on November 1, the Supreme Court agreed to hear a case challenging the SEC's authority to collect disgorgement, with a decision likely to be issued by the end of June 2020.[43] A decision in favor of the petitioners in the Supreme Court would curtail the SEC's ability to pursue disgorgement in civil actions filed in federal court, which *Kokesh* has already limited to those within the statute of limitations.

---

[37] *Cato Institute v. Sec. & Exch. Comm'n*, Case No. 1:19-cv-00047 (D.D.C. Jan. 9, 2019).

[38] *See Schulte Roth & Zabel Alert*, SEC's Disgorgement Authority Under Review (Nov. 22, 2019), available here.

[39] *Kokesh v. Sec. & Exch. Comm'n*, 137 S. Ct. 1635 (2017).

[40] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 21.

[41] *Kokesh*, 137 S. Ct. at 1642 n.3.

[42] *See,* e.g., *SEC v. Rio Tinto plc and Rio Tinto Limited, Thomas Albanese, and Guy Robert Elliott*, No. 17 Civ. 7994 (AT), 2019 WL 1244933, at *22 (S.D.N.Y. Mar. 18, 2019) (collecting cases).

[43] *SEC v. Liu*, 754 F. App'x 505, 509 (9th Cir. 2018), *cert. granted.*

©2020 Schulte Roth & Zabel LLP

But such a decision would soon be rendered obsolete if Congress were to grant the SEC express authority to seek disgorgement, and members of Congress have already advanced new legislation to do just that. On Nov. 18, 2019, the House of Representatives passed the Investor Protection and Capital Markets Fairness Act (H.R. 4344) with wide bipartisan support. The bill would reaffirm the SEC's statutory authority to seek disgorgement as a remedy in federal court, subject to a new 14-year statute of limitations. The bipartisan support indicates strong interest in expanding the enforcement authority and remedies currently available to the SEC in federal court.

A parallel measure was introduced in the Senate in March by Senators Mark Warner (D-Va.) and John Kennedy (R-La). That bill, the Securities Fraud Enforcement and Investor Compensation Act (S. 799), would authorize the SEC to seek disgorgement, subject to the existing five-year statute of limitations. Significantly, the bill would also grant the SEC authority to seek restitution of losses sustained by investors resulting from securities law violations, subject to a 10-year statute of limitations. Restitution has the potential to be a much more powerful financial remedy than disgorgement, as the financial benefit to a defendant can be far less than the harm alleged by a class of investor-victims. The Senate has referred the bill to the Committee on Banking, Housing and Urban Affairs, which has yet to take any further action as of Jan. 10, 2020.

B. *Robare Group, Ltd. v. SEC*

On April 30, 2019, the D.C. Circuit held that in order to establish a "willful" violation of Section 207 of the Investment Advisers Act of 1940, the SEC must prove that the investment adviser was more than merely negligent.[44]

The SEC had found that the defendants had willfully omitted a material fact (specifically, certain conflicts of interest) in their Form ADV registration, even though the Commission found that the failure to disclose constituted negligence and not intentional fraud. Following an earlier D.C. Circuit decision, the Commission interpreted "willfulness" to mean intentionally committing an act which constitutes the violation, regardless of whether the offender is aware that he/she is violating the law. In *Robare Group*, the D.C. Circuit clarified that negligent conduct cannot constitute a "willful" violation of Section 207. Rather, at least one individual must have subjectively intended to omit the material information from the Form ADV.[45]

It remains to be seen whether the decision will be extended to other securities law provisions requiring a willfulness finding, such as Exchange Act Sections 15(b)(4)[46] and (b)(6)[47] and Advisers Act Sections 203(e)[48] and (f).[49] Thus far, the SEC has taken the position that *Robare Group* is limited to Advisers Act Section 207.[50]

---

[44] *Robare Grp. v. Sec. & Exch. Comm'n*, 922 F.3d 468 (D.C. Cir. 2019).

[45] Still, negligently drafted or omitted statements in Form ADVs are subject to liability under Section 206(2) and the SEC may initiate cease-and-desist proceedings under Section 203(k) and obtain monetary penalties.

[46] Exchange Act Section 15(b)(4) applies to willful misstatements of material facts or omissions to state a material fact in registrations or reports filed by broker-dealers.

[47] Exchange Act Section 15(b)(6) applies to willful violations of Commission orders barring a person from being associated with broker-dealers, investment advisers and various other securities professionals.

[48] Advisers Act Section 203(e) applies to willful misstatements of material facts or omissions to state a material fact in registrations or reports filed by investment advisers.

[49] Advisers Act Section 203(f) applies to willful violations of Commission orders barring a person from being associated with an investment adviser.

[50] *See,* e.g., *In the Matter of Hefren-Tillotson, Inc.*, File No. 3-19514 (Sept. 25, 2019), n.3 ("'Willfully,' for purposes of imposing relief under Section 203(e) of the Advisers Act and Section 15(b)(4) of the Exchange Act, 'means no more than that the person charged with the duty knows what he is doing.'") (quoting *Wonsover*).

©2020 Schulte Roth & Zabel LLP

C. *Lorenzo v. SEC*

In March, the Supreme Court held that someone who knowingly disseminates a false or misleading statement made by another person can be primarily liable under the fraudulent scheme provisions of Rule 10b-5(a) and (c).[51] The decision clarifies the scope of the Court's 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders*, which held that only the "maker" of a statement can be primarily liable for its falsity under Rule 10b-5(b).[52] The "maker" of a statement is the "person or entity with ultimate authority over the statement."

> Rule 10b-5(a) extends liability to those who participate in a "device, scheme, or artifice to defraud," while Rule 10b-5(c) applies to participants in an "act, practice or course of business" that "operates . . . as a fraud or deceit."

In *Lorenzo*, an employee of a registered broker-dealer, at the request of his boss, sent two emails to potential investors using his boss's exact language, which the employee knew misrepresented the valuation of a company. Under *Janus*, the employee could not be held primarily liable under Rule 10b-5(b) because his boss, not he, was the "maker" of the statement. But the Court found that the employee could be primarily liable under Rule 10b-5(a) and (c) for disseminating statements he understood to be false to investors.

While the *Lorenzo* decision allows the SEC and private plaintiffs to seek primary liability for securities fraud from more prospective defendants, it may have limited practical effect on SEC enforcement actions because the Commission already can bring actions against such prospective defendants for secondary liability for aiding and abetting or causing a violation by another.[53]

But the ruling may have significant consequences for private securities litigation, where private plaintiffs, who cannot recover for secondary liability, may be able to seek recovery from more defendants by alleging participation in a fraudulent scheme.

D. *SEC v. Scoville*

In January, the Tenth Circuit held that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") allows the SEC and DOJ to bring fraud claims and claims under Section 17 of the Securities Act based on sales of securities that do not qualify as domestic transactions if the defendant engages in fraudulent conduct within the United States.[54]

The Tenth Circuit's decision resulted from an SEC civil enforcement action against Scoville and the company he founded, Traffic Monsoon LLC, alleging that the business was actually a Ponzi scheme. Traffic Monsoon sold "Adpacks," which offered the buyer visits to the buyer's website in order to improve the site's ranking in search engine search results, as well as the opportunity to share in Traffic Monsoon's revenue up to a maximum amount of $55. As a result, the Tenth Circuit held that Monsoon's Adpacks were investment contracts and thus securities subject to the anti-fraud provisions of the Securities Act and Exchange Act.

The defendants argued that under the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*,[55] the anti-fraud provisions of the federal securities laws did not apply to the sale of Adpacks to

[51] *Lorenzo v. Sec. & Exch. Comm'n*, 139 S. Ct. 1094 (2019).

[52] *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011).

[53] "Congress defined aiding and abetting liability to be the provision of "substantial assistance" to a securities law violator. It is important for us and the courts not to ascribe primary liability to every violation and thus write aiding and abetting out of the statute. Instead, we have to think carefully about where the line between primary and secondary liability lies in particular cases. Even substantial conduct may not qualify as a primary violation." Speech by Commissioner Hester M. Peirce, "Reasonableness Pants," (May 8, 2019), available here.

[54] *Sec. & Exch. Comm'n v. Scoville*, 913 F.3d 1204 (10th Cir. 2019).

[55] *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), held that the anti-fraud provisions of the federal securities laws apply only to transactions in securities listed on a U.S. exchange or transactions in other securities in the United States.

 ©2020 Schulte Roth & Zabel LLP

individuals outside the United States, which accounted for most of Traffic Monsoon's Adpack sales. The Tenth Circuit disagreed, holding that the Dodd-Frank Act, which was enacted less than a month after the *Morrison* decision, amended the anti-fraud provisions to allow for their extraterritorial application to foreign transactions if the wrongful conduct occurred in the United States or had a "foreseeable substantial effect" within the United States. This "conduct-and-effects" test was universally applied to determine the extraterritorial application of the securities laws prior to *Morrison*.

The Supreme Court denied a petition for *certiorari* in November.

VII. Recent SEC Enforcement Actions Against Investment Advisers

A. Overview of Key Enforcement Priorities

1. Conflicts of Interest
2. Failure to Seek Best Execution
3. Misstatements/Omissions
4. Excessive Fees
5. Valuation Issues
6. Allocation Issues
7. Insider Trading

B. Conflicts of Interest

1. *In the Matter of Talimco, LLC*[56]

Talimco, an investment adviser, breached its fiduciary duty to its client, a collateralized debt obligation ("CDO"), when the CDO sold a mortgage loan participation to another Talimco client, a commercial real estate investment fund created by Talimco. As the adviser to both the seller and buyer of the asset, Talimco had a conflict of interest. Talimco's COO convinced two unwilling parties to bid on the asset by assuring them that they would not win the auction, thereby depriving the CDO of the opportunity to receive multiple bona fide bids for the asset. The fund later sold the asset at a profit, resulting in fees for Talimco.

Talimco paid almost $83,000 in disgorgement and prejudgment interest and agreed to fully cooperate with any and all SEC investigations and other proceedings arising from the order.

2. *In the Matter of Foundations Asset Management, LLC* ("FAM")[57]

FAM, a registered investment adviser, improperly received approximately $254,000 in compensation from a private real estate fund and its manager while acting as an unregistered broker in violation of Section 15(a) of the Exchange Act. FAM solicited clients and recommended they invest in the real estate fund's promissory notes without disclosing the compensation arrangement between FAM and the fund, resulting in false and misleading statements in FAM's ADV Brochures in violation of Sections 206(2) and 207 of the Advisers Act.

FAM paid more than $278,000 in disgorgement and prejudgment interest, along with an $85,000 civil penalty. FAM also agreed to post a notice of the SEC settlement/order on its website and to relinquish its right to receive "trailing fees" for investments in the real estate fund.

---

[56] *In the Matter of Talimco, LLC*, Investment Advisers Act Rel. No. 5202 (March 15, 2019).

[57] *In the Matter of Foundations Asset Management, LLC*, Investment Advisers Act Rel. No. 86446 (July 24, 2019).

 ©2020 Schulte Roth & Zabel LLP

3. *In the Matter of MVP Manager LLC* (“MVP”)[58]

   MVP, a private fund manager whose funds invest in pre-IPO companies, on three occasions received brokerage commissions from counterparties selling pre-IPO company securities to MVP’s client funds. MVP failed to adequately disclose this conflict of interest to its client funds.

   MVP paid more than $169,000 in disgorgement and prejudgment interest, as well as a civil penalty of $80,000.

4. *In the Matter of Strategic Planning Group, Inc.* (“SPG”)[59]

   SPG, a registered investment adviser, invested its clients’ funds in the stock of a publicly traded company for which SPG’s principals previously had worked as outside consultants. Each of SPG’s two principals had provided consulting services to the public company for three years and received 100,000 shares of the company’s stock. SPG and its principals breached their fiduciary duty to SPG’s clients by failing to disclose the conflict of interest under which SPG’s principals had a potential incentive to invest SPG clients’ funds in the public company to support or increase the company’s stock price.

   SPG paid a civil penalty of $200,000.

5. *In the Matter of Fieldstone Financial Management Group, LLC* (“Fieldstone”)[60]

   From 2014 to 2016, Fieldstone, formerly a registered investment adviser, invested more than $7 million in securities issues by Aequitas Commercial Finance, LLC on behalf of 40 of its advisory clients. Fieldstone did so without disclosing to its clients that Aequitas had provided Fieldstone with a $1.5-million loan and access to a $2-million line of credit under terms that created an incentive for Fieldstone and its principal to recommend the Aequitas investments.

   Fieldstone and its principal were ordered to pay, jointly and severally, disgorgement and prejudgment interest totaling approximately $1.05 million along with a civil penalty of $275,000. Fieldstone’s principal was permanently barred from the securities industry.

C. Failure to Seek Best Execution

1. Section 206 of the Advisers Act imposes on investment advisers a fiduciary duty to act for the benefit of their clients. That duty includes, among other things, an obligation to seek best execution for client transactions — i.e., to seek the most favorable terms reasonably available under the circumstances.

2. *In the Matter of Lefavi Wealth Management, Inc.* (“LWM”)[61]

   LWM, a registered investment adviser, failed to seek best execution for its advisory clients by recommending and investing certain advisory client assets in non-traded real estate investment trusts, business development companies and private placements (collectively, “Alternative Investments”) at a higher share price that reflected a 7% commission, even though it could have invested the same client assets in the same Alternative Investments at a lower share price.

   LWM did not disclose that it could have invested advisory client assets in the same Alternative Investments at a lower share price, nor did it disclose the conflict of interest associated with its receipt of additional compensation for investing advisory client assets in Alternative Investments at a higher share price that included a commission.

[58] *In the Matter of MVP Manager LLC*, Investment Advisers Act Rel. No. 5319 (Aug. 13, 2019).

[59] *In the Matter of Strategic Planning Group, Inc.*, David A. Rourke, and Jarrod A. Sherman, Investment Adviser Act Rel. No. 5363 (Sept. 24, 2019).

[60] *In the Matter of Fieldstone Financial Management Group, LLC*, Securities Act Rel. No. 10655 (July 1, 2019).

[61] *In the Matter of Lefavi Wealth Management, Inc.*, Investment Advisers Act Rel. No. 5336 (Sept. 3, 2019).

LWM paid more than $1.38 million in disgorgement and prejudgment interest, along with a $150,000 civil penalty.

3. *In the Matter of Hefren-Tillotson, Inc.* ("Hefren")[62]

Hefren, a registered investment adviser and broker-dealer, received financial compensation of $1.95 per client trade from its unaffiliated clearing broker. Hefren received this compensation, which it failed to disclose to clients, by charging its clients more than what Hefren was charged by the clearing broker to clear and execute trades. The undisclosed compensation caused Hefren to violate its duty to seek best execution for its advisory clients.

Hefren paid almost $300,000 in disgorgement and prejudgment interest and an $80,000 civil penalty.

D. Misstatements and Omissions

1. *SEC v. American Growth Funding II, LLC*[63]

American Growth Funding II LLC ("AFG II"), an investment vehicle used to finance high-risk, high-interest loans, promised investors 12% annual returns and falsely claimed in its private placement memoranda ("PPMs") that its financial statements were being audited each year. AGF II also made misrepresentations in its PPMs about its management and concealed details about deteriorating loan values that could imperil full payment of the promised returns to investors.

AGF II consented to entry of a judgment in the Southern District of New York requiring it to pay a civil penalty of $75,000 and disgorgement in the amount of $577,731, less amounts paid by AGF II to unaffiliated third parties.

The SEC also charged the brokerage firm AGF II used as its placement agent for soliciting sales of AGF II securities despite the brokerage firm's knowledge that the PPMs were inaccurate. A jury ultimately found the brokerage firm and its principals liable for violating the antifraud provisions of the '33 and '34 Acts.[64]

2. *In the Matter of Garrison Investment Group, LP and Garrison Capital Advisers LLC* ("Garrison")[65]

Garrison, a registered investment adviser with a combined $3.6 billion AUM, arranged a series of loan transactions in which its clients — a closed-end investment company and private funds — participated along with third-party co-investors. Under Rule 17d-1,[66] Garrison had to submit an application to the SEC in order for the closed-end investment company to be able to participate in the transactions.

Garrison omitted from that application (i) the co-investment vehicles through which the co-investors would participate in the loan transactions and (ii) the fact that the Garrison entity advising the private funds would receive the co-investors' pro rata share of the upfront fee revenue (paid by the corporate borrowers), per agreement with the co-investors. Due to these omissions, the Co-Invest Order issued by the SEC did not include all participating Garrison affiliates and prohibited Garrison from receiving compensation from the loan transactions except for advisory fees. As a result, Garrison engaged in prohibited transactions.

Garrison paid a $250,000 civil penalty.

---

[62] *In the Matter of Hefren-Tillotson, Inc.*, Investment Advisers Act Rel. No. 5369 (Sept. 25, 2019).

[63] SEC Litigation Release No. 24382 (Jan. 25, 2019).

[64] SEC Press Release, "Jury Rules in SEC's Favor, Finds Brokerage Firm and Two of Its Executives Liable for Fraud" (May 15, 2019), available here.

[65] *In the Matter of Garrison Investment Group, LP and Garrison Capital Advisers LLC*, Investment Advisers Act Rel. No. 5345 (Sept. 13, 2019).

[66] Rule 17d-1 of the Investment Company Act prohibits any affiliate of a registered investment company from participating with the registered investment company in or effecting any joint enterprise or profit-sharing plan unless it first obtains an order from the SEC regarding the joint enterprise.

3. *In the Matter of Cetera Investment Advisers LLC* ("Cetera")[67]

   Cetera, an investment adviser with $10.1 billion in AUM, paid cash fees to 350 banks for solicitation activities without ensuring that advisory clients were informed of the relationship between the adviser and the soliciting banks as required by the Solicitor Rule of the Advisers Act.

   Rule 206(4)-3, the "Solicitor Rule," prohibits a registered investment adviser from paying a solicitor a cash fee for solicitation activities unless, among other things, the solicitor furnishes the client with a separate written disclosure document identifying the solicitor and the investment adviser, describing the nature of the relationship between the solicitor and the investment adviser, and specifying the terms of the compensation arrangement.

   Cetera paid a $185,000 civil penalty.

E. Excessive Fees

1. *In the Matter of ECP Manager LP* ("ECP")[68]

   ECP, a private equity fund adviser, charged excessive management fees following the write-off of a private equity fund investment. The shareholders agreement for the relevant fund provided that ECP's normal management fee of 2% per year of total invested capital contributions must be reduced as a result of certain triggering events, including write-offs of specific portfolio investments.

   In June 2010, the fund received warrants on the common stock of an African mining company. The Fund's financial statements valued the warrants at zero beginning with the period ended March 31, 2014, and, in June 2014, the warrants expired as worthless. Nevertheless, ECP included approximately $3.41 million of invested capital contributions attributable to the warrants in the base amount used to calculate management fees that were charged to the fund after the warrants had expired. As a result, the fund was overcharged $102,304 in management fees.

   ECP paid more than $122,000 in disgorgement and prejudgment interest.

2. *In the Matter of Corinthian Capital Group, LLC* ("Corinthian")[69]

   Corinthian, a registered investment adviser with $270 million in AUM, failed to apply a $1.2 million management fee offset due to a private equity fund client for capital contributions made to finance an acquisition. Corinthian also caused the fund to overpay approximately $590,000 in organizational expenses by charging such fees based on estimates before they were actually incurred and by improperly classifying placement fees as organizational expenses. Last, Corinthian improperly used fund assets to fund its advisory operations.

   Corinthian paid a civil penalty of $100,000, its CEO paid a civil penalty of $25,000 and its CFO paid a civil penalty of $15,000.

F. Valuation Issues

1. *SEC v. Direct Lending Investments, LLC*[70]

   Direct Lending Investments ("DLI"), an investment adviser who advised a combination of private funds that invested in various lending platforms, for years arranged with one lending platform to falsify borrower payment information to make it appear that borrowers had made far more monthly payments than they actually had made. Using this falsified payment information, DLI overstated the valuation of its funds' position in the lending platform by approximately $53 million, resulting in the

[67] *In the Matter of Cetera Investment Advisers LLC*, Investment Advisers Act Rel. No. 5371 (Sept. 26, 2019).

[68] *In the Matter of ECP Manager LP*, Investment Advisers Act Rel. No. 5373 (Sept. 27, 2019).

[69] *In the Matter of Corinthian Capital Group, LLC*, Investment Advisers Act Rel. No. 5229 (May 6, 2019).

[70] *Direct Lending Investments, LLC*, Litigation Rel. No. 24432 (March 25, 2019), No. 2:19-cv-02188 (C.D. Cal. filed March 22, 2019).

 ©2020 Schulte Roth & Zabel LLP

misrepresentation of the funds' performance by 2–3% annually from 2014 to 2017. The SEC alleges that DLI collected approximately $11 million in excess management and performance fees from the funds as a result of the scheme.

The court has appointed a receiver for the funds. Disgorgement and penalty amounts have yet to be decided.

2. SEC enforcement action against private fund manager

A private fund manager ("fund manager") failed to adopt and implement compliance policies and procedures reasonably designed to conform valuations of fund assets with GAAP.

GAAP provides that assets should be valued at "fair value," which it defines as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." GAAP further provides that the methods used to measure fair value "shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs," and that valuation models must be calibrated to relevant observable market data, including transaction prices, to ensure that they reflect current market conditions.

According to the SEC, the fund manager's valuation policy lacked procedures regarding how it should ensure consistency in measuring "fair value" in the context of the specific markets relevant to the fund and the specific types of inputs available to the fund manager. In fact, the fund manager's policy did not mention any valuation techniques or methodologies, nor did it mention the requirement that valuation models, upon which the fund manager relied heavily, must be calibrated to relevant observable market data. Moreover, the fund manager's Risk Management Committee lacked the expertise to determine whether bonds were valued in accordance with GAAP because none of the committee's three members had relevant experience in bond valuation.

The fund manager's valuation policy included a pricing-source protocol that prescribed when and how the fund manager was to use prices provided by third-party pricing vendors. According to the SEC, the pricing-source protocol gave significant discretion to the fund manager's traders as to when to use external prices, selection of pricing sources, and when and how to challenge prices provided by pricing sources, without adequate controls to address the potential conflict of interest arising from traders' ability to determine the fair value assessment of a portion of the positions they manage.

The SEC also stated that the fund manager failed to implement its existing valuation policy, finding that oversight of the valuation process was inadequate to ensure consistency and that valuations conformed with GAAP. For example, contemporaneous explanations for certain valuations include references to market activity at a higher price than the valuation and "sell[ing] for a profit when needed." As a result, the fund manager may have undervalued certain securities in its client fund's portfolio.

The fund manager agreed to pay a $5-million civil penalty, conclude its work with an independent compliance consultant and fully comply with the consultant's requests and schedule for submissions to the SEC.

G. Allocation Issues

1. *In the Matter of Laurel Wealth Advisors, Inc.* ("Laurel")[71]

Laurel, a registered investment adviser, failed to reasonably supervise an investment adviser representative ("IAR") who engaged in undisclosed "cherry-picking," a practice of fraudulently allocating profitable trades in an omnibus account to favored accounts.

[71] *In the Matter of Laurel Wealth Advisors, Inc.*, Investment Advisers Act Rel. No. 5330 (Aug. 26, 2019).

©2020 Schulte Roth & Zabel LLP

The IAR placed orders in his omnibus account to buy securities for allocation to his client or personal accounts, but he delayed the allocation of securities until after the trades were executed, by which time share prices had either increased or decreased such that those trades had unrealized profits on the trade date. The IAR allocated a disproportionate number of profitable trades to his personal accounts, while allocating a disproportionate number of unprofitable trades to his clients' accounts, resulting in the IAR receiving at least $56,227 in ill-gotten gains.

Laurel also failed to implement policies and procedures reasonably designed to prevent cherry-picking and other violations of the Advisers Act. For most of the period in which the IAR engaged in cherry-picking, Laurel had not yet implemented a compliance procedure that required IARs to pre-clear and obtain written approval before trading in their personal accounts, despite the fact that Laurel had stated throughout that entire period in its Forms ADV that it had such a procedure.

VIII. Insider Trading

A. Enforcement Statistics

1. The SEC brought 32 insider trading proceedings against 46 defendants in FY2019, including 22 civil actions and eight standalone administrative proceedings

2. Represents just 6% of standalone enforcement actions, down from 10% in FY2018

B. Second Circuit Appellate Developments

1. *United States v. Blaszczak*

On Dec. 30, 2019, the Second Circuit handed down a ruling making it easier for the Department of Justice to criminally prosecute insider trading in the context of registered securities.[72] In *U.S. v. Blaszczak*, the defendants had been acquitted of Title 15 securities fraud but found guilty of Title 18 securities fraud. The Title 15 securities fraud provisions were enacted by the Exchange Act of 1934 and implemented by Rule 10b-5. The Title 18 securities fraud provisions, appearing at 18 U.S.C. § 1348, are much newer, enacted as part of the Sarbanes-Oxley Act of 2002. Both the Title 15 and Title 18 fraud provisions prohibit in general terms schemes to "defraud." Critically, neither statute defines the word "defraud."

On appeal, the defendants argued that the term "defraud" should have the same meaning across the Title 18 fraud provisions and the Title 15 fraud provisions, so that the elements of insider-trading fraud are the same under both statutes. Although it does not appear in the statutory text, one of the elements of Title 15 insider-trading fraud is the *Dirks* personal-benefit test, which requires the government to prove that the insider received a personal benefit in exchange for tipping material, non-public information. The defendants asserted that this personal-benefit test should be considered an element of Title 18 insider-trading fraud, too.

The Second Circuit disagreed, holding that *Dirks'* personal-benefit test does not apply to the Title 18 securities fraud provisions, and thus, insider traders may be convicted without a showing that the insider received a personal benefit for tipping the confidential information. The court explained that the personal-benefit test was derived from the purpose of the Title 15 securities fraud statute (i.e., the Exchange Act of 1934), which was to "eliminate the use of inside information for *personal advantage*." The Title 18 securities fraud statute (i.e., Sarbanes-Oxley Act of 2002), on the other hand, was "intended to provide prosecutors with a different — and broader — enforcement mechanism to address securities fraud than what had been previously provided in the Title 15 fraud provisions." In other words, Congress enacted the Title 18 securities fraud provisions in order to make prosecuting insider trading easier, which in part meant not having to prove a personal benefit to the tipper. As a result, the court upheld the defendants' convictions under the Title 18 securities fraud provisions.

[72] *United States v. Blaszczak*, Nos. 18-2811, 18-2825, 18-2867, 18-2878, 2019 WL 7289753 (2d. Cir. Dec. 30, 2019).

©2020 Schulte Roth & Zabel LLP

While certainly providing the DOJ with an important tool to criminally prosecute insider trading, the *Blaszczak* ruling does not mean prosecutors will bring all insider trading cases under Title 18 going forward. The Title 18 fraud provisions apply only to trading in registered securities, whereas the Title 15 fraud provisions apply to trading in any security, registered or unregistered. In addition, the Title 18 fraud provisions impose only criminal liability, meaning that civil insider trading charges brought by the SEC still must be pursued under Title 15. Future criminal defendants charged with insider trading in registered securities, however, are likely to face charges under both provisions.

In a key preliminary holding, in the Second Circuit found that a government agency's "nonpublic predecisional information" constitutes "property" under the Title 18 securities fraud provisions. This finding was necessary because the inside information that the *Blaszczak* defendants misappropriated and traded on belonged to the Centers for Medicare & Medicaid Services ("CMS") and related to new rules the agency was contemplating. After emphasizing that Supreme Court precedent "did not . . . establish any rigid criteria for defining property," the court found that "CMS has a property right in keeping confidential and making exclusive use of its nonpublic predecisional information," and thus held that such information may constitute government property for purposes of the Title 18 fraud provisions. However, one of the three judges on the panel dissented on this issue, arguing that CMS's confidential predecisional information should not be considered the agency's "property" because the premature disclosure of such information "has no economic impact on the government" and need not affect the substance or timing of the planned regulation.

2. *Martoma II*

In 2017, the Second Circuit in *Martoma I* abrogated its earlier decision in *Newman* by holding that tippees may be convicted for trading on material, non-public information the tippee received as a gift, even if the tipper and tippee did not share a "meaningfully close personal relationship."[73] In June 2018, a divided Second Circuit panel revisited that decision in *Martoma II*.[74] In an amended opinion, the panel concluded that *Newman's* "meaningfully close personal relationship" standard may be merely one of the many ways to establish a personal benefit to the tipper, along with a quid pro quo or an "intent to benefit" the tippee.[75]

(a) In *Salman*, the Supreme Court held that "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift. In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."[76]

C. Legislative Developments

1. On Dec. 5, 2019, the House of Representatives passed a bill that would explicitly prohibit insider trading.[77] The Insider Trading Prohibition Act is meant to provide an express prohibition and more precise definition of insider trading so that enforcement authorities like the SEC and DOJ do not have to continue relying on general anti-fraud statutes to prosecute insider trading.

The bill would ban the trading of securities "while in possession of material, nonpublic information…if such person knows, or recklessly disregards, that such information has been obtained wrongfully." It also forbids passing along confidential information that could enable insider trading and shields employers from derivative liability for wrongdoing by their employees. However, thanks to a last-

[73] *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017) (*Martoma I*).

[74] *United States v. Martoma*, 894 F.3d 64, 71 (2d Cir. 2017) (*Martoma II*).

[75] *Id.* at 77-78.

[76] *Salman v. United States*, 137 S. Ct. 420, 427-28 (2016).

[77] Andrew Kragie and Jody Godoy, "House Passes 1st Explicit Ban On Insider Trading," *Law360* (Dec. 5, 2019), available here.

minute amendment, the bill adopts the personal-benefit test to prove insider trading in certain circumstances, likely including in cases brought under Rule 10b-5 of the Exchange Act.

D. 2019 Enforcement Actions

1. *SEC v. Tsai*[78]

In August, the SEC charged a junior analyst at a New York investment bank for trading on confidential information about a private equity firm's plans to acquire Electronics for Imaging Inc. The SEC alleges that soon after learning about the deal, Tsai purchased EFII call options through a brokerage account that he concealed from the investment bank. Tsai later sold the options for a profit of approximately $98,750, shortly after the deal was announced in mid-April 2019.

On Dec. 16, 2019, Tsai consented to entry of a final judgment in the Southern District of New York ordering him to pay approximately $100,000 in disgorgement and prejudgment interest.

Tsai is still facing criminal charges brought by the U.S. Attorney's Office for the Southern District of New York.

2. *SEC v. Fettner*[79]

In May, the SEC brought settled charges against a man who traded on inside information he had learned on a visit to the home of his longtime friend, who was the general counsel of a company. Without his friend's awareness, Fettner viewed documents contemplating an acquisition by his friend's company, then purchased the target company's stock in the brokerage accounts of his ex-wife and ex-girlfriend. Fettner also persuaded his father and another girlfriend to purchase stock in the target company.

Fettner consented to entry of a judgment in the Southern District of Florida ordering him to pay a civil penalty of almost $253,000. The ex-wife and ex-girlfriend, in whose accounts Fettner had made the trades, agreed to disgorge alleged profits of $250,000 plus prejudgment interest.

3. *In the Matter of Timothy M. Rooney, Sr.*[80]

Rooney, a former representative of a registered broker-dealer and investment adviser, traded in securities of Vera Bradley Inc. using material, non-public information he obtained from a senior employee of Vera Bradley, who was a friend and customer of Rooney's. Rooney purchased Vera Bradley stock and options in his personal brokerage account and in the accounts of his wife, mother, brother and many of his other customers, ultimately selling the stock for combined profits of approximately $575,000.

Rooney paid more than $160,000 in disgorgement and prejudgment interest, along with a civil penalty of more than $715,000. Rooney was also barred from the securities industry.

4. *In the Matter of Lorenz Erne*[81]

Erne, a former senior executive of a Swiss pharmaceuticals and diagnostics company, the parent company of which is Roche Holding Ltd ("Roche"), purchased stock in Spark Therapeutics Inc. ("Spark"), a gene therapy company. Using material, non-public information he had learned through his employment, Erne made the trades ahead of a February 2019 announcement that Spark had entered into a merger agreement with a Roche affiliate, resulting in illicit profits of almost $160,000.

---

[78] Litigation Release No. 24568, SEC Charges Investment Banking Analyst with Insider Trading (Aug. 16, 2019), available here.

[79] SEC Press Release, "SEC Charges Nevada Man Who Traded on Confidential Information Taken from Lifetime Friend" (May 7, 2019), available here.

[80] *In the Matter of Timothy M. Rooney, Sr.*, Exchange Act Rel. No. 86489 (July 26, 2019).

[81] *In the Matter of Lorenz Erne*, Exchange Act Rel. No. 86690 (Aug. 15, 2019).

 ©2020 Schulte Roth & Zabel LLP

Roche was ordered to disgorge the $160,000 and pay a civil penalty of almost $80,000.

IX. Foreign Corrupt Practices Act ("FCPA")

A. Both the DOJ and the SEC were very active in enforcing the FCPA in 2019.

1. As of early December, the FCPA unit of the DOJ had resolved seven corporate cases with criminal resolutions, as well as two additional cases that were resolved with declinations and disgorgement under the FCPA Corporate Enforcement Policy. The corporate resolutions amounted to $1.6 billion, and a total of $2.8 billion recovered globally through coordinated resolutions. This is the largest amount ever recovered by the DOJ in FCPA cases in a single year (versus previous high of $1.3 billion in 2016).[82]

2. The FCPA unit of the DOJ also announced more charges against individuals than any other year in history (34), and publicly announced more guilty pleas by individuals than ever before (30).

3. The SEC brought 18 FCPA actions against 15 entities and five individuals, with monetary relief of nearly $515 million (together with monetary relief in parallel criminal actions, over $1.4 billion).[83]

B. In March 2019, the Director of the CFTC announced that the CFTC was "committed . . . to enforcing the CEA provisions that encompass foreign corrupt practices."[84]

C. Noteworthy FCPA Actions

1. *In the Matter of Cognizant Technology Solutions Corporation* ("Cognizant")

In February, the DOJ issued a declination to Cognizant, a New Jersey-based information technology company. Cognizant also settled civil FCPA charges brought by the SEC by agreeing to pay $19 million in disgorgement and a penalty of $6 million. The company also agreed to fully cooperate with the SEC's investigation and to make periodic reports to the SEC on the status of its remediation and implementation of compliance measures.[85]

Between 2014 and 2016, Cognizant allegedly authorized contractors to pay a total of $3.6 million in bribes to Indian government officials to obtain government construction-related permits and operating licenses in connection with the construction and operation of commercial office buildings, resulting in violations of the anti-bribery, books and records and internal controls provisions.

DOJ issued a declination to Cognizant, citing the company's voluntary self-disclosure within two weeks of its board learning of the misconduct, its "thorough and comprehensive investigation," "full and proactive cooperation," "lack of prior criminal history" and its "full remediation," including terminating or disciplining employees involved in the misconduct.[86]

DOJ did indict two executives, Cognizant's president and chief legal officer, for authorizing at least one bribe payment and directing their subordinates to conceal the bribe by doctoring the contractor's change orders.[87]

---

[82] U.S. Dept. of Justice, "Assistant Attorney General Brian A. Benczkowski Delivers Remarks at the American Conference Institute's 36th International Conference on the Foreign Corrupt Practices Act," (Dec. 4, 2019), available here.

[83] 2019 Annual Report, Division of Enforcement, U.S. Securities and Exchange Commission, at 14.

[84] U.S. Commodity Futures Trading Commission, "Remarks of CFTC Director of Enforcement James M. McDonald at the American Bar Association's National Institute on White Collar Crime," (March 6, 2019), available here.

[85] *In the Matter of Cognizant Technology Solutions Corporation*, Exchange Act Rel. No. 85149 (Feb. 15, 2019), available here.

[86] Declination Letter Re: Cognizant Technology Solutions Corporation, Fraud Section, U.S. Dept. of Justice (Feb. 13, 2019), available here.

[87] SEC Litigation Release No. 24402, SEC Charges Cognizant and Two Former Executives With FCPA Violations (Feb. 15, 2019), available here.

2. *U.S. v. Mobile TeleSystems PJSC*; *In the Matter of Mobile TeleSystems PJSC*

   In March 2019, Mobile TeleSystems Public Joint Stock Company ("MTS"), Russia's largest mobile phone company, paid $850 million in penalties to the DOJ and SEC to resolve FCPA violations relating to Uzbekistan.[88]

   According to MTS's admissions, MTS and its wholly-owned Uzbek subsidiary paid approximately $420 million in bribes from 2004 to 2012 to Gulnara Karimova, a former Uzbek official who had influence over the Uzbek governmental body that regulated the telecom industry. The bribes were paid so that MTS could enter the Uzbek market, gain valuable telecom assets, and continue operating in Uzbekistan. MTS and its subsidiary admittedly structured and concealed the bribes through payments to shell companies that members of management knew were beneficially owned by Karimova. Also, MTS acquired the subsidiary for a price that it knew was inflated in order to bribe Karimova to allow an older MTS subsidiary to continue operating in Uzbekistan. MTS's subsidiaries made payments to purported charities and for sponsorships to entities related to Karimova, as well.

   DOJ stated that MTS did not voluntarily disclose its misconduct, did not fully cooperate and did not timely and adequately remediate.

   DOJ also filed charges against Karimova, who is the daughter of the former president of Uzbekistan, with conspiracy to commit money laundering. It also charged Bekhzod Akhmedov, the former CEO of the older MTS subsidiary who solicited and facilitated bribe payments to Karimova from various telecomm companies, with violations of the FCPA and money laundering.

   In connection with the settlement, MTS and one of its subsidiaries also agreed to retain a compliance monitor for three years. This was the third case brought by the SEC and the DOJ involving public companies operating in the Uzbek telecommunications market. Altogether, the three actions have led to $2.6 billion recovered by U.S. and foreign authorities.

3. *In the Matter of Walmart, Inc.*; *U.S. v. WMT Brasilia S.a.r.l.*

   Bringing an end to a long-running and highly publicized investigation, in June, Walmart Inc. agreed to pay the DOJ and SEC $282.7 million and to retain a corporate compliance monitor for two years to settle allegations that it violated the FCPA.[89]

   According to the settlement documents, from 2000 through 2011, Walmart's subsidiaries in Brazil, China, India and Mexico operated without a system of sufficient anti-corruption related internal accounting controls, resulting in payments to third-party intermediaries that may have been paid to government officials. Walmart also failed to sufficiently investigate known corruption allegations and to mitigate known risks.

   DOJ reduced Walmart's penalty by 20–25% compared to the applicable U.S. Sentencing Guidelines ("U.S.S.G.") fine range, crediting the company for its full cooperation in Brazil, China and India (but not in Mexico).

   Walmart spent more than $900 million investigating potential FCPA offenses and enhancing its anti-bribery compliance program, according to various SEC filings.

4. *U.S. v. Technip USA Inc.*; *In the Matter of TechnipFMC plc*

   Also in June, TechnipFMC plc, a U.K. oil and gas services company, entered into a three-year deferred prosecution agreement with the DOJ in connection with a criminal information charging the company with conspiracy to violate the anti-bribery provisions of the FCPA. TechnipFMC's U.S. subsidiary

---

[88] DOJ Press Release 19-200, "Mobile TeleSystems PJSC and Its Uzbek Subsidiary Enter into Resolutions of $850 Million with the Department of Justice for Paying Bribes in Uzbekistan," (March 7, 2019), available here; *In the Matter of Mobile TeleSystems PJSC*, Exchange Rel. No. 85261 (March 6, 2019), available here.

[89] DOJ Press Release 19-691, "Walmart Inc. and Brazil-Based Subsidiary Agree to Pay $137 Million to Resolve Foreign Corrupt Practices Act Case," (June 20, 2019), available here.

pleaded guilty to the same charge. Under the DPA, TechnipFMC will pay a total criminal fine of over $296 million, with approximately $214 million to be paid to Brazilian authorities.[90]

TechnipFMC also settled civil FCPA charges related to a bribery scheme in Iraq brought by the SEC, agreeing to pay more than $5-million disgorgement and prejudgment interest.[91] Brazil was not mentioned in the SEC settlement.

From 2003 to 2013, TechnipFMC's predecessor company made more than $69 million in "commission payments" to intermediaries, who passed along portions of such payments as bribes to Brazilian government officials employed by Petrobras to obtain and retain business with Petrobras. The company also made bribe payments to a Brazilian political party and some of its officials.

From 2008 to 2013, TechnipFMC's other predecessor company (the two predecessors merged to form TechnipFMC) gave over $794,000 to Monaco-based intermediary who paid some of the money as bribes to at least seven Iraqi government officials, including officials at the Ministry of Oil, in order to obtain and retain business in Iraq.

DOJ credited TechnipFMC for its "substantial cooperation" with the investigation and for taking "extensive remedial measures," including separating from or taking disciplinary measures against former and current employees, making changes to its business operations in Brazil and making "specific enhancements to the company's internal controls and compliance program," such as requiring additional compliance training. As a result, TechnipFMC received a 25% reduction off the applicable U.S.S.G. fine.

5. *In the Matter of Quad/Graphics, Inc.*

In September, Quad/Graphics Inc. agreed to pay $10 million to resolve FCPA violations.[92] The SEC alleged that Quad/Graphics engaged in multiple bribery schemes in Peru and China. In addition, the SEC alleged that Quad/Graphics violated the books and records provisions of the FCPA by creating false records to conceal commercial transactions with a state-controlled Cuban telecommunications company that was subject to U.S. sanctions and export controls laws.

This settlement is notable, in particular, insofar as the SEC used the FCPA books and records provisions to levy fines for sanctions and export control violations.

It is also notable that the DOJ issued a declination letter with respect to, and despite, "the bribery committed by employees of the Company's subsidiaries in Peru and China" based on an assessment of the factors set forth in the Corporate Enforcement Policy and the Principles of Federal Prosecution of Business Organizations.[93]

6. *U.S. v. Telefonaktiebolaget LM Ericsson*; *SEC v. Telefonaktiebolaget LM Ericsson*

In December, the Swedish company Ericsson, another telecom, agreed to pay the DOJ and SEC over $1 billion in the second largest FCPA enforcement action ever (behind Petrobras' $1.78-billion global settlement in 2018).[94]

The SEC alleged that Ericcson violated the anti-bribery, books and records and internal controls provisions of the FCPA, while DOJ charged Ericcson with conspiracy to violate the same provisions. According to the government, Ericcson collected about $84 million in slush funds that it used to bribe

---

[90] DOJ Press Release 19-714, "TechnipFMC Plc and U.S.-Based Subsidiary Agree to Pay Over $296 Million in Global Penalties to Resolve Foreign Bribery Case," (June 25, 2019), available here.

[91] *In the Matter of TechnipFMC plc.*, Exchange Act Rel. No. 87055 (Sept. 23, 2019), available here.

[92] *In the Matter of Quad/Graphics, Inc.*, Exchange Act Rel. No. 87128 (Sept. 26, 2019), available here.

[93] U.S. Dept. of Justice, Letter re: Quad/Graphics Inc. (Sept. 19, 2019), available here.

[94] DOJ Press Release 19-1360, "Ericsson Agrees to Pay Over $1 Billion to Resolve FCPA Case," (Dec. 6, 2019), available here; SEC Press Release 2019-254, "SEC Charges Multinational Telecommunications Company with FCPA Violations," (Dec. 6, 2019), available here.

officials via intermediaries in Djibouti, China, Vietnam, Indonesia and Kuwait. These intermediaries often were engaged through sham contracts and paid pursuant to false invoices, and the payments to them were improperly accounted for in Ericsson's books and records.

DOJ said Ericsson didn't receive full credit for cooperation because the company failed to "disclose allegations of corruption with respect to two relevant matters," was late producing some materials to DOJ, and didn't "take adequate disciplinary measures" against some of the employees involved in the corruption.

7. *United States v. Baptiste*. In a criminal trial brought by the DOJ, the chairman and CEO of an investment firm and a member of the firm's board of directors were convicted in the U.S. District Court for the District of Massachusetts for conspiring to violate the FCPA for their roles in a scheme to bribe Haitian officials to gain business advantages for their firm.[95]

8. *United States v. Hoskins.* In a criminal trial, Lawrence Hoskins, a U.K. resident and a former senior executive with Alstom S.A., was convicted after a two-week trial in the District Court for the District of Connecticut of six counts of violating the FCPA.[96] Although Hoskins is not a U.S. citizen and did not personally take any of his actions within the United States, the DOJ secured a conviction on the theory that Hoskins participated in a bribery scheme to secure a contract for a U.S. subsidiary and in that capacity was acting as the U.S. subsidiary's agent.

9. There were also a number of actions relating to hiring practices. One financial institution agreed to pay $6.3 million in September for hiring relatives of public officials in Asia, and another agreed to pay the SEC $16 million to settle FCPA offenses for hiring relatives of public officials in China and Russia.

D. DOJ's FCPA Corporate Enforcement Policy

1. Revisions were made in March and November of this year.

2. There is a presumption that a company will receive a declination[97] absent aggravating circumstances if the company:

(a) Voluntarily self-discloses FCPA violations to DOJ;

(i) In order for a company's disclosure to be voluntary, the company must (1) disclose the conduct to DOJ "prior to an imminent threat of disclosure or government investigation," (2) disclose the conduct "within a reasonably prompt time after becoming aware of the offense," with the burden on the company to demonstrate timeliness, and (3) disclose all relevant facts known to it, including all relevant facts about all individuals substantially involved in or responsible for the violation of law.

(b) Fully cooperates; and

(i) Full credit for full cooperation requires (1) timely disclosure of all facts relevant to the wrongdoing, including attribution of facts to specific sources, (2) proactive, rather than reactive, cooperation, (3) timely preservation, collection, and disclosure of relevant documents, including with respect to overseas documents, (4) de-confliction of witness interviews and other steps in the DOJ's investigation, when requested, and (5) endeavoring to make witnesses with relevant knowledge available for the DOJ to interview if requested.

---

[95] *United States v. Baptiste*, No. 17-cr-10305 (D. Mass. June 20, 2019).

[96] *United States v. Hoskins*, No. 3:12-cr-00238 (D. Conn. Nov. 8, 2019).

[97] A declination pursuant to the FCPA Corporate Enforcement Policy is a case that would have been prosecuted or criminally resolved except for the company's voluntary disclosure, full cooperation, remediation, and payment of disgorgement, forfeiture, and/or restitution.

(c) Timely and appropriately remediates

(i) Full credit for timely and appropriate remediation now requires by the time of resolution: (1) a root cause analysis, (2) a system for appropriate retention of business records, including "personal communications and ephemeral messaging platforms," (3) appropriate discipline of employees, and (4) an effective compliance program, the criteria for which are substantially similar to those used by OFAC in assessing the adequacy of a company's compliance program.

3. If there are aggravating factors, a company that satisfies the above three requirements:

(a) Will be eligible for a reduction of 50% off the low end of the fine range prescribed by the U.S. Sentencing Guidelines, except in the case of a criminal recidivist; and

(b) Generally will not be required to appoint a monitor, as long as the company has implemented an effective compliance program.

4. If a company does not voluntarily disclose its misconduct to DOJ, but later fully cooperates and timely and appropriately remediates, the company will be eligible for a reduction of up to 25% off the low end of the U.S.S.G fine range.

(a) If a company does not meet all the criteria for full cooperation and timely and appropriate remediation, it still will be eligible for some cooperation credit if it meets the criteria set forth in the Principles of Federal Prosecution of Business Organizations, but the credit generally will be markedly less than for full cooperation, depending on the extent to which the cooperation was lacking.

5. The policy applies to a company uncovering potentially willful violations at a company it has recently acquired in a merger or acquisition.

E. DOJ's Evaluation of Corporate Compliance Programs

1. In April, DOJ updated its guidance on how prosecutors should evaluate corporate compliance programs for purposes of determining the appropriate (1) form of any resolution or prosecution; (2) monetary penalty, if any; and (3) compliance obligations contained in any corporate criminal resolution (e.g., monitorship or reporting obligations).[98]

2. Three "fundamental questions":

(a) Is the corporation's compliance program well designed?

(b) Is the program being applied earnestly and in good faith? In other words, is the program being implemented effectively?

(c) Does the corporation's compliance program work in practice?

3. In making a determination as to whether the corporation's compliance program is well designed, the guidance advises prosecutors to review the company's risk assessment, policies and procedures, training and communications, confidential reporting structure and investigation process, third-party management and mergers and acquisitions process.

4. In making a determination as to whether the company's compliance program is being implemented effectively, prosecutors are advised to review commitment to compliance by senior and middle management, autonomy and resources of the compliance function, compliance incentives and disciplinary measures.

5. When analyzing whether the company's compliance program works in practice, prosecutors are instructed to consider whether the company shows continuous improvement, periodic testing and

[98] U.S. Dept. of Justice Criminal Division, "Evaluation of Corporate Compliance Programs" (April 30, 2019), available here.

 ©2020 Schulte Roth & Zabel LLP

review with respect to compliance, the company's investigation of misconduct and the company's analysis and remediation of any underlying misconduct.

X. Sanctions and Export Controls Enforcement

A. The Department of Treasury and OFAC have been very active this year, on each of the enforcement, policy development, and rulemaking fronts.

B. Policy and Rule Developments

1. In May, OFAC issued a Framework for Compliance Commitments ("Framework").[99] OFAC regulations do not require companies to maintain a sanctions compliance program. Nonetheless, OFAC encourages firms subject to U.S. jurisdiction — including foreign entities that conduct business in or with the United States, U.S. persons or using U.S.-origin goods or services — to adopt a formal sanctions compliance program. The Framework is intended to assist such firms in developing, implementing and updating their respective sanctions compliance programs. While each firm's risk-based sanctions compliance program will depend on a variety of factors, including the company's size and sophistication, products and services, customers and counterparties and geographic locations, each sanctions compliance program should incorporate five essential components of compliance: (1) management commitment; (2) risk assessment; (3) internal controls; (4) testing and auditing; and (5) training. Along with the Framework, OFAC also released a list of compliance program deficiencies most commonly identified as root causes of apparent violations of OFAC regulations.

2. In June, OFAC also issued an interim final rule amending the Reporting, Procedures and Penalties Regulations ("RPPR"), 31 CFR Part 501 ("Interim Final Rule").[100]

    (a) The rule significantly broadens the reporting requirements expanding both (i) the transactions that qualify for reporting; and (ii) the category of persons required to report on rejected transactions. Specifically, the rule requires:

        (i) Reporting of all "rejected transactions," which are defined broadly to include any transaction rejected because it would violate sanctions, including transactions "related to wire transfers, trade finance, securities, checks, foreign exchange and goods or services."

        (ii) Reporting by all U.S. persons and persons subject to U.S. jurisdiction. Previously, only financial institutions ("FIs") were subject to the reporting requirements.

    (b) There are a number of other changes in the interim final rule, including with respect to the scope of and kind of information reported, how information is submitted, license application procedures, Freedom of Information Act disclosures and the scope of OFAC's subpoena power. In addition, the rule implements an increase in the maximum term of imprisonment for willful violations of the Trading with the Enemy Act from 10 to 20 years.

3. In December, the DOJ issued a revised Voluntary Self-Disclosure Policy for Business Organizations that closely parallels the DOJ's FCPA cooperation policy.[101]

---

[99] U.S. Dept. of Treasury, "A Framework for OFAC Compliance Commitments," (May 2, 2019), available here.

[100] 31 C.F.R.§ 501, "Reporting, Procedures and Penalties Regulations," (June 21, 2019) available here.

[101] DOJ Press Release 19-1391, "Department of Justice Revises and Re-Issues Export Control and Sanctions Enforcement Policy for Business Organizations," (Dec. 13, 2019), available here.

The primary statutes governing export control and sanctions requirements are the Arms Export Control Act (AECA); the Export Control Reform Act (ECRA); and the International Emergency Economic Powers Act (IEEPA). U.S. Department of Justice, "Export Control and Sanctions Enforcement Policy for Business Organizations," Dec. 13, 2019, available here.

©2020 Schulte Roth & Zabel LLP

(a) Under the policy, there is a presumption that a company will receive a non-prosecution agreement ("NPA") and will not pay a fine, absent aggravating factors, if the company:

(i) Voluntarily self-discloses export control or sanctions violations to the Counterintelligence and Export Control Section ("CES") of DOJ's National Security Division;

In order for a company's disclosure to be voluntary, the company must (1) disclose the conduct to CES "prior to an imminent threat of disclosure or government investigation," (2) disclose the conduct to CES "within a reasonably prompt time after becoming aware of the offense," with the burden on the company to demonstrate timeliness, and (3) disclose all relevant facts known to it at the time of the disclosure, including as to any individuals substantially involved in or responsible for the misconduct at issue.

Effectively, this means the company must submit its voluntary self-disclosure to DOJ at substantially the same time that it is submitted to the appropriate regulatory agency (DDTC, BIS or OFAC).[102]

(ii) Fully cooperates; and

Full credit for full cooperation requires: (1) timely disclosure of all facts relevant to the wrongdoing, including attribution of facts to specific sources, (2) proactive, rather than reactive, cooperation, (3) timely preservation, collection, and disclosure of relevant documents, including with respect to overseas documents, (4) de-confliction of witness interviews and other steps in the DOJ's investigation, when requested, and (5) endeavoring to make witnesses with relevant knowledge available for the DOJ to interview if requested; and

(iii) Timely and appropriately remediates.

Full credit for timely and appropriate remediation now requires: (1) a root cause analysis, (2) a system for appropriate retention of business records, including "personal communications and ephemeral messaging platforms," (3) appropriate discipline of employees, and (4) an effective compliance program, the criteria for which are substantially similar to those used by OFAC in assessing the adequacy of a company's compliance program.

(b) If there are aggravating factors,[103] a company that satisfies the above three requirements:

(i) Will be eligible for a reduction of at least 50% off the statutory base penalty — effectively capping the fine at the dollar value of the violative transactions.

(ii) Will not be required to appoint a monitor, as long as the company has implemented an effective compliance program.

(c) This policy now applies to financial institutions, which were exempted from the original policy published in 2016, and to a company uncovering potentially willful violations at a company it has recently acquired in a merger or acquisition.

(d) While the revised policy makes the requirements for achieving full cooperation credit more defined, it also signals an increased focus by the DOJ in prosecuting willful sanctions violations.

---

[102] Self-reports to other regulatory agencies and not to DOJ will not qualify a company for the benefits of a VSD under this policy.

[103] Aggravating factors include: exports of items controlled for nuclear nonproliferation or missile technology reasons to a proliferator country; exports of items known to be used in the construction of weapons of mass destruction; exports to a Foreign Terrorist Organization or Specially Designated Global Terrorist; exports of military items to a hostile foreign power; repeated violations, including similar administrative or criminal violations in the past; and knowing involvement of upper management in the criminal conduct.

©2020 Schulte Roth & Zabel LLP

C. Enforcement Actions

1. As of mid-December, OFAC had announced settlements of 26 cases, totaling more than $1.3 billion in penalties. This is more in number of settlements and amount of fines than previous years.

2. Most of the settlements are related to violations of the Cuban and Iranian sanctions programs.

3. There are a number of general trends in sanctions enforcement by both the DOJ and OFAC: (a) willful conduct, including wire stripping or otherwise obscuring the interest or involvement of sanctioned parties in transactions sent to or through U.S. intermediaries, (b) operations or technical problems that have gone unfixed, (c) successor liability cases and (d) cases where a company failed to identify its supply or output chains. Examples include:

(a) *U.S. v. UniCredit Bank AG* and UniCredit Settlements with OFAC

UniCredit Bank AG ("UCB AG"), an affiliate, UniCredit Bank Austria, and their parent company, UniCredit SpA, agreed to pay more than $1.3 billion to settle criminal and civil actions brought by federal and state authorities.[104] According to OFAC, among other things, UniCredit operated U.S. dollar accounts on behalf of the Islamic Republic of Iran Shipping Lines ("IRISL") and several companies owned by or otherwise affiliated with IRISL, and managed the accounts of those companies in a manner that obscured the interest or involvement of IRISL in transactions sent to or through U.S. intermediaries. According to the DOJ, between 2002 and 2011, UCB AG processed at least $393 million of transactions through the U.S. financial system on behalf of IRISL, which is designated as a weapons of mass destruction proliferator, and other Iranian entities subject to U.S. sanctions. And, according to OFAC, for a number of years up to and including 2011 (UCB AG) and 2012 (UCB Austria and UCB S.p.A), all three banks processed payments to or through the United States in a manner that did not disclose the underlying sanctioned persons or countries to U.S. financial institutions.

(b) Apple Inc. Settlement with OFAC

Apple agreed to pay $467,000 to settle violations of the Foreign Narcotics Kingpin Sanctions Regulations with OFAC. According to OFAC, Apple continued to host apps owned by SIS, a Slovenian software company, for two years after OFAC had added SIS and its majority owner to the List of Specially Designated Nationals Blocked Persons ("SDN List"). Apple failed to identify that SIS, an App Store developer, was added to the SDN List and was therefore blocked. Apple claimed that it failed to block SIS because its sanctions screening tool failed to match the upper case name "SIS DOO" in Apple's system with the lower case name "SIS d.o.o." as written on the SDN List.

In all, Apple made 47 payments associated with the blocked apps, including payments directly to SIS, after OFAC put SIS on the SDN List. Apple collected $1.2 million over 54 months from customers who downloaded the blocked apps.

OFAC credited Apple for a previously clean sanctions compliance record, responding "to numerous requests for information in a prompt manner," reconfiguring its primary sanctions screening tool, and instituting mandatory training for all employees on export and sanctions regulations.

(c) Stanley Black & Decker Settlement with OFAC

In March, Stanley Black & Decker ("Stanley") agreed to settle its potential civil liability for 23 apparent violations of Iran sanctions for more than $1.8 million.[105] Between June 2013 and

---

[104] DOJ Press Release 19-383, "UniCredit Bank AG Agrees to Plead Guilty for Illegally Processing Transactions in Violation of Iranian Sanctions," (April 15, 2019), available here; *see also* Department of Treasury Press Release, available here.

[105] U.S. Dept. of Treasury, Settlement Agreement between the U.S. Department of the Treasury's Office of Foreign Assets Control and Stanley Black & Decker, Inc. and its foreign subsidiary, Jiangsu Guoqiang Tools Co., Ltd. (March 27, 2019), available here.

 ©2020 Schulte Roth & Zabel LLP

December 2014, a Chinese subsidiary that Stanley had recently acquired allegedly exported or attempted to export 23 shipments of power tools and spare parts, with a total value over $3 million, to or through Iran. According to OFAC, members of the subsidiary's management directed these shipments with knowledge that they violated U.S. sanctions and tried to conceal them by using conduits, creating false bills of lading, and instructing customers not to write "Iran" on documents.

OFAC determined that Stanley voluntarily self-disclosed the apparent violations on behalf of its subsidiary and that the apparent violations constitute an egregious case.

(d) e.l.f. cosmetics settlement with OFAC

In January, e.l.f. cosmetics ("ELF") agreed to pay $996,000 to settle its potential civil liability for 156 apparent violations of North Korea sanctions.[106] The apparent violations involved the importation of false eyelash kits from two suppliers located in the People's Republic of China that contained materials sourced by these suppliers from the Democratic People's Republic of Korea.

OFAC determined that ELF voluntarily self-disclosed the apparent violations and that the apparent violations constituted a non-egregious case, despite calling ELF's compliance program "either non-existent or inadequate."

4. OFAC has signaled that it may hold private equity firms responsible for sanctions violations of its foreign portfolio companies, even where the private equity firm does not have direct involvement in the underlying violations by its portfolio companies.

XI. Anti-Money Laundering

A. FinCEN still has not finalized the AML investment adviser rule, which would prescribe minimum standards for anti-money laundering programs to be established by certain investment advisers and to require such investment advisers to report suspicious activity to FinCEN pursuant to the Bank Secrecy Act ("BSA"). We do not know when or if the proposed rule will be finalized.

B. Due to the fact that there currently is not a rule requiring RIAs to have AML programs, many of the anti-money laundering program enforcement cases may not be directly relevant to private funds. Private funds may, however, be asked for various reasons to represent that they have implemented an AML program reasonably designed to comply with the BSA. Moreover, criminal AML and forfeiture statutes may be applicable to private funds.

C. There have been a number of noteworthy policy pronouncements that may be relevant relating to AML enforcement in the areas of cryptocurrencies and cannabis.

1. Joint Statement on Cryptocurrencies[107]

In October 2019, the chairmen of the CFTC and SEC and the director of FinCEN issued a joint statement reminding "persons engaged in activities involving digital assets" of their AML obligations under the BSA.

As noted in the Joint Statement, AML obligations apply to entities that the BSA defines as "financial institutions" and include establishing and implementing an effective AML program and meeting recordkeeping and reporting requirements, such as filing suspicious activity reports ("SARs").

The joint statement makes clear that it is not the label or terminology that market participants use for digital assets that determines whether they are subject to AML/CFT obligations. Rather, "it is the facts and circumstances underlying an asset, activity or service, including its economic reality and use

---

[106] U.S. Dept. of Treasury, Settlement Agreement between the U.S. Department of the Treasury's Office of Foreign Assets Control and e.l.f. Cosmetics, Inc. (Jan. 31, 2019), available here.

[107] Heath Tarbert (CFTC), Kenneth Blanco (FinCEN), Jay Clayton (SEC), Leaders of CFTC, FinCEN, and SEC Issue Joint Statement on Activities Involving Digital Assets (Oct. 11, 2019), available here.

©2020 Schulte Roth & Zabel LLP

(whether intended or organically developed or repurposed), that determines the general categorization of an asset, the specific regulatory treatment of the activity involving the asset, and whether the persons involved are 'financial institutions' for purposes of the BSA."

The nature of the digital assets-related activity not only determines whether the entity is a "financial institution," but also will determine which agency is responsible for overseeing the activity and person, and whether the person has registration and other obligations under the federal securities laws.

Certain BSA obligations that apply to a broker-dealer in securities, mutual fund, futures commission merchant or introducing broker, such as developing an AML program or reporting suspicious activity, apply very broadly and without regard to whether the particular transaction at issue involves a "security" or a "commodity," as those terms are defined under the relevant federal statutes.

The joint statement also clarifies an ambiguity about what regulations apply to covered persons or entities who are regulated by the SEC or CFTC (such as introducing brokers, futures commission merchants, broker-dealers in securities and mutual funds), but who also engage in money transmission activities. In that situation, such persons or entities would be subject to the BSA obligations of the type of regulated entity that they are and "would not be subject to BSA requirements that are applicable only to Money Services Businesses (MSBs)."

2. Joint Statement on Financial Services to Hemp-Related Businesses[108]

On December 3, 2019, the Federal Reserve, Federal Deposit Insurance Corporation, FinCEN and the Office of the Comptroller of the Currency issued a joint statement "to provide clarity regarding the legal status of commercial growth and production of hemp and relevant requirements for banks under" the BSA.

On Oct. 31, 2019, the U.S. Department of Agriculture issued an interim final rule establishing the domestic hemp production regulatory program to facilitate the legal production of hemp. The interim final rule includes requirements for maintaining information on the land where hemp is produced, testing hemp for tetrahydrocannabinol (THC) levels, disposing of plants with more than 0.3% THC and licensing for hemp producers.

BSA Considerations

Because hemp is no longer a Schedule I controlled substance under the Controlled Substances Act, banks are not required to file a SAR on customers solely because they are engaged in the growth or cultivation of hemp in accordance with applicable laws and regulations. For hemp-related customers, banks are expected to follow standard SAR procedures and file a SAR if indicia of suspicious activity warrants.

When deciding to serve hemp-related businesses, banks must comply with applicable regulatory requirements for customer identification, suspicious activity reporting, currency transaction reporting, and risk-based customer due diligence, including the collection of beneficial ownership information for legal entity customers.

In the context of marijuana-related businesses, banks should continue following FinCEN guidance FIN-2014-G001 – BSA Expectations Regarding Marijuana-Related Businesses.

D. DOJ Civil Forfeiture Settlement Regarding 1MDB

On the forfeiture side, in October, the DOJ resolved a major civil forfeiture action that involved money laundering.

[108] Board of Governors of the Federal Reserve System, SR 19-14: Statement on Providing Financial Services to Customers Engaged in Hemp-Related Businesses (Dec. 3, 2019), available here.

Specifically, the DOJ settled its civil forfeiture cases against assets acquired by Jho Low using funds allegedly misappropriated from 1Malaysia Development Berhad ("1MDB"), Malaysia's investment development fund, and laundered through financial institutions in the U.S. and other jurisdictions.[109] Jho Low agreed to surrender assets with an estimated value of over $700 million, including high-end real estate in Beverly Hills, New York and London; a luxury boutique hotel in Beverly Hills; and tens of millions of dollars in business investments that Low allegedly made with funds traceable to misappropriated 1MDB monies. Together with the prior disposition of other 1MDB-related forfeiture cases, the government now has recovered more than $1 billion in assets associated with the 1MDB international money laundering scheme, the largest civil forfeiture ever concluded by DOJ.

According to DOJ, more than $4.5 billion in funds belonging to 1MDB were allegedly misappropriated from 2009 through 2015 by high-level officials of 1MDB and their associates, including Low, through a criminal conspiracy involving international money laundering and bribery. Low still faces criminal conspiracy charges in two U.S. jurisdictions.

E. In addition, to the extent a private fund voluntarily seeks to comply with the AML program requirements of the BSA and its implementing regulations or relies on major financial institutions to perform AML diligence and monitoring, there have been a number of notable AML enforcement actions, both domestically and abroad, against major financial institutions that may be instructive. Examples of such enforcement actions include:

1. Danske Bank Investigations

A mid-level executive turned whistleblower revealed a history of money laundering at Denmark's largest bank that totaled over $220 billion in laundered funds between 2007 and 2015.[110] In September 2018, Danske Bank released the findings from an internal investigation revealing that over $235 billion flowed from Russia and other former Soviet countries through Danske's Estonian branch in order to be converted into "clean" money. Estonian regulators forced Danske Bank out of the country in February 2019, and the DOJ, SEC, European Banking Authority and other European authorities currently are investigating Danske Bank. Investigations into Danske Bank have led to investigations of the Estonian branches of Deutsche Bank and Swedbank.

2. *In the Matter of MUFG Bank Ltd.*

In February, the Office of the Comptroller of the Currency ("OCC") issued a cease-and-desist order for three U.S. branches of Japan's biggest bank after finding weaknesses in their due-diligence and risk management procedures.[111] According to the OCC, the three branches had "systematic deficiencies" in how they monitored high-risk transactions and correspondent accounts for foreign financial institutions, including failing to timely file reports of suspicious customer activity.

The OCC's order does not impose a financial penalty, but it does order MUFG to strengthen its risk assessment procedures and compliance with anti-money-laundering laws, develop a remediation plan, and ensure that it has qualified compliance officers at its branches to conduct regular audits and risk assessments.

[109] DOJ Press Release 19-1,176, "United States Reaches Settlement to Recover More Than $700 Million in Assets Allegedly Traceable to Corruption Involving Malaysian Sovereign Wealth Fund, (Oct. 30, 2019), available here.

[110] Dominic Chopping and Samuel Rubenfeld, "SEC Joins List of Authorities Probing Money Laundering at Danske Bank." *The Wall Street Journal*, (Feb. 21, 2019), available here.

[111] Kristin Broughton, "U.S. Regulator Asks MUFG Branches to Strengthen Anti-Money-Laundering Controls," *The Wall Street Journal,* (Feb. 22, 2019), available here.

 ©2020 Schulte Roth & Zabel LLP

Separately, in June 2019, MUFG agreed to pay $33 million to resolve claims by the New York Department of Financial Services and New York Attorney General that it violated anti-money laundering requirements while operating in New York.[112]

3. *In re BNP Paribas Securities Corp. and BNP Paribas Prime Brokerage, Inc.*

In October, FINRA announced that it had fined BNP $15 million for AML program and supervisory failures relating to (a) penny stock deposits and resales and (b) wire transfers, over the course of four years. FINRA also found that BNP's AML program was understaffed. The enforcement action arose out of FINRA's examinations of the firm.[113]

XII. Related Civil Litigation and Portfolio Company Litigation

A. Federal Court Rulings Regarding Private Securities Litigation

1. *Varjabedian v. Emulex Corp.*

The Ninth Circuit caused a circuit split by holding that a private litigant claiming a violation of Section 14(e) of the Exchange Act need plead only negligence on the part of a defendant who misrepresented or omitted a material fact in connection with a tender offer.[114] Previously, the Second, Third, Fifth, Sixth and Eleventh Circuits had held that a claimant must plead that the defendant acted with scienter.

The Supreme Court granted certiorari in January 2019, heard oral arguments and then dismissed the cert petition without explanation.[115] Based on oral argument, however, it appeared that several justices questioned whether there is a private right of action to bring a Section 14(e) claim but dismissed the matter because the standing issue had not been fully explored in the lower courts.[116] As a result, the circuit split remains, potentially leading to an increase in tender offer litigation in the Ninth Circuit, where the more lenient negligence standard will make it easier for plaintiffs to defeat motions to dismiss. It is widely expected that the Supreme Court will grant cert for a Section 14(e) case in the near future to revisit this issue.

2. *Singh v. Cigna Corp.*

In March, the Second Circuit held that plaintiffs failed to identify a materially false statement as a matter of law in alleging that defendant Cigna's statements about its commitment to regulatory compliance procedures were materially misleading in light of an undisclosed history of non-compliance with Medicare regulations.[117] The Second Circuit affirmed the district court's dismissal of the case, calling Cigna's statements about its policies and procedures in its Code of Ethics mere "puffery."

3. *Packer v. Raging Capital*

In August, a federal district court ruled that a private fund was the "beneficial owner" of registered equity shares it owned, and thus subject to liability for short-swing profits under Section 16 of the Exchange Act, even though the fund had delegated voting and investment authority to its investment

---

[112] *See* Settlement Agreement dated June 24, 2019 by and between MUFG Bank Ltd., and Linda Lacewell, in her official capacity as Acting Superintendent of Financial Services of the New York Department of Financial Services and Letitia James, in her official capacity as New York State Attorney General, available here.

[113] *In re BNP Paribas Securities Corp. and BNP Paribas Prime Brokerage, Inc.*, FINRA AWC No. 2016051105201 (Oct. 23, 2019), available here.

[114] *Varjabedian v. Emulex Corp.,* 888 F.3d 399 (9th Cir. 2018).

[115] *Emulex Corp. v. Varjabedian*, --S.Ct.--, 2019 WL 1768137, at *1 (April 23, 2019).

[116] *See* Tr. of Oral Arg., *Emulex Corp. v. Varjabedian*, 2019 WL 1598075, at *43-44, (April 15, 2019) (No. 18-459).

[117] *Singh v. Cigna Corp.*, 918 F.3d 57 (2d Cir. 2019).

 ©2020 Schulte Roth & Zabel LLP

adviser.[118] The ruling is significant because private funds have relied upon this type of delegation to avoid qualifying as a "beneficial owner" subject to Section 16.

Beneficial ownership of shares of a class of registered equity securities under Section 16(a) refers to the power to vote or dispose of such shares, or the right to acquire such power within 60 days. The SEC staff has taken the position that a party need not report as a beneficial owner if that party "has delegated all authority to vote and dispose of its stock to an investment adviser and [] does not retain the right under the contract to rescind the authority granted to the investment adviser within 60 days."[119] Following the staff's guidance, many investors (including private funds) have delegated such authority to their investment advisers in their investment adviser agreements to avoid the reporting requirements and potential liability of a beneficial owner. However, in 2012 the Second Circuit cast some doubt on the efficacy of this arrangement in *Huppe v. WPCS Int'l Inc.*,[120] holding that a limited partnership could not avoid qualifying as a beneficial owner by delegating voting and disposal power to its general partner.

In *Raging Capital*, a district court in the Eastern District of New York found a private fund holding more than 10% of a publicly traded common stock liable for almost $5 million in short-swing profits, despite the fact that the private fund had delegated to its investment adviser complete authority to buy, sell, and vote all securities in the private fund's account. The court rested its decision on three independent bases, the first of which suggests that the type of delegation endorsed by the SEC staff may no longer be a viable shield from short-swing profit liability. Citing language in the Second Circuit's *Huppe* decision, the district court explained that the agency relationship between the private fund and its investment adviser rendered the fund's delegation ineffectual because the investment adviser, as the private fund's agent, would exercise its voting and disposal power on behalf of the fund. In fact, the district court went so far as to say that *Huppe* "ha[d] disposed of such delegation theories."

The court also found that even if delegation were a viable shield from short-swing profit liability, the private fund had failed to effectively delegate its voting and investment authority for two reasons. First, nothing prevented the defendants, which included the private fund, its investment adviser and their common control person (who signed the investment adviser agreement on behalf of the fund and the adviser), from altering the agreement to restore the relevant authority to the private fund in 60 days or fewer. Second, voting and investment authority must be delegated to an unaffiliated third party in order to operate as a liability shield, according to treatises cited by the court. The private fund and its investment adviser, however, were affiliated due to their common control person.

This decision is currently on appeal to the Second Circuit.[121] In connection therewith, the Managed Fund Association has filed an amicus brief.[122]

B. Recent Delaware Rulings

1. *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*

In April, the Delaware Supreme Court held that the proper approach to determining fair value in an appraisal action is to subtract synergies from the deal price.[123]

---

[118] *Packer v. Raging Capital Mgmt., LLC*, 2019 WL 3936813 (E.D.N.Y. Aug. 20, 2019) (*Raging Capital*).

[119] SEC Div. of Corp. Fin., *Compliance and Disclosure Interpretations, Exchange Act Sections 13(D) and 13(G) and Reg. 13D-G Beneficial Ownership Reporting*, Q. 105.04 (Sept. 14, 2009).

[120] 670 F.3d 214, 221 (2d. Cir. 2012).

[121] *Packer v. Raging Capital Mgmt., LLC*, 2019 WL 3936813 (E.D.N.Y. Aug. 20, 2019), *appeal docketed*, Nos. 19-2703, 19-2852 (2d. Cir. Sept. 6, 2019).

[122] Amicus Curiae Brief in Support of Appellants, *Packer v. Raging Capital Mgmt., LLC*, Nos. 19-2703, 19-2852 (2d. Cir. filed Sept. 6, 2019).

[123] *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, 2019 WL 1614026 (Del. April 16, 2019) (Per Curiam).

In prior decisions, the Delaware Supreme Court had stated that the deal price often will be the best measure of fair value in appraisal actions involving open, competitive and arm's-length mergers of publicly-traded companies.[124] Unlike those cases, however, *Verition Partners* involved a merger resulting in significant synergies, which by statute must be deducted as part of the fair value determination. Thus, the Delaware Supreme Court used the target company's calculation of deal synergies and subtracted that number from the deal price to determine the fair value of the target's shares.

2. *In re PLX Tech. Inc. Stockholders Litigation*

In May, the Delaware Supreme Court affirmed a Court of Chancery ruling that an activist investor's agent sitting on the company's board of directors had breached his fiduciary duty and that the activist investor, as the director's principal, was liable for aiding and abetting his breach.[125] However, the court also held that the plaintiffs had failed to prove any damages, negating any chance of recovery from the activist investor.

The case arose from the acquisition of a stake in PLX Technology Inc. ("PLX") by an activist investor, who then induced PLX to sell itself to another public company, Avago. Prior to the sale, a co-managing member of the activist investor was elected to PLX's board of directors ("activist director"). The activist director received a tip from an Avago executive via a third party that indicated when and how much Avago was likely to bid for PLX, but failed to share the information with other members of PLX's board or management team, and steered the board to accept a deal price that Avago was willing to pay. After a trial, the Court of Chancery found that "by withholding this information from the rest of the Board, [the activist director] breached his fiduciary duty and induced the other directors to breach theirs[,] . . . fatally undermin[ing] the sale process."[126]

Despite its finding that PLX's board had breached its fiduciary duty in carrying out the sale process, the Court of Chancery held that the plaintiffs had failed to prove any damages because "the sale process was sufficiently reliable" such that the deal price should be accorded "heavy, if not overriding, probative value," as the Delaware Supreme Court has held in the context of appraisal actions. After noting that the post-signing market check failed to yield a topping bid, the Court of Chancery found that, given the significant synergies estimated to result from the sale, the deal price "exceeded the value of the Company on a stand-alone basis." On appeal, the Delaware Supreme Court affirmed the finding of no damages and declined to reach the issue of the fiduciary duty breach.

The case is notable for the Delaware Supreme Court's willingness to extend its recent appraisal jurisprudence, such as *Verition Partners*, into other contexts in which courts are asked to determine a company's "fair" or proper value.

3. *Olenik v. Lodzinski*

In April, the Delaware Supreme Court provided further guidance on how early the "dual protections" outlined in *Kahn v. M&F Worldwide Corp.* ("MFW") must be put in place in order for a take-private transaction to be accorded deferential business judgment review.[127]

Under *MFW*, a take-private transaction proposed by a controlling shareholder will be subject to business judgment review if two procedural protections were in place for the duration of the transaction: (i) the approval of an independent, adequately empowered special committee that fulfills its duty of care; and (2) the uncoerced, informed vote of a majority of the minority

---

[124] See e.g.*, DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017).

[125] *In re PLX Tech. Inc. Stockholders Litig.*, 2019 WL 2144476 (Del. May 16, 2019).

[126] *In re PLX Tech. Inc. Stockholders Litig.*, No. CV 9880-VCL, 2018 WL 5018535, at *47 (Del. Ch. Oct. 16, 2018), *aff'd*, 211 A.3d 137 (Del. 2019).

[127] *Olenik v. Lodzinski*, 208 A.3d 704 (Del. 2019).

©2020 Schulte Roth & Zabel LLP

shareholders. However, if those two procedural protections were not instituted from the beginning of negotiations, the traditional "entire fairness" standard applies.[128]

The transaction at issue in *Olenik* was a stock-for-stock merger between two companies controlled by the same shareholder, which, the plaintiffs alleged, was substantially responsible for the formulation and execution of the transaction. Reversing the Chancery Court's dismissal of the claims, the Delaware Supreme Court held that the plaintiffs had sufficiently pled that the merged companies and their controlling shareholder had engaged in "substantive economic negotiations" before putting the dual protections in place.

The Delaware Supreme Court's earlier ruling in *Flood v. Synutra International, Inc.* clarified that *MFW's* dual protections need not be in place during "preliminary discussions" or included in the controlling shareholder's initial written offer, but must be in place "early in the process and before there has been any economic horse trading."[129] *Olenik* provides additional clarity by holding that "early in the process" means before "substantive economic discussions," which most likely includes negotiation of price and other significant deal terms.

4. *venBio Select Advisor LLC v. Forrester, et al.*[130]

   In November, the Delaware Court of Chancery denied two motions to dismiss a complaint alleging breaches of fiduciary duties against purportedly independent directors. The ruling is significant because the breach of fiduciary duty was alleged to have occurred when the purportedly independent directors acted out of an entrenchment motive — i.e., to maintain their directorships in the face of an impending proxy contest — in lieu of acting for the benefit of the corporation and its shareholders.

   The decision highlights certain risks for directors (even independent ones) when acting in the context of a proxy contest. Although the director defendants in *venBio* were ostensibly independent and had no material financial motive to remain on the board, the actions they took to approve a significant transaction just before the potential loss of their directorships at the corporation's annual meeting amounted to improper entrenchment tactics and breaches of their fiduciary duties. This decision shows that Delaware law is not so formalistic as to automatically allow a supposedly independent board to approve significant corporate actions without giving due consideration to real-life circumstances.

C. Portfolio Company Litigation

1. Private equity firms face litigation risk through their portfolio companies by having the firm's managers or directors sit on a portfolio company's board, participating in the selection of portfolio company management, and implementing policy.

2. Corporate Veil-Piercing Risk

   (a) When one corporate entity controls another to the extent that the second entity is merely the alter ego of the first, courts may put aside limited liability and hold a corporation's shareholders or directors personally liable for the corporation's actions or debts.

   (b) *Marchan v. John Miller Farms, Inc.*[131]

   The plaintiffs were injured by equipment manufactured and sold by companies ("manufacturers") owned by an affiliate of a private equity fund. The affiliate had been created by the private equity fund's principals in order to make investments in the agricultural industry.

---

[128] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

[129] *Flood v. Synutra International, Inc.*, 195 A.3d 754, 756 (Del. 2018).

[130] *venBio Select Advisor LLC v. Forrester, at al.*, No. 2017-0108-JTL (Del. Ch. Ct. Nov. 13, 2019).

[131] No. 3:2016-cv-00357 (D.N.D. Dec. 11, 2018).

 ©2020 Schulte Roth & Zabel LLP

The private equity fund's principals were shareholders and board members of the affiliate, but the private equity fund itself was not a shareholder of the affiliate or the manufacturers.

Despite the private equity fund's argument that it lacked unity of ownership and unity of interest with the affiliate, a district court in the District of North Dakota denied its motion for summary judgment, holding that whether to pierce the corporate veil is a question of fact for the jury. The case settled this year.

3. In recent years, private equity firms have been investing more and more heavily in the health care space, particularly in retail health care companies, which have a very high level of exposure to False Claims Act ("FCA") liability.[132] FCA liability is not limited to the individual or entity that files a false claim, but extends to individuals owning or managing companies engaged in fraud.

   (a) *Ex rel. Medrano Diabetic Care RX, LLC*[133]

   On Sept. 18, 2019, the Department of Justice announced a $21.35-million settlement with compounding pharmacy Patient Care America, two of its executives and the pharmacy's private equity backer, Riordan, Lewis & Haden Inc.[134] The private equity firm and the pharmacy will fund substantially all of the settlement. The case may be the first in which the DOJ has intervened against a private equity firm in a False Claims Act matter.

   The FCA complaint, which the DOJ filed in intervention almost three years after a whistleblower initiated the litigation, alleged that the pharmacy had paid kickbacks to independent marketers to procure prescriptions for compound pain medications and that the private equity firm knew and approved of the illegal kickbacks.

4. Insurance Coverage For Portfolio Companies: *Charter Oak Fire Ins. v. American Capital Ltd.*

   In February, the Fourth Circuit upheld an insurance coverage award of $87 million to a publicly traded private equity firm, American Capital, that was involved in mass tort litigation with a pharmaceutical portfolio company.[135] American Capital had been named as a co-defendant in more than 1,000 product liability lawsuits brought by users of the blood-thinning drug heparin.

   The insurers argued they did not have to defend the product liability suits under American Capital's liability insurance policy because American Capital had not sought coverage for any subsidiaries in its insurance applications. American Capital countered that the portfolio company was covered under the policy's "majority interest clause," which provided coverage for "any organization, other than a partnership or joint venture, over which [American Capital] maintain[s] ownership or majority interest on the effective date of the policy." The Fourth Circuit affirmed the district court's finding that the "majority interest clause" was ambiguous and thus, must be interpreted against the insurers as drafters of the clause. As a result, American Capital's ownership of more than half of the portfolio company's voting *and* nonvoting shares was enough to satisfy the "majority interest clause."

   The insurers also argued they did not have to defend the product liability suits because the suits related to the conduct of a noninsured joint venture between the portfolio company and a Chinese pharmaceutical company. American Capital's policy excluded any joint venture not named in its application. However, the district found that this "joint venture clause" did not preclude coverage because several of the complaints against the insureds did not mention the joint venture and there

---

[132] The False Claims Act imposes liability (typically on government contractors) for submitting false claims for payment to the government. Alexander Owens, "First of Its Kind? Private Equity Firm and Its Portfolio Company Settle FCA Lawsuit," *The Legal Intelligencer* (Sept. 27, 2019), available here.

[133] No. 15 Civ. 62617 (S.D. Fla.).

[134] DOJ Press Release, "Compounding Pharmacy, Two of Its Executives, and Private Equity Firm Agree to Pay $21.36 Million to Resolve False Claims Act Allegations," (Sept. 18, 2019), available here.

[135] *Charter Oak Fire Insurance v. American Capital, Ltd.*, No. 17-2015 (4th Cir. 2019).

was evidence that some of the contaminated heparin came from sources other than the joint venture. Applying Maryland's rule requiring an insurer to defend "if there is a potentiality that the claim could be covered by the policy," the district court held, and the Fourth Circuit affirmed, that the heparin lawsuits created a potential for covered judgments against the insureds, and therefore, the insurers had a duty to defend.

Private equity firms should consider the organization and operations of their portfolio companies when acquiring liability insurance. PE firms should pay special attention to "majority interest clauses," including how "majority interest" is defined, and be aware that insurance companies may seek to modify the "standard" language to avoid coverage for these types of claims in the future.

©2020 Schulte Roth & Zabel LLP

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

This communication is issued by Schulte Roth & Zabel LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising. ©2020 Schulte Roth & Zabel LLP. All rights reserved. SCHULTE ROTH & ZABEL is the registered trademark of Schulte Roth & Zabel LLP.