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Second Quarter Brings New Leadership for the SEC's Enforcement Division and More Clarity on Enforcement Priorities

Following the appointment of Gary Gensler as Chairman of the U.S. Securities and Exchange Commission ("SEC" or "Commission"), the SEC has taken steps to outline and implement its enforcement agenda. While its early enforcement actions demonstrate that the SEC is still keeping an eye on classic concerns such as insider trading, fraud and registration requirements, the SEC has made clear that it is focused on the impact that new technologies have on the financial markets. The SEC continues to bring enforcement cases related to digital assets and has emphasized its focus on trading platforms and software applications designed to "gamify" trading activity.

In the final week of the second quarter, the SEC appointed New Jersey Attorney General Gurbir Grewal to serve as director of its division of enforcement.[1] Director Grewal is a former federal prosecutor, having served as the chief of the economic crimes unit in the U.S. Attorney's Office for the District of New Jersey. Director Grewal has experience handling complex securities cases, insider trading and cybercrimes. Director Grewal also has experience relevant to the SEC's ESG focus. While serving as the New Jersey attorney general, his office took aggressive measures against companies charged with polluting various sites throughout the state.

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This edition of Schulte Roth & Zabel's Securities Enforcement Quarterly frames the enforcement initiatives of the SEC by exploring recent statements made by Chairman Gensler, discussing the SEC's focus on cryptocurrencies and digital assets and reviewing the Enforcement Division's increased use of data analytics. Additionally, we examine and discuss the impact that *United States v. Blaszczak* could have on insider trading law moving forward, and then conclude with a review and summary of what we view to be key enforcement cases from financial regulators brought throughout the second quarter of 2021.

Chairman Gensler's Agenda Comes Into Picture

A. Public Statements Clarify SEC Focus

After becoming the new SEC Chairman in April, Gary Gensler has wasted no time articulating his priorities for the Commission he leads. Gensler's recent public statements concerning the SEC's objectives provide insight into what we should expect under his watch. As objections from Republican holdovers on the Commission highlight, Gensler's agenda includes revisiting and possibly reversing rulemakings that were completed in the last two years of former Chair Jay Clayton's leadership and adopted over the dissents of two Democratic Commissioners. Below we preview some of the issues that Gensler's public remarks suggest will become priorities for the SEC during his tenure as Chairman. These priorities will influence the investigations pursued and cases brought by the SEC as it advances issues that Chairman Gensler thinks are important.

Equity Market Structure. Gensler's public remarks have highlighted structural issues in the U.S. equity market, including market segmentation and concentration. Regarding segmentation, Gensler has noted that large public exchanges like Nasdaq and the NYSE accounted for as little as 53% of trading volume in a recent month.[2] Of the remaining 47% of trading volume, 9% took place in alternative trading markets known as dark pools, and 38% was executed by off-exchange wholesalers, according to Gensler. These various market-makers "are operating under very different rules," however. Exchanges "must compete with each other on an order-by-order basis to offer the best price," while wholesalers use the NBBO, which Gensler says is "a much less competitive benchmark"

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and "is not a complete enough representation of the market." A related concern noted by Gensler is the concentration of off-exchange market-making, with one firm accounting for nearly half of all retail trades and two firms executing more volume than all exchanges except the Nasdaq. Such concentration, according to Gensler, "can deter healthy competition [... ,] limit innovation ... [and] "increase potential system-wide risks."[3] Moreover, the segmentation and concentration of these markets raises fundamental questions about payments for order flow, including best execution concerns as to whether investor price improvement is being sacrificed for increased payments by wholesalers for retail order flow and rebate payments by exchanges. To address these and related issues, Gensler has asked the SEC staff to consider possible revisions to promote market efficiency and competition.

Gamification & "Meme" Stocks. Recent trading in so-called "meme" stocks — e.g., GameStop, AMC Entertainment — has seen "rapidly changing prices, high volatility, and significant trading volume."[4] Having just spent three years at MIT where his "researching and teaching centered on the intersection of finance and technology," Gensler understands their "symbiotic relationship."[5] Gensler appreciates how technological advances have strengthened securities markets by encouraging "greater access, innovation and competition."[6] As mobile brokerage and trading applications have proliferated, however, some trading apps have adopted game-like features, such as points, leaderboards and behavioral prompts. Gensler has observed that by incentivizing investors to trade more, trading apps raise concerns about possible conflicts of interest and whether trading is in the best interest of those using these apps. Gensler has asked SEC staff for recommendations for how to address these issues.

ESG Disclosure. In response to investor interest and direction from the Biden administration, Gensler intends for the Commission to consider adopting enhanced disclosure requirements concerning environmental, social and governance matters.[7] The SEC's focus on these so-called "ESG" matters predates Gensler's SEC tenure. In March, 2021, then Acting Chair Allison Herren Lee solicited public input regarding climate-related disclosures, resulting in more than 400 unique comment letters to the SEC, including calls for enhanced disclosures.[8] More recently, regarding human capital matters, Gensler asked SEC staff to recommend enhanced human capital disclosure requirements for the Commission's consideration.[9] These disclosures might include metrics "such as

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workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety" issues. Gensler has indicated that an ESG disclosure rulemaking is one of his top priorities.[10] We expect that the SEC will move quickly to issue proposed rules, perhaps as early as the late summer.

Transparency. Gensler has expressed interest in revising various disclosure rules to increase market transparency. One such area concerns the timing of beneficial ownership disclosures, which, Gensler has suggested, might be revised for the first time in decades to catch up to market and technological advances.[11] Gensler would like to enhance disclosure concerning "security-based swaps — essentially, derivatives on individual companies that provide exposure to the company[ies] without traditional equity ownership." Gensler has additionally referenced fallout from the unravelling of Archegos Capital Management as evidence of the need for enhanced disclosure requirements for security-based swaps. Similarly, Gensler has noted support for more robust disclosure requirements related to corporate stock buybacks.[12]

Rule 10b5-1 Trading Plans. Gensler also announced renewed SEC scrutiny of Rule 10b5-1 trading plans, which provide "affirmative defenses for corporate insiders and companies themselves to buy and sell stock as long as they adopt their trading plans in good faith, before becoming aware of material nonpublic information."[13] Since adopting the rule in 2000, the SEC has brought only a handful of enforcement actions concerning Rule 10b5-1 trading plans, even while academic studies have raised concern about potential abuse by insiders. Citing one such recent study, Gensler has stated that Rule 10b5-1 trading plans reflect "real cracks in [the SEC's] insider trading regime," and, as a result, he has asked the staff to make recommendations for a proposal to "freshen up" Rule 10b5-1. Among the potential reforms that Gensler has mentioned are adding "cooling off" periods between the adoption and implementation of 10b5-1 trading plans, restricting when and how plans may be canceled, requiring disclosures regarding the adoption, modification and terms of Rule 10b5-1 trading plans, and limiting how many plans an insider may have.[14]

Regulatory Agenda. Many of the issues highlighted above are included in Gensler's regulatory priorities and rulemaking agenda that the SEC released June 11, 2021. For instance, Gensler's agenda includes rulemaking for ESG disclosures, security-based swap and stock buyback

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transparency, and market structure modernization.[15] The regulatory agenda goes further, however, and includes reconsideration of rulemaking undertaken by the Commission under former Chair Jay Clayton. For example, new proxy rules that the SEC adopted in July 2020 — some of which are not yet effective — are among the subjects that Gensler would like the SEC to reconsider.[16] Similar targets are SEC rules regarding private, exempt offerings, including the definition of accredited investors (revised in August 2020), integration framework (addressed in November 2020) and enhanced disclosures for private offerings. Commissioners Hester Peirce and Elad Roisman voiced concern about the prospect of reversing such recent regulatory actions by the Commission.[17]

Given this expansive agenda, Chairman Gensler's SEC promises to be active, through both regulatory action and enforcement initiatives, in efforts to shape and modernize the securities markets. Gensler's public statements suggest he will urge the SEC to be bold and aggressive—even if that means reversing course on prior agency action or pursuing enforcement in matters that previously might have earned a pass. Indeed, we anticipate that the SEC will continue efforts to ensure the existence of robust regulatory controls and compliance programs, even as it pursues Chairman Gensler's regulatory priorities. Market participants should pay close attention to the SEC's efforts, and be prepared to respond and adapt to what may be swift and wide-ranging regulatory activity by the Commission under Chairman Gensler.

B. The SEC Continues to Target Cryptocurrencies and Digital Assets

Notwithstanding the popularity and acceptance of digital assets, U.S. legal and regulatory guidance regarding digital assets remains limited.[18] This is expected to change, however, as Chairman Gensler joined the SEC with considerable knowledge of both financial technology and digital assets, having previously been a professor at MIT where his teaching and research focused on blockchain technology and digital currencies.[19] Given this expertise, and Chairman Gensler's focus on under-regulated market activity and the impact of modern technology on markets discussed above, it is anticipated that digital asset guidance may come in the form of new regulations, specifically, registration requirements for digital asset exchanges, as well as a host of other measures aimed at preventing both fraud and manipulation.[20]

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Indeed, in a June 9, 2021 interview with CNBC, Chairman Gensler cautioned investors about the risks of trading Bitcoin and other cryptocurrencies, stating that "investors don't have the full protections that they have in the equity markets or in the commodity futures markets … Bitcoin and these other cryptocurrencies do not have those full protections."[21] He went on to comment on the SEC's enforcement actions related to digital assets and indicated that the SEC will be keeping a close eye on the space, explaining that "[t]he SEC has brought, I think, six to seven dozen enforcement actions over the last few years, but of course there's hundreds of other tokens. I think there's 1,600 tokens that purportedly have a market value of over a million and 70 or 80 over a billion. So we're going to keep trying to protect investors as best we can under the authorities."[22]

It was perhaps surprising, then, when, on June 11, 2021, the SEC released its Spring 2021 Unified Agenda of Regulatory and Deregulatory Actions ("Agenda")[23] and digital assets were not the subject of any of the proposed and final SEC rulemaking areas. This did not go unnoticed by SEC Commissioners Hester M. Peirce and Elad L. Roisman, who issued a joint statement on June 14, 2021, noting that "the Agenda is missing some other important rulemakings, including rules to provide clarity for digital assets."[24] It remains to be seen what place digital assets will have in Chairman Gensler's regulatory agenda moving forward.

Despite the limited regulatory guidance regarding digital assets, the SEC continues to pursue enforcement actions in the space. The high-profile lawsuit the SEC filed against Ripple Labs Inc. ("Ripple")[25] and a similar lawsuit the SEC brought against LBRY Inc. ("LBRY"),[26] alleging that that those companies' digital tokens are unregistered securities, illustrate the evolving theories under which the SEC is pursuing cryptocurrency companies.

For example, the SEC complaint against Ripple alleges that Ripple's digital token, XRP, is an "investment contract" under Section 2(a)(10) of the Securities Act and is, therefore, a security and subject to regulation as such. Whether something is an investment contract is determined by the four-pronged "*Howey* test" announced by the U.S. Supreme Court in *SEC v. W.J. Howey Co.*[27] Ripple is contesting the charges, claiming they never offered or sold XRP as an investment, that XRP holders have no control or ownership over Ripple, and that XRP holders are not entitled to share in any profits generated by Ripple.[28] Defendants also offered facts

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about XRP to help differentiate it from traditional securities, stating that XRP is decentralized, that it functions as a cryptocurrency, and that its price rises and falls in correlation with other cryptocurrencies and is not dependent on the actions taken by Ripple.[29] Those assertions, if proven true, would help Ripple negate all four prongs of the *Howey* test.

Notably, in the Ripple lawsuit, Ripple has asserted as an affirmative defense that the SEC failed to provide "fair notice" that Ripple's conduct violated U.S. securities laws, amounting to what Ripple contends is a violation of due process.[30] Ripple asserts that there is a lack of clarity regarding the SEC's position on digital assets due to the SEC's lack of formal guidance on the matter for the past several years.[31] If successful, this fair notice defense could have wide-ranging implications for future SEC enforcement actions against other cryptocurrency companies, who could raise a similar defense.

Beyond the Ripple and LBRY lawsuits, the SEC also continues to pursue enforcement actions under more traditional theories, including a recent lawsuit in connection with a digital asset lending program (akin to a stock loan desk, except participants allegedly loaned digital tokens instead of stock), which are becoming increasingly common.[32] In addition to alleging that certain defendants offered and sold unregistered securities in the lending program, the SEC also charged the same defendants with failing to register with the SEC as broker-dealers.[33] Specifically, on May 28, 2021, the SEC filed an action against five individuals, alleging that they "conduct[ed] an unregistered offering and sale of securities in the form of investments into" a digital asset lending program offered by defunct cryptocurrency company BitConnect, raising over $2 billion.[34]

These SEC enforcement actions come at a time of heightened volatility for Bitcoin and other cryptocurrencies globally. Amidst reports that the Chinese government is cracking down on crypto-mining, Bitcoin's price recently fell below $30,000, to one of its lowest points this year, before rebounding.[35] Bitcoin's hashrate, a measure of the computing power deployed by miners, has fallen sharply in China following this crackdown,[36] and will potentially force miners in China to relocate, causing further uncertainty while the world waits for clarity from the SEC and other governmental authorities on their regulatory approach to Bitcoin and other cryptocurrencies.

It is evident that the SEC's enforcement efforts remain focused on the digital asset space despite the lack of formal rulemaking. Accordingly, any

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market participants involved with digital assets should carefully evaluate the regulatory risks associated with their investments, including risks that the SEC and other regulators may take the position that they constitute unregistered securities. Furthermore, those involved with crypto-lending programs specifically should be knowledgeable of the relevant laws and regulations which may require crypto-lending programs to be registered as securities and also require those who offer and sell such securities to register with the SEC as broker-dealers.

New SEC Enforcement Cases Highlight Increased Usage of Data Analysis Tools

A string of recent SEC enforcement actions highlight the Commission's use of data analytical tools to uncover and identify suspicious trading patterns. The SEC litigation releases announcing the enforcement actions reference the use of "sophisticated data analysis" from the SEC Enforcement Division's Market Abuse Unit in identifying the alleged schemes.[37] Moreover, these cases touch upon conduct dating as far back as 2015 from investment advisors unregistered with the SEC, thus drawing increased attention to how the Commission may be sourcing and analyzing historical trading data from broker-dealers.

In *SEC v. Sugranes et al.*, for example, the SEC charged the partial owner of two nonregistered investment advisory firms, along with the firms themselves, with carrying out a cherry-picking scheme that diverted profitable trades to preferred accounts while allocating unprofitable trades to other accounts.[38] The complaint identified thousands of trades dating back to 2015 to chart the "stark contrast" in how defendants allocated profitable stock trades among accounts. Another cherry-picking scheme identified through data analytical tools, *SEC v. Paris et al.*, provided a similar review of thousands of trades dating back to 2015 and the complaint highlighted longstanding trading data at unnamed clearing brokers for the investment advisor as the source for the disparity in profitable trade allocations. [39]

In *SEC v. Wygovsky*, a front-running scheme case, the SEC charged a trader at a multi-billion dollar investment advisor with trading for the benefit of accounts of close family members in advance of large trades executed for the firm's clients.[40] Similar to the cherry-picking cases, the SEC identified over 600 suspicious trades dating back to January 2015 where the trader made trades on behalf of his relatives' accounts ahead

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of large client trades. Charts within the complaint highlight daily modeling of numerous examples of the suspicious same-day trading alleged by the SEC.

These cases demonstrate an ability, if not commitment, by the SEC to identify suspicious trading patterns. As part of their own compliance monitoring, investment advisers, whether registered with the Commission or not, should consider conducting their own trading analytics to identify and prevent suspicious trading before it is discovered by the SEC.

United States v. Blaszczak Poised to Further Reshape Insider Trading Law

The law of insider trading has aptly been called "judge-made law."[41] No federal criminal statute on the books specifically outlaws insider trading. To combat insider trading, federal prosecutors have instead adapted other laws of more general application. Traditionally, prosecutors have relied on the general anti-fraud prohibition in Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, but, increasingly, they have turned to a bevy of other federal statutes that were not written with insider trading in mind. All this has left it up to the courts to fill in the gaps and figure out when trading on material nonpublic information does, and does not, constitute a crime. And it has left market participants often puzzled and uncertain as to when their conduct may expose them to criminal punishment.

One long-running and still-ongoing prosecution, *United States v. Blaszczak*, helps to illustrate the amorphous contours of insider trading law. In *Blaszczak*, the government failed to obtain a conviction under a traditional § 10(b) charge, but prevailed on four other statutory theories, all of which have been vigorously challenged by the defendants on appeal. The case has already spawned one ruling of major import by the U.S. Court of Appeals for the Second Circuit. After a visit to the U.S. Supreme Court, the case is now back before the Second Circuit for what promises to be another highly consequential decision, especially for insider trading cases based on alleged misuse of material nonpublic information in the possession of the government. As we await that decision, now is a good time to take stock of what *Blaszczak* has wrought so far and what else it may have in store for the law of insider trading.

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Blaszczak's Background

The *Blaszczak* prosecution arises from the activities of David Blaszczak, a political intelligence consultant and former government employee. According to the government, Christopher Worrall, a former colleague and then employee of the Centers of Medicare and Medicaid Services ("CMS"), told Blaszczak that CMS was about to issue regulatory changes adjusting the reimbursement rates for Medicare and Medicaid services — information that was not public at the time. Worrall and Blaszczak understood CMS's reimbursement rates for medical services were a major factor in many healthcare companies' business strategies. Blaszczak allegedly shared this predecisional CMS information with hedge fund analysts Robert Olan and Theodore Huber, so they could invest in or bet against public companies, anticipating the impact this news would have on the companies' stock prices.

In 2017, the U.S. Attorney's Office in Manhattan brought insider trading charges against all four individuals. The press release announcing their arrests sent a message that, to prosecutors, confidential government information stood on the same footing as as-yet unannounced corporate news: "Just like trading on material nonpublic corporate information can be a federal crime, so can trading based on secret government information, as alleged to have happened here."[42]

A jury in the Southern District of New York acquitted all four defendants on charges that they committed securities fraud under § 10(b). Almost certainly this was because of the absence of proof, as required in a § 10(b) insider trading case, that Worrall had received a "personal benefit," in the form of money or otherwise, in exchange for sharing the CMS data, or that the other defendants knew or believed that Worrall had received any such benefit.

Nevertheless, the defendants were convicted of several other crimes under other statutes. Specifically, some or all of the defendants were convicted of violating and/or conspiring to violate:

- 18 U.S.C. § 1343, the federal wire fraud statute;
- 18 U.S.C. § 1348, a federal criminal securities fraud statute that is separate from § 10(b) and was enacted in 2002 as part of the Sarbanes-Oxley Act;

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- 18 U.S.C. § 641, which makes it a crime to convert property of the United States; and
- 18 U.S.C. § 371, which outlaws conspiracies to defraud the United States.

The latter two statutes (§ 641 and § 371) rarely have been used to prosecute insider trading and were available here only because the material nonpublic information in question emanated from CMS, a government agency, rather than from a private business.[43]

Blaszczak in the Second Circuit: Round 1

In 2019, the Second Circuit upheld the defendants' convictions under all these statutes. Most notably, the Court held that the wire fraud and Title 18 securities fraud statutes (§ 1343 and § 1348) do *not* require proof of a "personal benefit."[44] Therefore, the government's inability to prove Worrall's receipt of a personal benefit, or the other defendants' knowledge of such a benefit, did not invalidate their convictions under these statutes.

This ruling departed from the "personal benefit" requirement found in "tipping" cases brought under § 10(b). In a tipping case, the person who knows inside information ("tipper") shares it with someone else ("tippee"). Often, several tippees in turn become tippers by passing the information even further. As a result, several people — with varying degrees of separation from the owner of the information — may learn about and trade on the inside information.

In the 1980s, the Supreme Court held in *Dirks v. SEC* that the duty not to trade on inside information only arises "if the tippers in the informational chain" obtain a "personal benefit" in exchange for the tip of inside information.[45] In *United States v. Newman*, the Second Circuit expanded upon this holding and held that, in a criminal case, prosecutors must prove that a remote tippee was aware that the tipper received a "personal benefit" in exchange for the information.[46]

In reaching a different result for insider trading prosecutions under § 1343 and § 1348, the *Blaszczak* court reasoned that the *Dirks*' personal-benefit test "is a judge-made doctrine premised on the Exchange Act's statutory purpose" to "'eliminate[e] [the] use of inside information for *personal advantage*.'"[47] By contrast, the courts have fashioned an "embezzlement theory of fraud" to justify insider trading prosecutions under § 1343 and § 1348, pursuant to which the misappropriation of

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confidential information "'constitutes fraud akin to embezzlement.'"[48] Under that theory, in the *Blaszczak* court's view, there was no reason to impose a personal benefit requirement. As a result of this interpretation, the judge-made law of insider trading means one thing under the Exchange Act's federal securities fraud statute and another thing under Title 18's federal securities fraud statute.

The *Blaszczak* defendants also attacked their convictions on the ground that government agencies' "nonpublic predecisional information" does not constitute "property" and has no economic value. Those arguments would have pulled the rug out from the convictions based on § 1343 and § 1348, which are limited to schemes to defraud a victim of "money or property," as well as the convictions based on § 641, which requires that the confidential information be a "thing of value." But the Second Circuit, dividing two to one on this issue, rejected the defendants' arguments and held that the confidential CMS information did constitute "property" and a "thing of value" for purposes of these laws.[49]

Blaszczak in the Supreme Court

In 2020, before the *Blaszczak* defendants had sought further review of the Second Circuit's decision, the Supreme Court decided *Kelly v. United States*.[50] The *Kelly* case arose out of the "Bridgegate" scandal in which New Jersey government officials were charged with wire fraud and defrauding a program that received federal funds when, falsely claiming to be conducting a "traffic study," they limited the number of lanes available to access the George Washington Bridge as political retaliation against a local mayor.

The Supreme Court held that both of these statutes require that the defendant acted with the purpose to obtain "money or property" using fraud or deception. Because adjusting the traffic lanes was an exercise of regulatory power and did not actually take anything that had value in the hands of the government, the Court concluded that the convictions could not stand. That the government suffered a loss of property (in the form of employee time and labor wasted on the bogus traffic study) as an "incidental byproduct" of the scheme did not change the result.[51]

Arguing that *Kelly* vindicated their position on the "property" question, the *Blaszczak* defendants filed petitions for certiorari with the Supreme Court. At the request of the government, the Supreme Court granted the

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petitions for certiorari, vacated the Second Circuit's 2019 decision, and remanded the case back to the Second Circuit to reconsider its ruling in light of *Kelly*.[52]

Blaszczak in the Second Circuit: Round 2

The stage is now set for the Second Circuit's next ruling, on remand, in *Blaszczak*. The issues have been fully briefed and the court held oral argument on June 6, 2021. Of note, the panel of judges who will decide the case includes only two of the judges who decided the earlier appeal: Judge Richard J. Sullivan (who wrote the majority opinion) and Judge Amalya L. Kearse (who wrote the dissent). The third judge retired the day after the decision was announced and has been replaced on the panel by Judge John M. Walker.

The Second Circuit has before it two issues of particular importance for insider trading prosecutions based on an alleged misappropriation of material nonpublic information from the government: (1) Does such information constitute "property" as required to support a prosecution under federal property fraud statutes such as § 1343 and § 1348 or a "thing of value" under § 641? (2) Can such cases be prosecuted on the theory that the defendant conspired "to defraud the United States" under § 371? The answers to these questions will not, it should be noted, affect insider trading liability in the normal context where material nonpublic information has been allegedly misappropriated from a private business enterprise. In that context, the Supreme Court decided nearly 25 years ago, in *Carpenter v. United States*, that the federal property fraud statutes apply to intangible property rights such as the confidential business information misappropriated by a *Wall Street Journal* reporter in that case.[53]

On the first issue, the Department of Justice has taken an unusual position on remand: It has confessed error. The government now agrees with the defendants that the convictions based on §§ 1343, 1348 and 641 cannot stand because, after *Kelly*, it can no longer be said that the confidential CMS information constituted "property" or a "thing of value." The government argues that, unlike the confidential business information involved in *Carpenter*, the confidential CMS information only implicates the government's interests as a regulator, not as a property holder. The government also notes that, in its prior ruling, the Second Circuit found that the CMS has an economic interest in the confidential predecisional

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information because it is the product of its employees' time and labor. But this, the government asserts, is no longer sufficient after *Kelly* because depriving CMS of its employees' time and labor was not an "object" of the alleged fraud.

With none of the parties defending its prior ruling on the property issue, the Second Circuit appointed an *amicus* to argue what the government did not. The *amicus* argues that whereas the scheme in *Kelly* sought to alter a regulatory decision, the *Blaszczak* defendants sought to misappropriate confidential information, and that this should be sufficient under *Carpenter* because there is no sound reason to provide lesser protection to highly sensitive government information than to business information. In addition, the *amicus* points to the Second Circuit's prior decision in *United States v. Girard*, which held that the Drug Enforcement Agency had a property interest in confidential information about its informants, even though that information had no economic value to the government.[54]

On the second issue, the government maintains that the convictions under § 371 remain valid, because the crime of conspiring to defraud the United States does not depend on whether property is involved. Rather, that statute has long been held to embrace any conspiracy for the purpose of "impairing, obstructing, or defeating the lawful function of any department of government" through deceit or dishonest means.[55] The government argues that the defendants' actions obstructed the lawful function of CMS by compromising the confidentiality of the predecisional information, which was of great importance to the agency, and unfairly tilting the playing field in favor of the recipients of the information, contrary to CMS' regulatory interest in ensuring that all market participants receive the information at the same time.

The defendants argue that their conspiracy-to-defraud convictions under § 371 should be reversed for two reasons. First, the defendants argue that, far from impairing or obstructing CMS' lawful functioning, the alleged scheme depended on CMS *carrying out* its regulatory functions because the funds' trades could only be profitable if CMS proceeded to timely issue the new rates. Second, the district court told the jury that it could convict on § 371 if it found there was an agreement to accomplish either conversion, securities fraud or conspiracy to defraud the United States. Accordingly, the jury might have convicted on the ground that the defendants stole government property, which cannot survive *Kelly*.

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While the legal issues decided and to be decided in the *Blaszczak* case are undoubtedly significant, it should be noted that they do not affect the scope of either criminal or civil liability under § 10(b) of the Exchange Act, which remains the principal tool used by federal prosecutors and the SEC to combat insider trading. In future cases involving confidential government information where the personal benefit requirement has been satisfied, the government may rely on § 10(b) to impose insider trading liability irrespective of whether the material nonpublic information constitutes "property" or whether the defendant's actions can be said to have impaired a government agency's lawful functioning.

The Second Circuit's forthcoming decision in *Blaszczak* surely will shape the next chapter in the evolution of insider trading law. Whatever the outcome, one thing is certain — it is a chapter that will be written by federal judges, continuing to expound what is, in function if not in form, the federal common law of insider trading.

Investment Adviser Enforcement Actions

A. Fictitious Performance: *SEC v. Silver*

Early in the Quarter, the SEC pursued charges in response to a decade-long, multimillion dollar fraud perpetrated by the co-founders of former registered investment adviser International Investment Group ("IIG"). On April 13, 2021, the SEC filed partially settled charges in the U.S. District Court for the Southern District of New York against Martin Silver, the co-founder and Chief Operating Officer of IIG, for defrauding IIG's clients by grossly overvaluing certain debt assets held by IIG's flagship hedge fund, TOF.[56]

The complaint alleges that, between 2007 and 2017, Silver and IIG Managing Partner David Hu[57] sought to disguise TOF losses caused by defaulting debtors by incorrectly valuing the loans in question on TOF's books. When this strategy became untenable, the SEC alleged that Silver and Hu then replaced certain loans on TOF's books with a number of fictitious substitute loans to foreign companies that had in fact received nothing of value from TOF and would never make payments to TOF. Hu and Silver also oversaw the creation of false documentation to make these substitute loans appear valid for audit purposes. According to the

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SEC, Hu and Silver would repeat this scheme several times to avoid reporting losses on a number of under-performing loans held by TOF.

Between 2013 and 2017, IIC came under pressure as a result of investor redemption demands on TOF. In response, Silver allegedly led an effort to securitize TOF's loan portfolio, resulting in IIG obtaining bank financing to capitalize a collateralized loan obligation trust ("CLO"). Eventually, the SEC alleged, Hu began diverting cash from the CLO to TOF through a series of loans to shell companies controlled by IIG. The loans to these shell companies, which were worthless, were valued on the CLO's books for tens of millions of dollars. With IIG's liquidity issues persisting, the SEC alleged that Silver and Hu then formed two new funds to purchase the worthless loans, and one other loan that was disputed, for tens of millions of dollars. Silver is alleged to have prepared and provided reports to investors that fraudulently inflated the value of these loans and characterized them as legitimate assets.

The Complaint charges Silver with violating the antifraud provisions of Sections 17(a)(1)-(3) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rules 10b-5(a),(b), and (c) thereunder, and Section 206(1) and (2) of the Investment Advisers Act of 1940. In resolving this matter, Silver agreed to be permanently enjoined from violating the above provisions, while the SEC's claims for disgorgement of ill-gotten gains and a civil monetary penalty will be separately adjudicated.

B. Misrepresentations Regarding Investment Strategy: *SEC v. Franzone et al.*

The SEC continues to aggressively enforce the misappropriation of client funds by advisers looking to pursue their personal interests in violation of their publicly touted investment strategies. On April 23, 2021, the SEC filed one such contested action in U.S. District Court for the Southern District of New York against Andrew T. Franzone, and investment advisor FF Fund Management LLC ("FFM") for fraudulently raising and misappropriating tens of millions of dollars from the sale of limited partnership interests in a private fund, FF Fund I LP.[58]

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The complaint alleges that Franzone, the sole owner and principal of FFM, defrauded investors by making misrepresentations regarding the fund's strategy and investments, failing to eliminate or disclose conflicts of interest, misappropriating fund assets and falsely representing the fund would be audited annually.

Specifically, the SEC has alleged that, from August 2014 through Sept. 24, 2019, Franzone told potential and existing investors that his investment strategy for the fund was to maintain a highly liquid portfolio primarily focused on options and preferred stock trading. Franzone allegedly raised more than $38 million for the fund from approximately 90 investors through these representations. In reality, as alleged in the complaint, Franzone diverted substantial fund assets to an entity he owned, and invested the fund's remaining assets mainly in highly illiquid private companies and real estate ventures owned by himself and his friends. According to the SEC, Franzone failed to disclose these conflicts of interest. Finally, Franzone and FFM allegedly removed a critical safeguard for investors by failing to have the fund audited on an annual basis despite representations they would do so, ensuring that their malfeasance wouldn't be uncovered.

The Complaint charges Defendants with violating the antifraud provisions of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1), (2), and (4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder. Separately, Franzone is charged with aiding and abetting FFM's violations. The SEC seeks disgorgement of ill-gotten gains, civil penalties and permanent and conduct-based injunctive relief. The U.S. Attorney's Office for the Southern District of New York filed criminal charges against Franzone in a parallel action based on the same conduct.

C. Over-Touting Experience/Offering Fraud: *SEC v. Knight Nguyen Investments, et al.*

Investment advisers should beware to avoid misrepresentations regarding their experience, and must take care that their actions match their words to clients regarding their investment strategies. On May 13, 2021, the SEC filed a contested action in the U.S. District Court for the

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Southern District of Texas, charging investment adviser Knight Nguyen Investments ("KNI"), Christopher Knight Lopez ("Chris Lopez"), Forrest Andrew Jones and Jayson Lopez ("Jason Lopez") with scheming to invest funds from advisory clients and retail investors in at least five fraudulent securities offerings.[59]

The SEC alleges that KNI majority owner Chris Lopez and representative Jones held out the firm as an established investment adviser with expertise in low-risk alternative investments. The SEC also alleges that Chris Lopez and Jones largely targeted older and unsophisticated investors seeking to preserve or grow their retirement savings, telling them that KNI only invested in "proven" companies that met the firm's stated investment criteria.

According to the SEC's Complaint, however, Chris Lopez had no experience as a securities professional before forming KNI and the firm had little or no experience with alternative investments. In addition, the SEC alleges that investor funds were only placed in high-risk securities issued by companies that did not fit KNI's claimed investment criteria and were in fact owned or controlled by Chris Lopez and/or his brother Jayson Lopez. Moreover, KNI lacked written policies and procedures and failed to keep books and records, resulting in numerous misrepresentations related to KNI's assets under management, the failure to disclose conflicts of interest, and the violation of rules relating to registration requirements and custody of client funds.

The complaint charges KNI with violations of the registration provisions of Section 203A of the Investment Advisers Act of 1940, the antifraud provisions of Section 206(4) of the Advisers Act and Rules 206(4)-2 and 206(4)-7 thereunder arising from failure to properly take custody of client assets and establish appropriate policies and procedures, and the books and records provisions of Section 204 of the Advisers Act and Rule 204-2(a) thereunder. The complaint additionally charges KNI and Chris Lopez with violations of the antifraud provisions of Sections 206(1) and (2) of the Advisers Act, and charges KNI, Chris Lopez and Jones with violations of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933, and with violations of the broker-dealer registration provisions of Section 15(a) of the Exchange Act. Chris Lopez, Jayson Lopez and Jones are each all charged with aiding and abetting the violations of their co-defendants. The SEC seeks an order permanently enjoining defendants

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from further violations of the charged provisions and requiring them to pay disgorgement with prejudgment interest, and certain defendants to pay civil penalties pursuant to Section 20 of the Securities Act.

D. Misstatements Regarding Investment Risk: *SEC v. Caine et al.*

Advisers should take care that any statements made to investors regarding investment risk levels and risk management are accurate. On May 27, 2021, the SEC filed a contested action in the U.S. District Court for the Northern District of Illinois alleging that investment advisers LJM Funds Management Ltd. and LJM Partners Ltd. and their portfolio managers, Anthony Caine and Anish Parvataneni, fraudulently misled investors and the board of directors of a fund they advised about LJM's risk management practices and the level of risk in LJM's portfolios.[60] The SEC separately settled related charges with LJM's Chief Risk Officer, Arjuna Ariathurai.

According to the SEC's complaint, LJM adopted a short volatility trading strategy that carried risks that were remote but extreme. The complaint alleges that, in order to ease investor concerns about the potential for losses, LJM, Caine and Parvataneni made a series of misstatements to investors and the mutual fund's board about LJM's risk management practices, including false statements about its use of historical event stress testing and its commitment to maintaining a consistent risk profile instead of prioritizing returns. The complaint further alleges that, beginning in late 2017, during a period of historically low volatility, LJM, Caine and Parvataneni increased the level of risk in the portfolios in order to chase return targets, while falsely assuring investors that the portfolios' risk profiles remained stable. According to the complaint, in February 2018, the markets suffered a large spike in volatility, resulting in catastrophic trading losses exceeding $1 billion, or more than 80% of the value of the funds LJM managed, over two trading days.

The complaint charges the defendants with violating the antifraud provisions of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1) and (2) of the Investment Advisers Act of 1940. LJM Funds Management Ltd., Caine and Parvataneni have been additionally charged with violating the antifraud provisions of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. LJM Funds Management Ltd. and

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Parvataneni have been additionally charged with violating the antifraud provisions of Sections 15(c) and 34(b) of the Investment Company Act of 1940. Finally, LJM Funds Management, Ltd. has been charged with violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder for its compliance failures surrounding its risk management policies. The SEC's complaint and seeks permanent injunctions, disgorgement with prejudgment interest and civil penalties.

E. Conflicts of Interest / Policies and Procedures / Compliance: *In re Chandhoke et al.; In re MacDonald*

A recent pair of administrative enforcement actions brought by the Commission demonstrates its continued focused on the role of compliance professionals as gatekeepers, especially with regard to the prevention of conflict of interest transactions. On June 4, 2021, the SEC filed two actions related to the failure to prevent such transactions against an adviser, its principal and one of its compliance officials.

In re Chandhoke et al. First, on June 4, 2021, in a settled administrative enforcement proceeding action brought against VII Peaks Capital LLC ("VII Peaks"), a registered investment adviser, and Gurprit Chandhoke, the co-owner, co-principal, and managing member of VII Peaks, the SEC alleged a breach of fiduciary duty for failing to disclose certain transactions to the Board of Directors of VII Peaks Co-Optivist Income BDC II Inc. ("BDC"), to which VII Peaks acted as investment adviser. [61] Specifically, the SEC alleged that Respondents failed to disclose or seek approval to collect diligence fees for loans made by BDC to its portfolio companies. According to the SEC, the existence of this fee structure created an undisclosed material conflict of interest because Respondents were incentivized to cause the BDC to make loans to portfolio companies in order to generate the fees for themselves. Additionally, the SEC also alleged that Chandhoke caused BDC to enter into a number of transactions that benefitted him personally without disclosing the conflict of interest to the BDC board. Finally, the SEC alleged that VII Peaks had failed to implement its own valuation-related policies and procedures, resulting in a failure to update the value of certain assets on a quarterly basis in 2018.

In re MacDonald. Also on June 4, 2021, in a related administrative enforcement proceeding, the SEC charged VII Peaks Vice President of

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Compliance and BDC Chief Financial Officer Michelle MacDonald with causing VII Peaks to breach its fiduciary duty to BDC. [62] According to the SEC, on multiple occasions, when BDC received due diligence fees for loans it made to portfolio companies, MacDonald caused BDC to transfer payment of those fees to VII Peaks despite knowing that the agreements identified BDC as the recipient of the fees and not being aware of any obligation to transfer the fees to VII Peaks. MacDonald failed to disclose fee arrangement to BDC's board and failed to seek approval to have VII Peaks retain the fees.

Upon filing, the administrative proceedings against respondents VII Peaks, Chandhoke and MacDonald were fully settled. Each was charged with violating the antifraud provisions of Section 206(2) of the Investment Advisers Act of 1940. In addition, VII Peaks was charged with violating Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder for having failed to adopt appropriate policies and procedures, and Chandhoke was charged with violating the conflict of interest provisions of Section 57(a) of the Investment Company Act of 1940 and Rule 17d-1 thereunder. All respondents were ordered to cease and desist any further violations. VII Peaks received a censure and was ordered to pay disgorgement of $722,500, prejudgment interest of $123,199, and a civil penalty of $185,000. Chandhoke, for a period of 12 months, agreed to an associational suspension, investment company prohibition and penny stock suspension, and agreed to pay disgorgement of $87,500, prejudgment interest of $16,587, and a civil penalty of $90,000. MacDonald was ordered to pay a civil penalty of $20,000.

F. Failure to Disclose Conflicts of Interest: *In re Verus Capital Partners LLC*

The existence of financial incentives to maintain business relationships create conflicts of interest that must be disclosed. On June 7, 2021, the SEC announced a fully settled administrative enforcement proceeding against Verus Capital Partners, LLC ("Verus") for its failure to disclose revenue received by its investment adviser representatives ("IARs") from a third-party broker-dealer and its affiliates.[63]

The SEC alleged that Verus failed to disclose that its IARs had received more than $1 million in revenue in the form of forgivable loans between 2010 and 2020 from a broker-dealer and its affiliates, and that these transactions created a conflict of interest. The loans were forgivable over

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a period of five years or less, and the forgiveness was tied either to: (i) the satisfaction of annual revenue targets, which included both brokerage commission and advisory fees; or (ii) the maintenance of the relationship between the Verus IAR and the broker-dealer for a certain number of years. Because the existence of the loans created a direct incentive for Verus and its IARs to maintain a relationship with the broker-dealer in question, they created a conflict of interest that Verus was obligated to disclose.

Verus was charged with violating the antifraud provisions of Section 206(2) of the Investment Advisers Act of 1940, and was censured, ordered to comply with an undertaking to retain an independent compliance consultant, and ordered to pay a civil money penalty in the amount of $45,000.

G. Failure to Disclose Conflicts of Interest: *In re Intervest International Inc. et al.*

While it is acceptable, under certain circumstances, for investment advisers to use affiliated entities as brokers, such arrangements must be disclosed and otherwise comport with the adviser's obligation to seek best execution for their clients. On June 11, 2021, the SEC announced fully settled administrative enforcement proceedings against Intervest International Inc., a registered investment adviser, and Craig L. Carson, one of its investment adviser representatives.[64] The SEC alleged generally that both had breached their fiduciary duties in connection with purchases of certain unit investment trusts ("UITs") and shares of funds on behalf of Intervest advisory client accounts.

According to the SEC's order, from at least April 2016 through August 2019, Carson, on behalf of certain Intervest advisory client accounts, recommended and purchased UITs and Class A shares of mutual funds that included sales charges or front-end loads even though the accounts were eligible to purchase cheaper, identical versions of the UITs and funds. As a result of the purchases, the order finds, the advisory clients paid $378,295 in avoidable transaction costs. The order found that a wholly owned subsidiary of Intervest that acted as the introducing broker on the transactions collected these costs as commissions and passed on a portion to Carson, who also served as a registered representative of the subsidiary. As set forth in the order, Intervest and Carson did not adequately disclose to their advisory clients the conflicts of interest that

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arose from the purchases of the UITs and funds. The order also found that Intervest and Carson breached their duty to seek best execution for those transactions.

The SEC charged Intervest and Carson with violating the antifraud provisions of Section 206(2) of the Investment Advisors Act of 1940. Intervest and Carson were ordered to cease-and-desist, were censured, and were ordered to pay disgorgement with prejudgment interest of $130,489 and $304,396, respectively, and to pay civil penalties of $75,000 and $50,000, respectively.

H. False and Misleading Marketing: *SEC v. Jones*

The SEC continues to pursue fraud charges against investment advisers who falsely tout certain investment opportunities as "low risk." On June 29, 2021, the SEC filed a contested action in the U.S. District Court for the Northern District of Georgia against John Robert Jones, Jr., a registered investment adviser, in connection with his alleged fraudulent offer and sale of two private unregistered funds — PED Index Fund LP and PED Index Fund A1, LP — that Jones founded and controlled.[65]

According to the SEC's complaint, Jones induced at least 24 investors to invest at least $5.1 million in the two funds by falsely promising growth and safety with limited risk. From October 2017 through December 2018, Jones claimed that investors could lose only 10-15% of their principal investment, that investors' principal was insured, and that his investment strategy was created in concert with a purported national financial organization. As alleged, however, investors' downside exposure was not limited to 10-15%, there was no insurance protecting investors, and the national financial organization did not exist. The complaint further alleges that Jones received a 2% annual management fee, collecting at least $86,823, while investors lost approximately $2.6 million, or on average, 57% of their investments.

The SEC's complaint charges Jones with violations of the registration provisions of Sections 5(a) and (c), and the antifraud provisions of Sections 17(a)(1)-(3) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder and Section 206(4) of the Investment Advisers Act of 1940 and Rules 206(4)-8(a)(1)

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and (2) thereunder. The SEC is seeking an injunction, disgorgement of allegedly ill-gotten gains with interest and a civil penalty.

I. Misrepresentations Regarding Conflicts of Interest: *SEC v. SkiHawk Capital Partners LLC et al.*

Late in the quarter, the SEC announced charges related to a series of false representations relating to conflicts of interest and the value and condition of certain assets. On June 29, 2021, the SEC filed a contested action in the U.S. District Court for the District of Colorado against SkiHawk Capital Partners LLC ("SkiHawk"), a registered investment adviser, and The Convergence Group LLC ("TCG"), an unregistered investment adviser, along with Clement Borkowski and Sean Hawkins, the owners and managers of SkiHawk and owners of TCG, and Joseph Schiff, owner and CFO of TCG.[66]

According to the SEC's complaint, the defendants violated the securities laws in connection with three private funds. First, from 2016 to present, Borkowski and Hawkins, through SkiHawk, allegedly caused a private fund, ASI Healthcare Capital Partners I LP, to engage in conflicted transactions that resulted in significant financial benefits to themselves without adequate disclosure or consent. The SEC alleges that SkiHawk, Borkowski, and Hawkins made false and misleading statements to investors about both the existence of conflicts and the fund's review of those conflicts. Second, from 2016 to 2020, SkiHawk, TCG, Borkowski, and Hawkins allegedly made false and misleading statements to investors in another private fund, ASI Capital Income Fund LLC ("Income Fund"), by representing that bonds offered by that fund were secured by UCC-1 financing statements, when, in fact, they were not. Finally, the complaint alleges that SkiHawk, TCG, Borkowski, Hawkins, and Schiff overvalued assets held by the Income Fund and/or a third private fund, ASI Capital, LLC, and also falsely represented to investors that these funds' financial statements were prepared in accordance with generally accepted accounting principles.

The complaint charges all defendants with violations of the antifraud provisions of Sections 17(a)(1) and (3) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rules 10b-5(a) and (c) thereunder, and Sections 206(2), 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder. SkiHawk, TCG, Borkowski and

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Hawkins have been additionally charged with violating Section 17(a)(2) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5(b) thereunder. SkiHawk, Borkowski, and Hawkins have been further charged with violating Advisers Act Section 206(1). Finally, Schiff is charged with aiding and abetting the violations of the his co-defendants, and Borkowski and Hawkins have been charged in the alternative with aiding and abetting those violations. The SEC seeks permanent injunctions, disgorgement with prejudgment interest and civil penalties.

J. Policies & Procedures: *In re Securities America Advisors Inc.*

Advisers must be sure that they are not merely adopting appropriate policies and procedures in accordance with the SEC's requirements, but that those policies are actually being enforced. On June 30, 2021, the SEC announced fully settled administrative enforcement proceedings against Securities America Advisors Inc. ("SAA"), a Nebraska-based investment adviser, for failing to implement policies and procedures reasonably designed to protect the misappropriation of advisory client assets, which resulted in the misappropriation of millions of dollars from SAA's clients' advisory accounts.[67]

According to the SEC's Order, from November 2014 to March 2018, SAA adopted the policies of Securities America Inc. ("SAI") — the introducing broker for its advisory clients that is owned by the same parent company as SAA — for safeguarding client assets from misappropriation, and delegated to SAI responsibility for surveilling SAA advisory accounts. Three SAI units, the Financial Investigations Unit ("FIU"), Cashiering and Trade Support, held primary responsibility for identifying potential misappropriation of SAA client assets, but they failed to implement required policies and procedures. As set forth in the Order, FIU's automated Trade Monitor surveillance system generated multiple alerts for potentially suspicious withdrawals from client accounts, but its analysts failed to carry out the prescribed processes for investigating those alerts. Cashiering permitted disbursements without the required signatures, and Trade Support failed to contact clients to verify that they had initiated disbursement requests and, when they did carry out verification procedures, failed to obtain the required information from clients. As a result of these failures, the SEC charged that an individual whose clients participated in certain SAA advisory programs

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misappropriated, without SAA's detection, approximately $8 million from the SAA advisory accounts of at least 15 SAA advisory clients.

The SEC's order charged SAA with violating the policies and procedures focused provisions of Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder. SAA consented to the entry of an order censuring it and requiring it to cease and desist from further violations, comply with an undertaking to retain an independent compliance consultant, and pay a $1,750,000 civil monetary penalty.

Broker-Dealer Enforcement Actions

A. Market Manipulation: *SEC v. Spot Tech House Ltd. et al.*

Early in the second quarter of 2021, the SEC announced charges relating to a fraudulent scheme enacted by a broker-dealer that structured transactions intentionally designed to siphon money out of the hands of investors and into the hands of its partners. On April 16, 2021, the SEC filed a contested action in the U.S. District Court for the District of Nevada charging Spot Tech House Ltd. ("Spot"), Malhaz Pinas Patarkazishvili and Ran Amiran with implementing a scheme to deceive U.S. investors out of more than $100 million through fraudulent and unregistered online sales of risky securities known as binary options; according to the SEC, the defendants structured the licensing of their proprietary binary options platform such that they stood to gain whenever retail investors using their platform lost money.[68]

The complaint alleges that Spot — under the control of Patarkazishvili, the company's founder and former chief executive officer and Amiran, the company's former president — defrauded retail investors worldwide through a scheme involving the sale of online binary options, which permit investors to essentially bet one way or the other with regard to two possible outcomes (e.g., a publicly traded asset will be at or below a specific price at a specific time). The SEC alleges that the defendants developed nearly all of the products and services necessary to offer and sell these binary options, which were never registered with the SEC, through the internet, including a proprietary trading platform, and that they licensed these products and services to entities they called "white label partners," who directly marketed the binary options. Spot allegedly instructed its white label partners to aggressively market the binary

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options as a highly profitable investment for retail investors. As alleged, investors were not told that the defendants' white label partners were the counterparties on all investor trades; in other words, Spot did not disclose to its investors that its partners directly profited as a result of their losses. Furthermore, to ensure sufficient investor losses and thus increase the profitability of their scheme, Spot allegedly instructed its partners to permit investors to withdraw only a portion of the monies they had deposited, and devised a manipulative payout structure for binary options trades that was designed to ensure that retail investors stood to gain less on trades that they won than they stood to lose on trades that they lost. According to the SEC, these actions were taken to increase the probability that investors' binary options trades would expire as worthless, generating a windfall for Spot's white label partners. The defendants allegedly made millions in profit as a result of this scheme.

The complaint charges defendants with violations of the registration-based provisions of Sections 5(a) and (c) of the Securities Act of 1933. Spot has been additionally charged with violating the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and of Section 17(a) of the Securities Act of 1933. Defendants Patarkazishvili and Amiran have been additionally charged with control person liability under Section 20(a) of the Exchange Act in relation to the 10(b) and 10b-5 charges against Spot. The SEC seeks disgorgement of ill-gotten gains, prejudgment interest, financial penalties and permanent injunctions against all three defendants.

B. FINRA Levies Record-Setting Penalty: *In re Robinhood Financial LLC*

FINRA announced a record-setting settlement against in-the-news broker-dealer Robinhood for a host of failures relating to its diligence of its technology and its failure to adequately communicate with its customers. On June 30, 2021, FINRA fully settled charges against Robinhood Financial LLC ("Robinhood"), fining Robinhood a record-setting approximately $70 million, plus interest, in connection with "widespread and significant harm suffered by customers" on the platform.[69] We expect this may be just the first of a number of actions arising from recent headlines regarding Robinhood and the associated trading of "meme" stocks.

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Specifically, FINRA charged that Robinhood had negligently communicated false and misleading information to its retail customers, pushing membership status upgrades that were unnecessary while falsely telling consumers that they could only trade on margin if they upgraded to "Robinhood Gold Status." FINRA also found that Robinhood displayed inaccurate cash balances to certain customers that were sometimes significant. Additionally, FINRA highlighted Robinhood's allegedly false claim that customers would "never lose more than the premium paid to enter [a] debit spread," when in fact customers could and did lose vastly more than the premiums paid. Finally, FINRA found that Robinhood issued erroneous margin calls to certain customers, informing them that they were in "danger of a margin call" when they were not. Moreover, FINRA flagged Robinhood's failure to exercise due diligence before approving options accounts, finding that Robinhood's bots responsible for approving options trading by customers had minimal oversight and featured certain programming flaws that resulted in approval of customers for options trading who did not satisfy Robinhood's eligibility criteria for such trading.

Relatedly, FINRA charged that, between January 2018 and February 2021, Robinhood failed to reasonably supervise the operation and maintenance of its technology, outsourcing such oversight to its parent company, Robinhood Markets Inc., which is not a FINRA member firm and is not subject to broker-dealer oversight. As a result, FINRA explained, when Robinhood experienced a number of outages and system failures between 2018 and 2020, it could not provide its customers with basic broker-dealer services such as order entry and execution. Relatedly, FINRA also found that Robinhood's business continuity plan was not reasonably designed to allow it to meet its obligations to customers in the midst of a significant disruption, as is required by FINRA Rule 4370. Finally, FINRA found cause for concern in Robinhood's failure to identify and disclose its customers, to report any customer complaints to FINRA as required by FINRA Rules 4530(d) and 2010, and to display complete market data on its website and mobile applications as required by Rule 603(c) of the Exchange Act's Reg NMS and FINRA Rule 2010.

Robinhood settled the matter with FINRA and, as a result of FINRA's numerous concerns, accepted a censure, a $57 million fine, restitution of $12,598,445, and an undertaking to retain a third-party consultant at its own expense to conduct a comprehensive review of Robinhood's compliance functions in connection with all areas identified by FINRA.

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Other Enforcement Actions

A. Digital Asset Offering Fraud: *SEC v. Radjabli et al.*

The SEC recently pursued sweeping charges arising out of a series of securities frauds that included claims of offering fraud relating to digital assets. On June 11, 2021, the SEC announced a settled action, filed in the U.S. District Court for the District of South Carolina, against Edgar Radjabli and two entities he controlled with engaging in three separate securities frauds.[70]

The SEC's complaint alleges three separate frauds. First, that Radjabli, formerly a practicing dentist, and Apis Capital Management LLC ("Apis Capital"), an unregistered investment adviser that Radjabli owned and controlled, conducted a fraudulent offering of Apis Tokens, a digital asset representing tokenized interests in Apis Capital's main investment fund. Second, the complaint further alleges that Radjabli and Apis Capital manipulated the securities market for Veritone Inc., a publicly traded artificial intelligence company, by announcing in December 2018 an unsolicited cash tender offer to purchase Veritone for $200 million, when, in truth, Radjabli and Apis Capital lacked any reasonable prospect of obtaining the financing needed to complete such and acquisition. Finally, the complaint alleges that Radjabli raised nearly $20 million from more than 450 investors in an unregistered, fraudulent securities offering launched in August 2019, through My Loan Doctor LLC ("Loan Doctor"). Radjabli falsely represented that investor funds raised by Loan Doctor would be used to originate loans to healthcare professionals, but, instead, invested the funds in unsecured and uninsured loans to digital asset lending firms, including a loan of almost $1.8 million to Apis Capital.

The SEC charged all defendants with violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Radjabli and Apis Capital were also charged with violations related to the commission of fraud in connection with a tender offer pursuant to Exchange Act Section 14(e) and Rule 14e-8 thereunder, and the antifraud provisions of Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder. Finally, Radjabli and Loan Doctor were charged with violating the registration provisions of Securities Act Sections 5(a) and (c).

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The defendants have agreed to a settlement, which is subject to court approval. The settlement would hold Radjabli, Apis Capital, and Loan Doctor jointly and severally liable for $600,000 in monetary relief, composed of $162,800 in disgorgement, $17,870 in prejudgment interest, and $419,330 in civil penalties. The settlement would also permanently enjoin Radjabli, Apis Capital, and Loan Doctor from violating the charged provisions of the federal securities laws, impose a conduct-based injunction and penny stock bar on Radjabli, and bar Radjabli from the securities industry.

B. ICO Fraud: *SEC v. Hamid et al.*

The SEC appears increasingly attuned to the presence of unsavory actors in the digital asset markets. On June 15, 2021, the SEC filed a partially settled action in the U.S. District Court for the District of New Jersey against Ali Asif Hamid, Michael Gietz and Cristine Page for their roles in a $30 million initial coin offering ("ICO") fraud that was spearheaded by convicted criminal Boaz Manor and his associate, Edith Pardo.[71] The SEC previously charged Manor, Pardo and their companies, CG Blockchain Inc. and BCT Inc. SEZC in connection with the scheme in January 2020.

According to the Complaint, Hamid, Gietz and Page all had leadership roles in an ICO that would purportedly fund the development of technology to trade digital assets, while at the same time actively hiding Manor's role as the head of this venture. As alleged in the complaint, the three defendants knew that Manor was a convicted criminal at the center of a widely publicized Canadian hedge fund collapse. To conceal Manor's involvement and his history from investors, they used Manor's chosen alias, "Shaun MacDonald," in ICO related-communications and helped create and distribute materially misleading ICO marketing materials, which omitted any reference either to Manor or to the fictional "MacDonald" and instead touted a purported "executive team" of individuals who, in reality, had no senior managerial authority over the business.

The complaint charges all three defendants with violations of the registration provisions of Sections 5(a) and (c) of the Securities Act of 1933, as well as the antifraud provisions of Sections 17(a)(1) and (3) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. All defendants were charged in the alternative

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with aiding and abetting the antifraud-related charges. The complaint seeks disgorgement of ill-gotten gains plus prejudgment interest, penalties and injunctive relief.

The matter is being fully contested by Hamid and Gietz, but has been settled, pending court approval, by Page. Page's settlement includes permanent injunctions, disgorgement of the digital assets that she received in connection with her misconduct and a civil penalty of $192,768.

C. Unregistered ICO: *In re Loci Inc. et al.*

The SEC's Enforcement Division continues to demonstrate increased interest in ensuring that the registration requirements of the federal securities laws are observed with regard to the offering of digital assets deemed to be securities. On June 22, 2021, the SEC announced fully settled administrative enforcement proceedings against Loci Inc. ("Loci") and its founder and Chief Executive Officer John Wise.[72]

The SEC alleged that, from August 2017 to January 2018, Loci, the developer of a software platform called InnVenn, raised $7.6 million by offering and selling digital tokens called "LOCIcoin" through an unregistered and fraudulent initial coin offering ("ICO"). In promoting the ICO, the SEC alleged that Loci and Wise made numerous materially false and misleading statements, touted the value of LOCIcoin to investors, highlighted their efforts to make LOCIcoin available for trading on digital asset trading platforms, and claimed that LOCIcoin would increase in price as a result of their efforts. According to the SEC, these efforts and representations tend to show that LOCIcoin were offered and sold as investment contracts under the test set out in *SEC v. W. J. Howey Co.*, and are therefore securities. The SEC argued that a purchaser in the offering of LOCIcoin would have had a reasonable expectation of obtaining a future profit based upon Loci's and Wise's efforts, including, among other things, efforts to create demand and market appreciation for LOCIcoin.

LOCIcoin and Wise were charged with violating the registration provisions of Sections 5(a) and (c) of the Securities Act of 1933, and the antifraud provisions of Securities Act Section 17, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Pursuant to their settlement, the respondents agreed to destroy all LOCIcoin in their

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possession or control within ten days of the order, issue requests to remove LOCIcoin from any further trading on all digital trading platforms, and refrain from participating in any offering of a digital asset security, except that Wise may purchase or sell digital assets for his own personal account. Wise agreed to be barred from serving as an officer or director and to pay disgorgement of $38,163 with prejudgment interest of $6,209.40. Loci agreed to a civil money penalty of $7,600,000.

D. FCPA Violations: *In re Amec Foster Wheeler Ltd.*

Following on its headlining enforcement of the Foreign Corrupt Practices Act ("FCPA") in Q1, the SEC continues to demonstrate its attention to policing the foreign dealings of issuers. On June 25, 2021, the SEC announced fully settled administrative enforcement proceedings against Amec Foster Wheeler Limited for violating the anti-bribery, books and records and internal accounting controls provisions of the FCPA.[73]

Between 2012 and 2014, the SEC alleged that Amec's UK subsidiary, Foster Wheeler Energy Limited ("FWEL"), made improper payments to Brazilian officials in connection with efforts to win a contract with the Brazilian state-owned oil company, Petróleo Brasileiro S.A. — Petrobras. The bribes were allegedly made through third-party agents, including one agent who failed Amec's due diligence process for prospective sales agents, but was nonetheless allowed to "unofficially" continue working on the project. Amec, through FWEL, is alleged to have paid approximately $1.1 million in bribes in connection with the Brazilian contract; Amec allegedly obtained a benefit of over $17.6 million as a result of these bribes. Moreover, the SEC charged that none of the allegedly improper payments were accurately recorded in Amec's books and records, and that Amec did not have sufficient internal accounting controls in place to detect or prevent the misconduct.

The SEC's Order charged AMEC with violations of the foreign bribery provisions of Section 30A of the Securities Exchange Act of 1934, the books and record provisions of Section 13(b)(2)(A) of the Exchange Act, and the provisions relating to the maintenance of internal accounting controls of Section 13(b)(2)(B) of the Exchange Act. In settling the matter, Amec agreed to a cease-and-desist order, disgorgement of $17,656,302, and prejudgment interest of $5,107,985. The SEC's order provides for offsets for up to $9.1 million of any disgorgement paid to the

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Controladoria-Geral da Uniao / Advocacia-Geral da Uniao and the Ministerio Publico Federal of Brazil and up to $3.5 million of any disgorgement paid to the Serious Fraud Office of the United Kingdom. Therefore, Amec's minimum payment to the SEC would be approximately $10.1 million. In a related settlement, FWEL entered into a three-year deferred-prosecution agreement with the DOJ and agreed to an $18,375,000 criminal fine.

Closing Thoughts

In the second quarter of 2021, the new leadership of the financial regulators demonstrated their commitment to exercise increased oversight of emerging technologies in the financial services space while aggressively pursuing traditional priorities. The SEC's focus on digital assets and gamification, along with FINRA's strong signal to FinTech firms with its charges against Robinhood, are intended to signal that the "wild west" era experienced by participants in these markets in their earliest days may be coming to an end. As we noted in our inaugural Securities Enforcement Quarterly, we continue to anticipate that regulators of the financial services industry will continue scrutinizing market participants to ensure the existence of robust regulatory controls while marrying that focus with new priorities, with an eye towards emerging technologies and their impact on markets.

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[1] SEC Press Release 2021-114, *SEC Appoints New Jersey Attorney General Gurbir S. Grewal as director of enforcement*, June 29, 2021, available here.

[2] Gary Gensler, *Prepared Remarks at the Global Exchange and FinTech Conference*, June 9, 2021, available here. ("Gensler FinTech June 9.")

[3] *Id*.

[4] Gary Gensler, *Testimony Before the Subcommittee on Financial Services and General Government*, May 6, 2021, available here.

[5] *Id.*

[6] Gensler FinTech June 9.

[7] Gary Gensler*, Prepared Remarks at London City Week*, June 23, 2021, available here. ("Gensler June 23 Remarks.")

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[8] Allison Herron Lee, *Public Input Welcomed on Climate Change Disclosures*, March 15, 2021, available here.

[9] Gensler June 23, 2021 remarks.

[10] Andrew Ramonas, *SEC Readying New Company Workforce Disclosures, Gensler Says*, Bloomberg Law, May 13, 2021, available here.

[11] Gensler June 23, 2021 remarks.

[12] *Id*.

[13] Gary Gensler, *Prepared Remarks CFO Network Summit*, June 7, 2021, available here.

[14] *Id*.

[15] *See* SEC Press Release, *SEC Announces Annual Regulatory Agenda*, June 11, 2021, available here.

[16] Gary Gensler, *Statement on the Application of the Proxy Rules to Proxy Voting Advice*, June 1, 2021, available here.

[17] Hester M. Peirce and Elad L. Roisman, *Response to Chair Gensler's and the Division of Corporation Finance's Statements Regarding the Application of the Proxy Rules to Proxy Voting Advice*, June 1, 2021, available here. In addition to objecting to possible reversal of prior SEC actions, these commissioners mentioned notable omissions from Chair Gensler's formal agenda, in particular the absence of digital assets from the priority list.

[18] *See,* e.g., FIN-2019-G001, *Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies*, May 9, 2019, available here (consolidating current FinCEN regulations, related administrative rulings and guidance issued since 2011, to common business models involving convertible virtual currency).

[19] Zach Church, *Biden SEC Pick Gary Gensler on Fintech, Regulation, and Blockchain*, *MIT Management; Thinking Forward Newsletter*, Jan. 21, 2021, available here.

[20] Bob Pisani, *Gary Gensler Has a Full Agenda as He Gets Set to Take Over the SEC*, *CNBC*, April 14, 2021, available here.

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[21] CNBC, *Gensler on Cryptocurrencies: Investors Do Not Have Full Protection*, June 9, 2021, available here.

[22] *Id.*

[23] SEC Press Release No. 2021-99, *SEC Announces Annual Regulatory Agenda*, June 11, 2021, available here.

[24] SEC Commissioner Hester M. Peirce & SEC Commissioner Elad L. Roisman, *Moving Forward or Falling Back? Statement on Chair Gensler's Regulatory Agenda*, June 14, 2021, available here.

[25] SEC Press Release No. 2020-338, *SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering*, Dec. 22, 2020, available here.

[26] SEC Litigation Release No. 25060, *SEC Charges New Hampshire Issuer of Digital Asset Securities with Registration Violations*, March 29, 2021, available here.

[27] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The *Howey* test asks whether the instrument in question is (1) an investment in (2) a common enterprise with (3) the expectation of profits (4) based on the efforts of a promotor or a third party. *See id* at 297–300.

[28] Answer of Def. Ripple Labs, Inc. to Pl's. First Am. Compl. ("Ripple Answer"), 5–8, *SEC v. Ripple Labs, Inc. et al.*, No. 20 Civ. 10832 (S.D.N.Y. Feb. 18, 2021).

[29] *Id.* at 6.

[30] *Id.* at 91.

[31] *Id.*

[32] SEC Press Release 2021-90, *SEC Charges U.S. Promoters of $2 Billion Global Crypto Lending Securities Offering*, May 28, 2021, available here.

[33] *Id.*

[34] Complaint, *SEC v. Brown et al.*, Case No. 1:21-cv-04791, ¶¶ 1–2 (S.D.N.Y. May 28, 2021).

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[35] Ryan Browne, *Bitcoin surges 18% after a wild day that saw the cryptocurrency briefly drop below $30,000*, CNBC, June 23, 2021, available here.

[36] Joanna Ossinger, *Bitcoin Drops as Hashrate Declines With China Mining Crackdown*, Bloomberg, June 20, 2021, available here.

[37] *See* Securities and Exchange Commission, Press Release, *SEC Charges Investment Advisers With Cherry-Picking, Obtains Asset Freeze*, June 17, 2021, available here; Securities and Exchange Commission, Press Release, *Six Charged in Silicon Valley Insider Trading Ring*, June 15, 2021, available here; Securities and Exchange Commission, Press Release, *SEC Charges Investment Adviser and Its Coo with Defrauding Clients*, June 29, 2021, available here. *See also* Securities and Exchange Commission, Press Release, *SEC Charges Hedge Fund Trader in Lucrative Front-Running Scheme*, July 2, 2021, available here.

[38] Complaint, *SEC v. Sugranes et al.*, Docket No. 1:21-cv-22152, (S.D. Fla. June 10, 2021), available here.

[39] Complaint, *SEC v. Paris et al.*, Docket No. 1:21-cv-03450 (N.D. Ill. June 28, 2021), available here.

[40] Complaint, *SEC v. Wygovsky*, Docket No. 1:21-cv-05730 (S.D.N.Y. July 2, 2021), available here.

[41] *United States v. Whitman*, 904 F. Supp. 2d 363, 367 n.1 (S.D.N.Y. 2012) (Rakoff, J.).

[42] Press Release, U.S. Attorney's Office for the S. Dist. of N.Y., *Four Charged in Scheme to Commit Insider Trading Based on Confidential Government Information* (May 24, 2017), available here.

[43] Another law, the Stop Trading on Congressional Information Act ("STOCK Act") addresses insider trading in the context of material nonpublic information originating from Congress. For more details, see our prior alert, available here. The STOCK Act is not implicated in *Blaszczak*.

[44] *United States v. Blaszczak*, 947 F.3d 19, 35 (2d Cir. 2019), *cert. granted and judgment vacated*, 141 S. Ct. 1040 (2021).

[45] *Dirks v. SEC*, 463 U.S. 646, 663 (1983).

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[46] *United States v. Newman*, 773 F.3d 438, 450 (2d Cir. 2014), *overruled on other grounds*, *Salman v. United States*, 137 S. Ct. 420 (2016).

[47] *Blaszczak*, 947 F.3d at 35 (quoting *Dirks*, 463 U.S. at 662).

[48] *Id.* at 35-36 (quoting *United States v. O'Hagan*, 521 U.S. 642, 654 (1997)).

[49] *Id.* at 30-34, 39-40.

[50] *Kelly v. United States*, 140 S. Ct. 1565 (2020).

[51] *Id.* at 1573-74.

[52] *Olan v. United States*, 141 S. Ct. 1040 (2021); *Blaszczak v. United States*, 141 S. Ct. 1040 (2021).

[53] C*arpenter v. United States*, 484 U.S. 19 (1987).

[54] *United States v. Girard*, 601 F.2d 69, 71 (2d Cir. 1979) (affirming defendant's conviction under § 641).

[55] *Hammerschmidt v. United States*, 265 U.S. 182, 185 (1924).

[56] SEC Litigation Release No. 25070, *SEC Charges IIG Co-Founder Martin Silver With Fraud*, April 15, 2021, available here.

[57] In February 2021, Hu consenb- ted to the entry of partial judgment enjoining him from violating the antifraud provisions of Sections 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 105 thereunder, and Sections 206(1) and (2) of the Investment Advisers Act of 1940, and barring him from associating with any regulated entity.

[58] SEC Litigation Release No. 25081, *SEC Charges Fund Manager and Former Race Car Team Owner with Multimillion Dollar Fraud*, April 23, 2021, available here.

[59] SEC Litigation Release No. 25089, *SEC Charges Texas Investment Adviser and Three Individuals with Defrauding Advisory Clients and Retail Investors*, May 13, 2021, available here.

[60] SEC Litigation Release No. 25101, *SEC Charges Mutual Fund Executives with Misleading Investors Regarding Investment Risks in Funds That Suffered $1 Billion Trading Loss*, May 28, 2021, available here.

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[61] *Chandhoke et al.*, Securities Exchange Act of 1934 Release No. 92114, June 4, 2021, available here.

[62] *MacDonald*, Investment Advisers Act of 1940 Release No. 5747, June 4, 2021, available here.

[63] *Verus Capital Partners LLC*, Investment Advisers Act of 1940 Release No. 5748, June 7, 2021, available here.

[64] *Intervest International Inc. et al.*, Securities Exchange Act of 1934 Release No. 92166, June 14, 2021, available here.

[65] SEC Litigation Release No. 25125, *SEC Charges Investment Adviser with Fraudulent Offer and Sale of Unregistered Funds*, June 29, 2021, available here.

[66] SEC Litigation Release No. 25128, *SEC Charges Investment Advisers and Others with Fraud in Offering and Managing Private Funds*, June 30, 2021, available here.

[67] *Securities America Advisors Inc.*, Investment Advisers Act of 1940 Release No. 5762, June 30, 2021, available here.

[68] SEC Litigation Release No. 25073, *SEC Charges Binary Options Trading Platform and Two Top Controlling Executives with Fraudulent and Unregistered Offers and Sales of Securities*, April 19, 2021, available here.

[69] FINRA News Release, *FINRA Orders Record Financial Penalties Against Robinhood Financial LLC*, June 30, 2021, available here.

[70] SEC Litigation Release No. 25115, *SEC Charges Dentist-Turned-Investment Adviser for Three Separate Frauds*, June 11, 2021, available here.

[71] SEC Litigation Release No. 25117, *SEC Charges Additional Defendants in $30 Million ICO Fraud*, June 15, 2021, available here.

[72] *Loci Inc. et al.*, Securities Act of 1933 Release No. 10950, June 22, 2021, available here.

[73] *Amec Foster Wheeler Limited*, Securities Exchange Act of 1934 Release No. 92259, June 25, 2021, available here.

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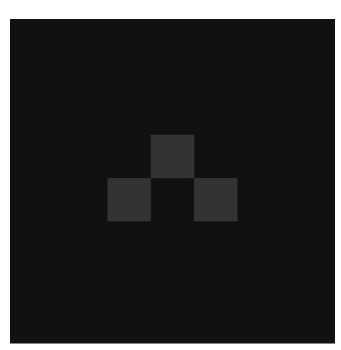

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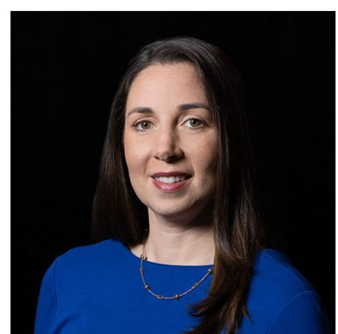

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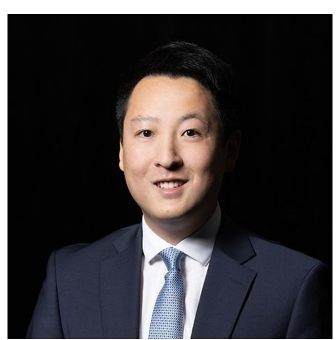

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