ROPES & GRAY ALERT

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The SEC Speaks 2017: Division of Enforcement Highlights

At the SEC Speaks 2017 conference, held in Washington, D.C. from February 24-25, 2017, senior Securities and Exchange Commission ("SEC") officials shared their observations about the SEC's Division of Enforcement's ("Division") activity over the past year and what they believe the legal and business community should expect from the Division in coming years. Over the course of two panels dedicated to the Division, panelists[1] discussed key enforcement trends and priorities across the following subject areas: market abuse, public finance, broker-dealers, asset management, financial reporting and audit, the FCPA, and the OTC markets. The panelists also provided the SEC defense bar with guidance regarding effective legal advocacy, cooperation, and recommendations for dealing with whistleblowers, while further describing certain of the Division's investigatory tactics and litigation strategies. The SEC defense bar and those subject to SEC oversight should carefully review and learn from the panelists' remarks, as such lessons will likely be helpful in near-term investigations and enforcement actions.

I. Enforcement Trends and Priorities

A. Market Abuse

Joseph Sansone (Co-Chief, Market Abuse Unit) discussed recent cyberfraud and insider trading cases that involved the hacking or theft of information from law firms, news services, and other employers.[2] Mr. Sansone predicted that hacking incidents will likely increase, and that hackers will target more than just law firms and news services, so individuals and companies must exercise continued vigilance to protect against such attacks.

Significantly, Stephanie Avakian (Acting Director, Division of Enforcement) added that even though it has not yet done so, the Division may consider whether institutions that are victims of future hacking incidents should be the subject of an action relating to disclosures about the policies, procedures and other protections that the institution implemented to prevent such attacks. Ms. Avakian also claimed that the insider trading cases premised upon hacking incidents were notable because they were premised not on a classical misappropriation theory, but on the deceptive conduct used to obtain the information from the victim firms.

B. Public Finance

[1] The participants of the panels focusing on the Division included, among others, Stephanie Avakian (Acting Director, Division of Enforcement), Joseph K. Brenner (Chief Counsel, Division of Enforcement), Bridget Fitzpatrick (Acting Co-Chief Litigation Counsel, Division of Enforcement), David Gottesman (Acting Co-Chief Litigation Counsel, Division of Enforcement), Joseph Sansone (Co-Chief, Market Abuse Unit, Division of Enforcement), LeeAnn G. Gaunt (Chief, Public Finance Abuse Unit, Division of Enforcement), Jane A. Norberg (Chief, Office of the Whistleblower, Division of Enforcement), Andrew M. Calamari (Co-Chair, Broker-Dealer Task Force and Regional Director, New York Regional Office, Division of Enforcement), Antonia Chion (Co-Chair, Broker-Dealer Task Force and Associate Director, Home Office, Division of Enforcement), C. Dabney O'Riordan (Co-Chief, Asset Management Unit, Division of Enforcement), Margaret McGuire (Chief, Financial Reporting and Audit Group, Division of Enforcement), Charles E. Cain (Deputy Chief, FCPA Unit, Division of Enforcement), Jason R. Berkowitz (Co-Chief, Microcap Fraud Task Force, Division of Enforcement), and Lori Walsh (Chief, Center for Risk and Quantitative Analytics).

[2] *See, e.g.*, Complaint, *SEC v. Hong*, No. 1:16-CV-9947 (S.D.N.Y. Dec. 27, 2016); Complaint, *SEC v. Dubovoy*, No. 2:15-CV-6076 (D.N.J. Aug. 10, 2015).

LeeAnn G. Gaunt (Chief, Public Finance Abuse Unit) explained that one of the top priorities for the Public Finance Abuse Unit is offering and disclosure fraud. Offering and disclosure fraud involving municipal bonds was an especially high priority because municipal bonds are typically exempt from registration and are not subject to periodic reporting requirements (e.g., 10-Ks and 8-Ks), and most investors in these securities are retail investors, including many senior citizens. Ms. Avakian added that in actions against municipal issuers, the Division typically seeks penalties that will not hurt taxpayers, such as user fees from the New York Port Authority.[3] However, in some cases, penalties might be appropriate where the municipal issuer is a recidivist, such as the City of Miami.[4]

Ms. Gaunt also stated that identifying and eliminating public corruption is another top priority for her unit. The Division is especially interested in investigating pay-to-play schemes and improper payments to government officials, such as in the recent complaint filed against Navnoor Kang, the former Director of Fixed Income for the New York State Common Retirement Fund, who allegedly received improper benefits, entertainment, and travel from broker-dealers in exchange for directing public pension trades to the broker-dealers.[5]

C. Broker-Dealers

Antonia Chion (Co-Chair, Broker-Dealer Task Force and Associate Director, Home Office) noted that compliance with Bank Secrecy Act (BSA) reporting requirements, including Suspicious Activity Reports (SARs), is a priority for the Broker-Dealer Task Force. In 2016, the Division brought its first action against a broker-dealer for failure to file SARs,[6] and the Division also brought an action against a company's AML officer for causing violations of the BSA by his employer and for aiding and abetting such violations.[7] Ms. Chion explained that one key takeaway from these cases is that the requirement to file an SAR does not depend on absolute knowledge that a transaction is facilitating bad activity, only that a person knows of, or has reason to suspect fraudulent activity. Ms. Chion cautioned that companies and individuals should watch for red flags, which have been described in guidance from OCIE, FinCen, and SROs (e.g., NASD 02-21).

Andrew M. Calamari (Co-Chair, Broker-Dealer Task Force and Regional Director, New York Regional Office) stated that the Division has developed a new theory for bringing actions against brokers for excessive trading in client accounts. Rather than relying on a theory that a broker controlled an account, the Division can also charge a broker under Section 17(a) and 10(b) for employing a trading strategy that is not suitable for the broker's client if: 1) the broker dictates the trading strategy for certain accounts, 2) that strategy has no reasonable likelihood of success given the costs associated with the trading strategy, and 3) the broker knew or should have known this.[8] Mr. Calamari said that the Division has several other cases involving suitability in the pipeline, so this will likely be an area of increased scrutiny for brokers in 2017 and beyond.

D. Asset Management

C. Dabney O'Riordan (Co-Chief, Asset Management Unit) explained that the Asset Management Unit has different focus areas for each of its three primary regulated parties: retail investments, registered investment advisors, and private funds. With respect to retail investments, the Division is focused on undisclosed fees, expenses, and conflicts

[3] *In re Port Auth. of New York and New Jersey*, Securities Act Release No. 10278 (Jan. 10, 2017).
[4] *See* Press Release, Sec. & Exch. Comm'n, Statement on Jury's Verdict in Trial of the City of Miami and Michael Boudreaux (Sept. 14, 2016).
[5] Complaint, *SEC v. Kang*, No. 16-cv-9829 (S.D.N.Y. Dec. 21, 2016).
[6] *In re Albert Fried & Co, LLC*, Exchange Act Release No. 77971 (June 1, 2016).
[7] *In re Windsor Street Capital, L.P.*, Securities Act Release No. 10293, Exchange Act Release No. 79877, Investment Company Act Release No. 32451 (Jan. 25, 2017).
[8] Complaint, *SEC v. Dean*, No. 1:17-CV-139 (S.D.N.Y. Jan. 9, 2017). According to Mr. Calamari, the trading strategy used by Mr. Dean and Mr. Fowler had no reasonable likelihood of success because the broker would have had to make a 100 percent return to offset the fees to the customer from excessive trading. *Id.*

of interests by fund advisors and brokers. In addition, Ms. O'Riordan identified three types of allocation issues where advisors should expect to see more scrutiny 1) whether advisors allocate more favorable trades to their own accounts rather than to their clients, 2) whether advisors allocate more favorable trades to accounts where the advisors earn higher fees, and 3) whether advisors allocate trades in a manner inconsistent with its disclosures to clients or with its policies and procedures.

Ms. O'Riordan anticipated that the Division will continue to scrutinize registered investment companies regarding valuation, fund governance, and compliance issues. As illustrated in two recent cases, the Division will charge such companies for a mutual fund's failure to accurately value certain bonds, a failure to provide information about the source of performance for an ETF, a failure to accurately value positions in mortgage-backed securities, and a failure to follow the advisors' own policies and procedures when correcting previously identified accurate valuations.[9]

Ms. O'Riordan expected the Asset Management Unit to continue to investigate whether private investment funds properly valued fund assets, disclosed fees, and allocated trades. Recent cases dealing with these issues involve the use of sham broker quotes to artificially inflate valuations of private fund assets[10] and a failure to supervise a principal who improperly allocated personal expenses to funds.[11]

Ms. O'Riordan also predicted that the Asset Management Unit will continue to scrutinize gatekeepers of private investment funds. In a recent case, for example, an accounting firm and one of its partners settled charges that they failed to exercise due care during audit examinations of an investment adviser whose President had been misappropriating client funds.[12]

E. Financial Reporting and Audit

Margaret McGuire (Chief, Financial Reporting and Audit Group (FRAud)) noted that FRAud's key areas of interest have been deceptive tax accounting, rebate accounting, warranty accruals, loan losses and impairments. In addition, Ms. McGuire noted that FRAud will continue to evaluate the internal controls of both issuers and auditors. Certain issuers, however, may receive more scrutiny than others, as FRAud has identified approximately 300 issuers of interest as part of its Monitoring Initiative. After FRAud's liaisons work with the regional offices to conduct a detailed analysis on these issuers, FRAud and the regional offices will work together to determine if an issuer should be subject to further investigation.

F. FCPA

Charles Cain (Deputy Chief, FCPA Unit) stated that the SEC defense bar and regulated parties should be aware of increasing international cooperation in the FCPA space. In several actions during 2016 and 2017, the Division received substantial assistance from foreign regulators.[13] The Division has also taken steps to further this international cooperation by providing foreign bribery training to more than 100 foreign prosecutors from more than 70 agencies located in more than 35 jurisdictions.

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[9] *In re Pac. Inv. Mgmt. Co. LLC*, Investment Advisers Act Release No. 4577, Investment Company Act Release No. 32376 (Dec. 1, 2016); *In the Matter of Calvert Inv. Mgmt., Inc.*, Investment Advisers Act Release No. 4554, Investment Company Act Release No. 32321 (Oct. 18, 2016).
[10] Complaint, *SEC v. Lumiere*, No. 1:16-CV-4513 (S.D.N.Y. June 15, 2016).
[11] *In re Apollo Management V, L.P.*, Investment Advisers Act Release No. 4493 (Aug. 23, 2016).
[12] *In re Santos*, Exchange Act Release No. 77745, Investment Advisers Act Release No. 4380, Accounting and Auditing Enforcement Release No. 3772 (Apr. 29, 2016).
[13] *See, e.g.*, Press Release, Sec. & Exch. Comm'n, SEC Charges Two Former Och-Ziff Executives With FCPA Violations (Jan. 26, 2017); Press Release, Sec. & Exch. Comm'n, VimpelCom to Pay $795 Million in Global Settlement for FCPA Violations (Feb. 28, 2016); Press Release, Sec. & Exch. Comm'n, Embraer Paying $205 Million to Settle FCPA Charges (Oct. 24, 2016).

In one of the most direct statements about future enforcement trends by a panelist, Mr. Cain said that the public is likely to see more FCPA investigations and enforcement actions in the financial sector. In addition, he said that the Division will continue to leverage its cooperation tools, such as NPAs and DPAs, to secure settlements with individuals.

G. OTC Markets (Berkowitz)

Jason R. Berkowitz (Co-Chief, Microcap Fraud Task Force) identified a growing trend of cases involving schemes that target senior citizens, such as pump and dump schemes. Going forward, Mr. Berkowitz expects that schemes targeting seniors, offshore schemes, gatekeepers, and recidivist conduct will likely be key areas of focus for the Division's enforcement of OTC markets.

II. Guidance

A. Legal Advocacy

Joseph K. Brenner (Chief Counsel, Division of Enforcement) advised legal practitioners that in investigations and proceedings with the Division, legal arguments relying on decisions of the Commission are likely to be more persuasive than decisions of federal courts. In other words, absent a binding opinion from the U.S. Supreme Court, the Division tends to rely on the Commission's prior guidance and decisions. In spite of these statements, Mr. Brenner cautioned that federal court decisions are still significant, especially when litigating with the Division in federal court, when the Commission has not addressed a topic, or when the district court might disagree with the Commission.

Mr. Brenner also detailed how the Division's views on three issues have been illustrated in recent cases. First, Mr. Brenner explained that with respect to negligence-based claims, whether conduct is reasonable depends on the circumstances. For example, reasonableness may require more from someone who owes a fiduciary duty than from someone who does not.[14] Mr. Brenner also cautioned that to establish what is reasonable, expert testimony is not always necessary; however, he acknowledged that expert testimony may be necessary to establish what is reasonable for a party with a narrowly specialized role.[15] Further, Mr. Brenner explained that when a party asserts a reliance on counsel (or other reliance) defense in the negligence context, the Commission may look to the four factors used to evaluate reliance in the scienter context – ask for advice, full disclosure of the facts, received advice, and relied on the advice in good faith.[16]

B. Cooperation

Bridget Fitzpatrick (Acting Co-Chief Litigation Counsel) explained that the Division continues to encourage cooperation with its investigations "early, frequently, and strongly," as the possible benefits of full cooperation might include reduced (*e.g.* non-scienter) or declined charges, or reduced or no penalties.

Mr. Cain said that a good example of full cooperation can be found in a recent case involving Harris Corporation as a good example of where a company's full cooperation reaped significant awards. He explained that the Division declined to bring charges against Harris Corporation in connection with the Division's investigation of Harris

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[14] Opinion of the Commission, *In re The Robare Group, Ltd.*, Investment Advisers Act Release No. 4566, at 12-13 (Nov. 7, 2016).
[15] Opinion of the Commission, *In re Harding Advisory LLC*, Securities Act Release No. 10277, Investment Advisers Act Release No. 4600, Investment Company Act Release No. 32415, at 10 (Jan. 6, 2017).
[16] Opinion of the Commission, *In re The Robare Group, Ltd.*, Investment Advisers Act Release No. 4566, at 13-14 (Nov. 7, 2016).

Corporation's Carefx subsidiary in China, and the Carefx's subsidiary's former Chairman and CEO.[17] Mr. Cain said that the Division credited Harris Corporation for identifying the improper conduct quickly, self-reporting it to the Division, and fully cooperating with the Division.[18] Mr. Cain noted that this declination was similar to when the Division did not bring charges against Morgan Stanley in connection with alleged improper conduct by Garth Peterson, a former Morgan Stanley employee.[19] Other ways in which a company could demonstrate its full cooperation with the Division could include producing documents from overseas, providing translations of foreign language documents, facilitating Division interviews with foreign employees, encouraging former employees to talk to the Division, and sharing the results of the Company's internal investigations.

According to Ms. Fitzpatrick, the Division favors bifurcated settlements in which liability is established but the remedies are deferred to a later date, so that the full force of an individual's or entity's cooperation can be taken into account by the Commission. Ms. Fitzpatrick cautioned legal practitioners that, when representing multiple clients, the full array of these benefits might not be available if the Division has already put together its case, or if another individual or entity has secured such benefits first.

Ms. Fitzpatrick warned that cooperation agreements must be honored; otherwise, the Division will move to enforce such agreements. In a recent case, an individual entered into a cooperation agreement with the SEC to provide testimony about other individuals, and the agreement promised a $2,533 civil judgment for his full cooperation.[20] But after his trial testimony varied greatly from his deposition testimony only seven months earlier, a federal judge found that he violated the agreement and ordered him to pay a nearly $1 million penalty.[21] Ms. Fitzpatrick indicated that this case illustrates both the potential for low penalties from full cooperation and the consequences for failing to abide by a cooperation agreement.

C. Whistleblower

Jane Norberg (Chief of the Office of the Whistleblower) outlined the successes of the SEC's whistleblowing program: a steady increase in tips (over 4,200 in 2016 alone), over $900 million in financial remedies ordered against wrongdoers, and over $150 million awarded to whistleblowers. Ms. Norberg also expressed concern, based on recent SEC actions, that companies have used severance or other agreements to chill whistleblowers' communications with the SEC.[22] Ms. Norberg encouraged employers and counsel to review severance, confidentiality, and other agreements to determine if they are in compliance with Rule 21F-7. She further recommended that employers and counsel would be well-served to read those agreements through the eyes of an employee.

III. SEC Strategy

A. Litigation Strategy

David Gottesman (Acting Co-Chief Litigation Counsel) emphasized that litigation continues to be an important part of the Division's strategy. As part of the Division's "Investigate to Litigate" initiative, enforcement attorneys seek to gather trial evidence and to involve the Division's Trial Unit attorneys early in investigations. Mr. Gottesman stated that this approach puts the Division in a better position to evaluate settlement prior to trial, and, if settlement cannot be reached, then the Division is in a better position to litigate.

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[17] Press Release, Sec. & Exch. Comm'n, SEC Charges Former Information Technology Executive with FCPA Violations; Former Employer Not Charged Due to Cooperation with SEC (Sept. 12, 2016).
[18] *Id.*
[19] Press Release, Sec. & Exch. Comm'n, SEC Charges Former Morgan Stanley Executive with FCPA Violations and Investment Adviser Fraud (Apr. 25, 2012).
[20] Memorandum Order and Final Judgment, *SEC v. Conradt*, No. 12-CV-8676 (S.D.N.Y. June 16, 2016).
[21] *Id.*
[22] *See, e.g., In re Sandridge Energy, Inc.*, Exchange Act Release No. 79607 (Dec. 20, 2016).

Ms. Avakian and Ms. Fitzpatrick provided insight about how the Division views the recent circuit split between the D.C. and Tenth Circuits' decisions in *Lucia* and *Bandimere*, respectively, regarding constitutional challenges to the ALJ selection process.[23] While the D.C. Circuit's *en banc* rehearing of *Lucia* is pending, Ms. Fitzpatrick indicated that the Division would follow the D.C. Circuit's panel decision in *Lucia* in most jurisdictions and continue to litigate before ALJs. Indeed, Ms. Fitzpatrick referred to the Commission's opinion in *In re Harding Advisory LLC*, where the Commission applied the D.C. Circuit's reasoning from *Lucia* because the respondent was not in the Tenth Circuit[24] Ms. Avakian appeared to endorse the Commission's limited application of *Bandimere* to Tenth Circuit litigation, conceding only that the circuit split has been a "factor" in the Division's forum selection decisions in the Tenth Circuit.

B. Data Analytics

Underscoring many of the Division's actions in 2016 was an increased reliance on data analytics. Lori Walsh (Head of the SEC's Center for Risk and Quantitative Analytics (CRQA)) described how CRQA mines large data sets for patterns, provides investigative support to other units and divisions, and provides enforcement attorneys with tools to allow them to analyze and visualize data sets themselves.

Several of the Division's panelists credited the SEC's data analytics program for assisting with investigations and enforcement actions in 2016. For example, Mr. Sansone said that in recent cyberfraud and insider trading cases, the SEC's data analytics program was instrumental in discovering alleged fraud earlier, identifying offshore accounts involved in improper conduct, and, in at least one case, allowing the Division to freeze the assets of an employee who stole information from his law firm.[25] Mr. Berkowitz likewise praised the SEC's data analytics program for aggregating and screening trading data to uncover suspicious trading, trace networks of individuals, and identify gatekeepers and recidivists. In addition, Mr. Calamari said that the Division used data analytics to evaluate cost-to-equity and cost-to-maintenance ratios, which was critical in identifying brokers whose trading strategy required the broker to achieve a 100% return before the customer would realize any profit in his or her portfolio. With the SEC's recent successes involving data analytics, legal practitioners should be prepared to receive, understand, and defend against data-driven analysis from the Division for years to come.

[23] *Raymond J. Lucia Companies, Inc. v. SEC*, 832 F.3d 277, 289 (D.C. Cir. 2016) (concluding that the Appointments Clause does not apply to ALJs), reh'g en banc granted, judgment vacated (Feb. 16, 2017); *Bandimere v. SEC*, No. 15-9586, slip op. (10th Cir. Dec. 27, 2016) (holding that an ALJ was an inferior officer).
[24] Opinion of the Commission, *In re Harding Advisory LLC*, Securities Act Release No. 10277, Investment Advisers Act Release No. 4600, Investment Company Act Release No. 32415, at 27 n.90 (Jan. 6, 2017).
[25] Complaint, *SEC v. Hong*, No. 16-CV-9947 (S.D.N.Y. Dec. 27, 2016).