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Second Annual

Federal Enforcement Forum

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Federal Enforcement Forum
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Agenda

1:00 pm – 1:05 pm ET	Welcome
1:05 pm – 2:05 pm	**Panel I:** ***The SEC at the Crossroads: Key Trends in SEC Enforcement*** ***Moderator: Thomas O. Gorman****,* Partner, Dorsey & Whitney LLP and former SEC Enforcement Official ***Genna Garver,*** Of Counsel, Dorsey & Whitney LLP ***Paul D. Glenn,*** Special Counsel, Investment Adviser Association ***Thomas Quaadman,*** Senior Vice President, U.S. Chamber Center for Capital Markets Competitiveness, U.S. Chamber of Commerce
2:05 pm – 2:15 pm	*Break*
2:15 pm – 3:15 pm	**Panel II:** ***Current Developments in Energy and Commodities Regulatory Enforcement*** ***Moderator: Joseph Hall****,* Partner & Co-Chair of Energy Industry Group, Dorsey & Whitney LLP ***Thomas O. Gorman****,* Partner, Dorsey & Whitney LLP ***Shaun D. Ledgerwood****,* Principal, The Brattle Group ***Nathan B. Ploener****,* Managing Director, KPMG LLP
3:15 pm – 3:25 pm	*Break*
3:25 pm – 4:25 pm	**Panel III:** ***Current Developments in Financial Services Regulatory Enforcement*** ***Moderator: Joseph T. Lynyak III,*** Partner, Dorsey & Whitney LLP ***David J. Kogut*****,** Principal, Charles River Associates ***J.H. Jennifer Lee*****,** Partner, Dorsey & Whitney LLP and former CFPB Enforcement Official
4:25 pm – 4:30 pm	Closing
4:30 pm	Reception

Federal Enforcement Forum
Speaker Biographies

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Genna Garver is Of Counsel in Dorsey's Corporate Group and chairs the Investment Regulation practice. Ms. Garver takes pride in the close personal attention she provides when advising investment management clients in connection with federal and state securities laws, private fund formation and securities offerings. She has extensive experience representing financial institutions in transactional and regulatory matters. She focuses on representing investment advisers, hedge funds and other private investment funds implementing various investment strategies. Ms. Garver advises clients on: formation and offering matters for both domestic and offshore funds; SEC and state investment adviser, broker-dealer and private fund regulation; Investment Advisers Act compliance programs; and mock audits and regulatory examinations and investigations. She also counsels banking and private fund clients on all aspects of the Volcker Rule and related matters.

Paul D. Glenn
Special Counsel
Investment Adviser Association
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Paul Glenn joined IAA in February 2006. Mr. Glenn grew up in Cleveland, OH, and has spent his professional career in the Washington, DC area. He has worked at the US Securities and Exchange Commission as a trial attorney and special counsel in the Division of Enforcement and the Office of General Counsel, respectively. Mr. Glenn has also worked at the Office of the Comptroller of the Currency (then OTS), US Treasury, as Deputy Chief Counsel and special counsel. He served as Vice President and Director of Compliance for PNC Bank N.A. in Washington, DC, (formerly Riggs) and Washington First Bank N.A. in Reston, VA (formerly Millennium Bank N.A.). Mr. Glenn has his masters of law degree (LLM) from Georgetown University Law Center and his Juris Doctor and Bachelor of Arts (Political Science) from Case Western Reserve University. In 2010, he received an honorary doctor of laws degree from Nyack College, Nyack, NY. Mr. Glenn is a member of the Bar of the Supreme Court of Ohio, the Supreme Court of the United States, and other federal courts.

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Tom Gorman is a Partner in Dorsey's Government Enforcement & Corporate Investigation Group. He has defended public companies and individuals in regulatory actions involving insider trading, market manipulation, financial fraud, corporate governance matters, accounting and auditing issues, FCPA issues, and similar matters. He has also defended securities class action and derivative suits and led teams conducting internal investigations focused on financial fraud and other securities law issues. Mr. Gorman regularly speaks on, and publishes articles regarding, securities litigation issues including the FCPA, internal investigations, financial fraud and insider trading. He has been interviewed on

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these issues by the *New York Times*, *Wall Street Journal*, *Washington Post*, *Financial Times*, and other leading publications in addition to appearing on CNBC, CNN, and other TV networks. Mr. Gorman publishes a widely-read securities blog, http://www.secactions.com/, which analyzes trends in securities enforcement inquiries and litigation, and provides expert commentary for the LEXIS Securities web page. He serves as a member of the editorial board of the Securities Regulation Law Journal. Mr. Gorman's practice regularly includes other complex business litigation matters arising under the securities, commodities, antitrust laws and the federal racketeering statutes. He served for seven years in positions of increasing responsibility on the staff of the Securities and Exchange Commission in Washington, D.C. Those positions included Senior Counsel, Division of Enforcement and Special Trial Counsel, Office of the General Counsel. In those positions, Mr. Gorman was responsible for the investigation and litigation of securities enforcement actions, accounting and auditing cases and defending suits brought against the Commission and its staff.

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Joe Hall is a Partner and Co-Chair of Dorsey's Energy Industry Group and is responsible for, among other things, developing, implementing and managing Dorsey's strategic initiatives in the power, clean tech, oil, and natural gas industries. Mr. Hall's practice focuses on the power industry, with an emphasis on industry participant responses to competition. He has extensive experience representing electric utilities, independent power producers, power marketers, industrial customers, private equity firms, and other entities in regulatory matters concerning, among other things: participation in Energy Markets, including Regional Transmission Organizations; "Open Access" policies; Transmission Planning and Cost Allocation; Mergers and Acquisitions; Market-Based Rate Authority; Standards of Conduct; Affiliate Restrictions; Rate Cases (transmission and wholesale power); Public Utility Regulatory Policies Act ("PURPA") (federal and state); Merchant Generation; Power Purchase Agreements; Renewable Generation and Integration (including distributed generation); FERC Enforcement and Compliance; FERC Litigation; and NERC Reliability.

David Kogut
Principal
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David Kogut has over 15 years of experience analyzing an array of economic and financial issues and specializes in conducting analyses related to the United States' housing and mortgage markets. Since joining CRA in March 2008, he has applied his analytical and market expertise to several matters involving regulatory and litigation actions brought against various primary and secondary mortgage market institutions. Prior to joining CRA, Mr. Kogut was Director of Mortgage Market Analysis at Fannie Mae, a senior financial analyst at Freddie Mac, and a senior consultant at Price Waterhouse.

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Jenny Lee is a Partner in Dorsey's Securities & Financial Services Litigation Group. She is a pragmatic problem solver. Ms. Lee assists clients in responding to Civil Investigative Demands from the CFPB and defends their interests in ongoing enforcement investigations or litigation matters, including drafting NORA response letters, negotiating compliance with CIDs and negotiating consent orders. As a former CFPB Enforcement Attorney, Ms. Lee understands how the CFPB thinks and applies its authorities to enforce consumer protection laws, including UDAAP, EFTA, GLB Act, FDCPA, FCRA, TILA and RESPA. Ms. Lee has extensive experience in consumer financial matters involving the CFPB, state

attorneys general or state banking agencies, the Department of Justice and prudential banking regulators or in Congressional investigations. Her philosophy is that a client's legal strategy should be managed carefully to fit the business' budget, not the other way around. Ms. Lee assists banks and supervised institutions subject to CFPB supervisory examinations. She identifies multi-faceted issues that accompany a CFPB inquiry and moves decisively to extinguish embers before they catch fire. Based on her substantive expertise, Ms. Lee represents clients in proactive engagement opportunities with the CFPB to submit comments on new or proposed regulations and conducts due diligence for deals involving acquisitions of financial services firms. She helps companies implement or update their compliance programs to decrease risk or litigation exposure in light of new consumer financial protection regulations. Ms. Lee represents large credit card issuers, consumer reporting agencies, data analytics companies, mortgage bankers, student loan companies, short-term and small-dollar lenders, retail-installment lenders and financial technology companies involved with digital wallets, virtual currencies, money transmission and mobile apps.

Shaun D. Ledgerwood
The Brattle Group
Principal
Washington, DC

Dr. Shaun Ledgerwood is an expert in market competitiveness with an emphasis on the economic analysis of potential market manipulation claims in commodities and securities markets. He specializes in the analysis of competitive matters within and across physical and financial markets; issues pertinent to economic regulation, ratemaking, and resource planning; asset valuations; and analyses pursuant to matters in tort, contracts, or involving fraud. His twenty-three years of experience as an economist and an attorney allow him to provide clients with unique insights into matters involving potential litigation, especially as they relate to meeting burdens of proof under statutory requirements. As a former economist and attorney for the Office of Enforcement for the Federal Energy Regulatory Commission (FERC), Dr. Ledgerwood evaluated manipulative behavior within and across wholesale electricity and natural gas markets. This experience led him to develop a framework for detecting and analyzing manipulative behavior. The framework separates actions that cause the manipulation from those that benefit from its effect, simplifying the proof (or disproof) of the manipulation. This logic is particularly useful in assisting clients in maintaining compliance and for supporting or defending enforcement actions brought under the anti-manipulation rules in place in the U.S. and EU. Dr. Ledgerwood has testified as an expert witness before state utility commissions and in federal court. He previously taught graduate courses in microeconomic theory, regulation, law and economics, antitrust and remedies at the University of Oklahoma and was an Affiliated Faculty member at the Georgetown University Public Policy Institute.

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Joe Lynyak is a Partner in Dorsey's Finance & Restructuring Group and is a member of the Banking Industry Group. He practices in both the Dorsey's Washington, D.C. and Southern California offices. Mr. Lynyak possesses a broad knowledge base regarding foreign banks and domestic banks, savings associations, bank holding companies, finance companies, mortgage banking companies and their subsidiaries and affiliates. His practice includes providing financial intermediaries advice in the areas of regulatory and strategic planning, application and licensing, legislative strategy, commercial and consumer lending, examination, supervision and enforcement, and general corporate matters.
Mr. Lynyak's FDIC-insured financial institution clients benefit from his experience

in the special state and federal statutory and regulatory requirements—including safety and soundness issues—that apply to regulated financial intermediaries. He regularly counsels clients on matters such as retail operations, privacy, identity theft, consumer compliance, application and underwriting, payments systems, Internet, electronic commerce, examination, supervision and enforcement, operational and strategic planning matters. Mr. Lynyak is a frequent lecturer on legal topics involving the operation and regulation of financial service companies. Specific regulatory topics upon which he has advised clients and spoken at conferences include the Dodd-Frank Act, prudential regulation, the Volcker Rule, the Bank Secrecy Act (and other anti-money laundering provisions), mortgage lending and the CFPB.

Nathan Ploener
KPMG LLP
Managing Director
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Nathan Ploener is a Managing Director in the New York City office of KPMG's U.S. Forensic Advisory Services practice. Mr. Ploener is a skilled professional with more than 29 years of experience in several sectors within risk consulting including energy, financial services, metals, and agriculture. He comes to KPMG with an impressive track record that includes high-profile regulatory matters such as false reporting, fraud, market manipulation, and market abuse. Prior to joining KPMG, Mr. Ploener spent nine years at the U.S. Commodity Futures Trading Commission (CFTC) as a Senior Trial Attorney, where he focused on conducting regulatory investigations of potential Commodity Exchange Act violations, market manipulation, fraud, trade practice violations and compliance failures. He was an active member of the manipulation and disruptive trading practice squad at the CFTC and managed high profile, complex investigations in market manipulation and spoofing. At the CFTC, Mr. Ploener was responsible for bringing the first spoofing case under the Dodd Frank Act against Panther Energy Trading.

Tom Quaadman
Senior Vice President,
U.S. Chamber Center for Capital Markets Competitiveness
U.S. Chamber of Commerce
Washington DC

Tom Quaadman is Senior Vice President of the U.S. Chamber Center for Capital Markets Competitiveness. The Center was established in March 2007 to advocate legal and regulatory policies for the U.S. capital markets to advance the protection of investors, promote capital formation, and ensure U.S. leadership in the financial markets in the 21st century. Mr. Quaadman develops and executes strategic policies to implement a global corporate financial reporting system, address ongoing attempts of minority shareholder abuse of the proxy system, communicate the benefits of efficient American capital markets, and promote an innovation economy and the long-term interests of all investors. Prior to joining the Chamber, Mr. Quaadman was chief of staff to Congressman Vito John Fossella Jr. (R-NY) from 1997 to 2008. In that capacity, he helped establish the Republican Policy Committee Task Force on Capital Markets, Economic, and Information Security to develop a legislative program on economic competitiveness. Mr. Quaadman also worked on the passage of the Investors Capital Markets Fee Relief Act. This act reduced SEC transaction fees, representing a savings of billions of dollars for investors.

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Federal Enforcement Forum:

Trends in SEC Enforcement

Moderator:
Thomas O. Gorman, Dorsey & Whitney LLP and former SEC Enforcement Official

Panelists:
Paul D. Glenn, Investment Adviser Association

Thomas Quaadman, U.S. Chamber of Commerce

Genna Garver, Dorsey & Whitney LLP

INTRODUCTION

- **Last year record number of actions**
- **Critics: Is enforcement effective?**
- **Cite items such as**
  - **political bickering**
  - **Policies like broken windows and**
  - **shift to administrative proceedings**
  - **OCIE as the front edge of enforcement**

INTRODUCTION

- To examine SEC Enforcement consider
  - Insider trading: *Newman* and *Salman*
    - Is *Newman* the end of tipping
    - Why *Salman* and how is the Supreme Court likely to rule
  - The OCIE exam program
    - The front edge of enforcement?
    - The debate over CCOs
    - Select investment adviser cases

INTRODUCTION

- The shift to administrative proceedings
  - Suits against the SEC
  - Legislative proposals
  - Revisions to the Rules of Practice

Newman - Salman

- ***Newman*** **-- the most significant insider trading/tipping case in decades**
  - **Elements of tipping based on *Dirks v. SEC***
    - **Breach of duty by disclosure + for personal benefit**
    - **Tippee knows of breach + personal benefit**
  - **What is personal benefit?**
    - **"evidence of a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the latter"**

Newman - Salman

- ***Salman*** **– applies *Newman***
  - **Based on *Dirks* person benefit; includes "pecuniary gain or reputational benefit that will translate into future earnings…"**
  - **Rejects defense contention that no evidence that tipper received a tangible personal benefit for information fails *Newman***
  - **Court: "To the extent *Newman* can be read to go so far, we decline to follow it"**

Newman - Salman

- Supreme Court declines to hear *Newman*
- Supreme Court accepts *Salman*
- Will the Court roll back *Newman*?
- Fate of *Dirks*?

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INVESTMENT ADVISERS

- The OCIE National Exam Program
- Key elements
  - Protecting retail investors and retirement savings
  - Market wide risk
  - Data analytics to identify potential illegal activity
- Front edge of enforcement
  - The use of deficiency notices
  - APA issues?

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INVESTMENT ADVISERS

- The debate over CCOs
  - Beginning: Former Commissioner Daniel Gallagher: Statement on Recent SEC Settlements Charging Compliance Officers Regarding Rule 206(4)-7
    - The Rule is unclear
    - Addressed to advisers, not CCOs
    - No real guidance
    - CCOs are critical gatekeepers

INVESTMENT ADVISERS

- Commissioner Luis Aguilar
  - Recent dialogue created "atmosphere of fear"
  - Few cases brought against CCOs
- Chairman Mary Jo White
  - Tremendous respect for tough job
  - But no immunity

INVESTMENT ADVISERS

- The standard for procedures is "reasonable" - but is it?
- Select cases
  - *In the Matter of BlackRock*
    - CCO named as Respondent
    - Based on conflicts
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    - Only CCO Ourand reviewed accounts – insufficient procedures

INVESTMENT ADVISERS

- Select cases (cont.)
  - *In the Matter of Marwood*
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    - Deficient procedures: no CCO review
  - *In the Matter of Wolf*
    - ALJ decision of no liability
    - Violations established
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- Commission announced move to administrative proceedings
- Cornerstone Research report confirms
- Results: Suits filed
  - SEC defense: no jurisdiction based on Section 25 of the Exchange Act
  - Split among courts
    - 2 cases: found appointment clause violation
    - 2 cases: Reject appointment clause violation theory
    - Certiorari pending in one

VENUE SELECTION

- U.S. Chamber
  - H.R. 3798 – Permits Respondent to opt out
  - Proposed amendments to Rules of Practice
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CONCLUSION

- **SEC faces key issues moving forward**
  - **Supreme Court: *Newman/Salman***
  - **Investment advisers – fair application of the law**
  - **Overall enforcement policy**
  - **Collegiality**

Speaker

Thomas O. Gorman – Dorsey & Whitney LLP

Tom Gorman is a Partner in Dorsey's Government Enforcement & Corporate Investigation Group. He has defended public companies and individuals in regulatory actions involving insider trading, market manipulation, financial fraud, corporate governance matters, accounting and auditing issues, FCPA issues, and similar matters. He has also defended securities class action and derivative suits and led teams conducting internal investigations focused on financial fraud and other securities law issues. Mr. Gorman regularly speaks on, and publishes articles regarding, securities litigation issues including the FCPA, internal investigations, financial fraud and insider trading. Mr. Gorman's practice regularly includes other complex business litigation matters arising under the securities, commodities, antitrust laws and the federal racketeering statutes. He can be contacted via email at gorman.tom@dorsey.com or at (202) 442-3507.

Speaker

Genna Garver – Dorsey & Whitney LLP

Genna Garver is Of Counsel in Dorsey's Corporate Group and chairs the Investment Regulation practice. Ms. Garver advises investment management clients in connection with federal and state securities laws, private fund formation and securities offerings. She has extensive experience representing financial institutions in transactional and regulatory matters. She focuses on representing investment advisers, hedge funds and other private investment funds implementing various investment strategies. Ms. Garver advises clients on: formation and offering matters for both domestic and offshore funds; SEC and state investment adviser, broker-dealer and private fund regulation; Investment Advisers Act compliance programs; and mock audits and regulatory examinations and investigations. She also counsels banking and private fund clients on all aspects of the Volcker Rule and related matters. She can be contacted via email at garver.genna@dorsey.com or at (212) 415-9341.

Speaker

Paul D. Glenn – Investment Adviser Association

Paul Glenn joined IAA in February 2006. Mr. Glenn grew up in Cleveland, OH, and has spent his professional career in the Washington, DC area. He has worked at the US Securities and Exchange Commission as a trial attorney and special counsel in the Division of Enforcement and the Office of General Counsel, respectively. Mr. Glenn has also worked at the Office of the Comptroller of the Currency (then OTS), US Treasury, as Deputy Chief Counsel and special counsel. He served as Vice President and Director of Compliance for PNC Bank N.A. in Washington, DC, (formerly Riggs) and Washington First Bank N.A. in Reston, VA (formerly Millennium Bank N.A.). Mr. Glenn is a member of the Bar of the Supreme Court of Ohio, the Supreme Court of the United States, and other federal courts.

Speaker

Tom Quaadman - U.S. Chamber of Commerce

Tom Quaadman is Senior Vice President of the U.S. Chamber Center for Capital Markets Competitiveness. Mr. Quaadman develops and executes strategic policies to implement a global corporate financial reporting system, address ongoing attempts of minority shareholder abuse of the proxy system, communicate the benefits of efficient American capital markets, and promote an innovation economy and the long-term interests of all investors. Prior to joining the Chamber, Mr. Quaadman was chief of staff to Congressman Vito John Fossella Jr. (R-NY) from 1997 to 2008. In that capacity, he helped establish the Republican Policy Committee Task Force on Capital Markets, Economic, and Information Security to develop a legislative program on economic competitiveness. Mr. Quaadman also worked on the passage of the Investors Capital Markets Fee Relief Act. This act reduced SEC transaction fees, representing a savings of billions of dollars for investors.

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Select Trends in SEC Enforcement

By: Tom Gorman
Kim Frumkin
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I. Introduction

An effective enforcement program is critical to the mission of the Securities and Exchange Commission ("SEC"). Last year record numbers of enforcement actions were brought, although the total amount of penalties levied declined compared to the prior year. Nevertheless, many critics question the effectiveness of the agency. Political bickering among the Commissioners and policies like "broken windows" have lead many commentators to question whether the program is effective.

This program will focus on key trends in three areas: 1) Insider trading; 2) Regulation of investment advisers; and 3) the shift in venue for many enforcement actions from federal court to administrative proceedings. Collectively, these issues provide critical insight into the effectiveness of SEC enforcement.

II. Insider trading: *U.S. v. Salman*

The Supreme Court recently granted the defendant's Petition for Certiorari in *Salman v. United States.,* No. 15-628 (January 19, 2016). In that case, the Ninth Circuit upheld the insider trading conviction of Bassam Salman. *U.S. v. Salman,* 792 F.3d 1087 (9th Cir. 2015)**.** The tipping case follows, at least in part, the Second Circuit's landmark decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014) regarding the elements of proof required to establish illegal tipping. In October 2015, the Supreme Court declined to hear *Newman.*

Following the Second Circuit's *Newman* decision, and the Supreme Court's subsequent declination to hear the case, a number of insider trading guilty pleas and convictions were undone. *See, e.g., U.S. v. Steinberg*, No. 12-cr-00121 (RJS) (S.D.N.Y. Oct. 30, 2015) (vacating conviction and indictment against defendant); *U.S. v. Conradt*, 12-cr-00887 (S.D.N.Y. Jan. 29, 2012) (dismissing charges against all four defendants at prosecutors' request); *SEC v. Payton*, 97 F.Supp.3d 588 (S.D.N.Y. 2015) (denying defendants' motion to dismiss the complaint based on *Newman*).

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A. Newman

U.S. v. Newman is the most significant insider trading –tipping case to be handed down in years. The decision considered the cases against Todd Newman and Anthony Chiasson centers on remote tippees and the personal benefit test which, according to the Second Circuit, derives from the Supreme Court's decision in *Dirks v. SEC,* 463 U.S. 646 (1983). The SEC and the U.S. Attorney's Office for the Southern District of New York have both cited the decision as detrimental to their efforts to halt insider training.

Newman is based on the alleged tipping of remote tippees. Newman and Chiasson were three to four steps removed from the source of the inside information about pending earnings announcements for Dell and NVIDIA. They were convicted of insider trading. In reviewing their convictions for insider trading, the Second Circuit stated: "We note that the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading." *U.S. v. Newman,* 773 F.3d at 448. The Circuit drew a clear line regarding the requirements for tipper liability using the "personal benefit" test crafted for the protection of analysts by the Supreme Court in *Dirks v. SEC.* The convictions were reversed.

Todd Newman and Anthony Chiasson were portfolio managers at, Diamondback Capital Management, LLC and Level Global Investors, L.P, respectively. Both were convicted of insider trading in the shares of Dell and NVIDIA following a six week trial. Both were remote tippees. With regard to the trading in Dell, the inside information went down a chain: Company investor relations employee Rob Ray transmitted the earnings information to analyst Sandy Goyal, who in turn tipped Diamondback analyst Jesse Tortora who then told Mr. Newman and Level Global analyst Sam Adondakis who told Mr. Chiasson. Each portfolio manager traded based on the information.

The inside information regarding NVIDIA traveled a similar, lengthy path to the two portfolio managers. It began with company insider Chris Choi tipping Hyung Lim, whom he knew from church, who passed the information to Whittier Trust analyst Danny Kuo who furnished it to a group of analyst friends, including Messrs. Tortora and Adondakis who transmitted it to, respectively, Mr. Newman and Mr. Chiasson. Each portfolio manager traded in NVIDA shares.

At the close of the evidence each defendant made Rule 29 motions for acquittal, arguing that tippee liability derives from that of the tipper. Since there was no evidence that the corporate insiders obtained a personal benefit, they argued, the charges should be dismissed. The District Court reserved judgment and sent the case to the jury for consideration based on its instructions. The defendants argued that the jury charge on tippee liability should include the element of knowledge of a personal benefit received by the insider. The Court gave the jury an alternate instruction which stated in part that the Government had to prove that the insider "intentionally breached that duty of trust and confidence by disclosing material nonpublic information for their own benefit." The

instructions also stated that the defendant had to "have known that it [the inside information] was originally disclosed by the insider in violation of a duty of confidentiality." *Newman,* 773 F.3d at 444. The jury found both defendants guilty of insider trading.

The Second Circuit disagreed. The Court held that the jury instructions were inadequate and that the evidence on tippee liability was insufficient. Accordingly, the convictions were reversed and the charges dismissed with prejudice.

The Court began its analysis by reviewing the basic tenants of the classical and misappropriation theories of insider trading. The elements of tipping liability are the same regardless of the theory utilized, according to the Court. Under *Dirks* the test for determining if there has been a breach of fiduciary duty is "whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, *there has been no breach of duty* . . .." . *Newman,* 773 F.3d at 446 (citing *Dirks*, 463 U.S. at 662). The tippee's liability stems directly from that of the insider. Since the disclosure of inside information alone is not a breach, "without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach." *Newman,* 773 F.3d at 448.

In reaching its conclusion the Court held that "nothing in the law requires a symmetry of information in the nation's securities markets." *Id.* at 449. That notion was repudiated years ago in *Chiarella v. U.S.,* 445 U.S. 222 (1980). While efficient capital markets depend on the protection of property rights in information, they also "require that persons who acquire and act on information about companies be able to profit from the information they generate." *Newman*, 773 F.3d at 449 (quoting *United States v. Chestman*, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring)). It is for this reason that both *Chiarella* and *Dirks* held that insider trading liability is based on breaches of fiduciary duty, not on "informational asymmetries." *Newman*, 773 F.3d at 449.

Based on these principles, the elements of tippee liability are: "(1) the corporate insider was entrusted with a fiduciary like duty; (2) the corporate insider breached his duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade . . ." *Id.* at 450. Lacking these elements, the jury instructions failed.

Finally, in reviewing the sufficiency of the evidence, the Court enunciated the personal benefit test. That test is broadly defined to include pecuniary gain and also reputational benefit that will translate into future earnings and the benefit one would obtain from making a gift of confidential information to a relative or friend. While the test is broad it does not include, as the Government argued, "the mere fact of a friendship, particularly of a casual or social nature." *Id.* at 452. A personal benefit can be inferred from a

personal relationship but "such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. In other words, this requires evidence of a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the latter." *Id.* (internal quotes omitted). In *Newman*, the evidence was not sufficient to meet this test. The Second Circuit subsequently denied a motion for rehearing by the U.S. Attorney.

B. *Salman*

Salman follows and interprets *Newman* in an opinion written by Judge Jeb S. Rakoff, sitting by designation on the Ninth Circuit. Petitioner-defendant Bassam Salman is the brother-in-law of Maher Kara who joined Citigroup's healthcare investment banking group in 2002. Over a period of years Mr. Maher began discussing information about his job with his brother Michael who traded while in possession of it. The year after Mr. Maher began at Citigroup he became engaged to Mr. Salman's sister, Suzie Salman. As the families became close, Michael began sharing the inside information with Mr. Salman who traded through the joint account of his wife's sister and her husband, Karim Bayyouk. The profits were split. At one point Mr. Salman asked Michael where the information came from and was told that it came from Maher.

Brothers Maher and Michael had a close and mutually beneficial relationship, according to the evidence. For example, Michael helped pay for Maher's college and aided him in a number of other ways. At one point Michael called and asked Maher for assistance with a debt. Michael refused Maher's offer of cash but instead accepted inside information. Mr. Salman was aware of this relationship, according to the evidence.

A jury found Mr. Salman guilty on one count of conspiracy and four counts of securities fraud. On appeal, Mr. Salman argued that the evidence was insufficient to meet the requirements of *Newman.* The Ninth Circuit affirmed.

The personal benefit requirement for tippee liability traces to *Dirks v. SEC* the circuit court stated. In that case, the Supreme Court stated that imposing a duty to disclose or abstain simply because the person knowingly received inside information "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." *Salman*, 792 F.3d at 1091(quoting *Dirks*, 463 U.S. at 658). The *Dirks* Court went on to hold that "'the test is whether the insider personally will benefit, directly or indirectly, from his disclosure.'" *Salman*, 792 F.3d at 1092 (quoting *Dirks*, 463 U.S. at 662). In such a case, the insider has breached his fiduciary duty and the tippee is equally liable if "'the tippee knows or should have known that there has been [such] a breach… *i.e.* knows of the personal benefit.'" *Salman,* 792 F.3d at 1092 (quoting *Dirks,* 463 U.S. at 660). This applies equally to cases based on the misappropriation theory, the circuit court held.

The key here is what constitutes a personal benefit. Quoting *Dirks*, the court held that it includes "a pecuniary gain or a reputational benefit that will translate into future earnings . . . [the] elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend." *Salman,* 792 F.3d at 1092 (quoting *Dirks*, 463 U.S. at 663-64) (emphasis omitted).

This statement from *Dirks* governs this case, according to the circuit court. Maher's disclosures to Michael with the knowledge that Michael intended to trade while in possession of the information is a *Dirks* gift to a relative. Indeed, Maher testified he intended to give Michael a benefit. Michael testified that he told Mr. Salman the source of the information. In addition, "[g]iven the Kara brothers' close relationship, Salman could readily have inferred Maher's intent to benefit Michael. Thus, there can be no question that, under *Dirks,* the evidence was sufficient . . ." *Salman,* 792 F.3d at 1092.

Finally, Mr. Salman argued that "because there is no evidence that Maher received any such tangible benefit [as described in *Newman*] in exchange for the inside information, or that Salman knew of any such benefit, the Government failed to carry its burden." *Id.* at 1093. The court responded, stating: "To the extent *Newman* can be read to go so far, we decline to follow it." *Id.*

Salman, like *Newman,* is built on *Dirks.* To establish tipping both require that there be a breach of fiduciary duty, a personal benefit and knowledge of those elements by the tippee. In resolving *Salman*, the Ninth Circuit presented its conclusions as a straight forward application of *Dirks.* Nevertheless, the court's rejection of the defense contention about *Newman* appears to delimit the scope of the decision, at least in the view of many commentators.

C. Salman and Newman

Whether that reading of *Salman* is correct is no longer the critical question, however. Rather, the key point now is how the High Court will resolve the question. The answer to that may lie in the reason the Court chose to hear *Salman* and not *Newman.* The Court, of course, does not give reasons for granting or denying certiorari.

The answer to the Court's case selection — and perhaps the ultimate resolution of *Salman* — may lie in the record. In *Newman,* the Second Circuit carefully reviewed the record and concluded that not only did the district court fail to give proper instructions, but there was no evidence of any *Dirks* personal benefit in the record. While the government argued otherwise in its Petition for Certiorari, virtually rewriting the record, debating what is and is not in the record is not likely an issue the Supreme Court wanted to tussle with.

Salman, in contrast, is not mired with the same factual difficulties as *Newman.* Rather, the question of what constitutes a personal benefit comes to the High Court on what appears to be a well-developed factual record. This at least suggests the question is not if a personal benefit is necessary, but what constitutes sufficient evidence of such. Stated differently, the factual record in *Salman* presents the Supreme Court with a better vehicle through which to discuss and define the *Dirks* personal benefit, suggesting that the test will continue but with a clearer definition following the Court's decision.

III. Investment advisers

The SEC regulation of investment advisers is a key focus for enforcement. Critical to examining the trend here are three areas: 1) the examination priorities by the SEC's Office of Compliance Inspection and Examination ("OCIE"); 2) the discussion among SEC Commissions regarding Chief Compliance Officers ("CCOs"); and 3) trends in actions brought against the advisers.

A. Examination priorities

OCIE announced its examination priorities for 2016 which generally "reflect certain practices and products that OCIE perceives to present potentially heightened risk to investors and/or the integrity of the U.S. Capital markets." OCIE, "OCIE Examination Priorities for 2016" (Jan. 11, 2016).

The examination priorities are built on the same three themes as last year. Those are: 1) matters important to retail investors and saving for retirement; 2) market-wide risk issues; and 3) the use of data analysis to ascertain if there is illegal activity. Under each category OCIE identified a number of key exam areas which include:

1) Protecting retail investors and retirement savings:

- ReTIRE which includes examining the reasonable basis for recommendations, conflicts and supervision and compliance controls
- ETFs focusing on sales strategies, trading practices and disclosures
- Fee Selection and reverse churning
- Variable annuities, including an assessment of suitability and the adequacy of the disclosures
- Public pension advisers, focusing on pay-to-play and other key risk areas

2) Market wide risk, including an assessment of structural risks and trends that may involve multiple firms or entire industries:

- Cybersecurity
- Regulation systems compliance and procedures
- Liquidity controls
- Clearing agencies

3) Data analytics to identify potential illegal activity:

- Recidivist representatives and their employers
- Anti-money laundering
- Microcap fraud
- Excessive trading
- Product promotion

OCIE also has initiatives which include: municipal advisors, private placements, never-before-examined investment advisers and investment companies, private fund advisers and transfer agents.

B. Chief Compliance Officers

Last year the SEC Commissioners debated the role of Chief Compliance Officers and their gatekeeper function in opinions and speeches. The debate began with two dissents in enforcement actions by then-SEC Commissioner Daniel Gallagher. *See* Commissioner Daniel Gallagher, "Statement on Recent SEC Settlements Charging Chief Compliance Officers with Violations of Investment Advisers Act Rule 206(4)-7" (June 18, 2015). In that statement, the Commissioner called for guidance for CCOs who are critical gatekeepers.

The two enforcement actions which prompted Commissioner Gallagher's dissent are *In the Matter of Blackrock Advisers, LLC*, Adm. Proc. File No. 3-16501 (April 20, 2015and *In the Matter of SFX Financial Advisory Management Enterprises, Inc.*, Adm. Proc. File No. 3-16590 (June 15, 2015) In each action the Commission charged the firm's CCO with violations of Advisers Act Rule 206(4)-7. *Blackrock Advisers* centered, in part, on the question of whether the firm had adequate policies and procedures to monitor the outside activities of employees and disclose conflicts to fund boards and advisory clients. *SFX Financial Advisory* focused on whether the firm's policies and procedures were sufficient to detect a multi-year fraud. Each CCO settled.

Rule 206(4)-7 is at the center of Commissioner Gallagher's concerns. The rule is "not a model of clarity," according to the Commissioner. It provides, in part, that the adviser is required to adopt "and implement written policies and procedures reasonably designed . . ." to prevent violations of the Act. On its face the rule addresses the adviser –

it requires the firm to designate a CCO. While the adviser is responsible for implementation, the SEC interprets Rule 206(4)-7 as if it is directed to CCOs, according to the Commissioner.

The rule also offers "no guidance as to the distinction between the role of CCOs and management in carrying out the compliance function," the Commissioner noted. The SEC has offered none in the years since the enactment of the rule except through enforcement actions which at times have "unfairly contorted the rule to treat the compliance function as a new business line, with compliance officers assuming the role of business heads."

Enforcement actions are not the way to resolve the uncertainty surrounding the rule, according to Commissioner Gallagher. Rather, the Commission should consider the message sent to the compliance community of resolving the ambiguity inherent in the rule through enforcement actions. Those actions have a "psychological impact, and in many cases [cause] reputational damage . . . [from] months or years of testimony, the Wells process, and settlement negotiations . . . [that can be] as chilling as the scarlet letter of an enforcement violation" he stated.

Yet CCOs are critical gatekeepers, necessary to effectively implement compliance programs. They are "all we have. They are not only the first line of defense, they are the only line of defense," Commissioner Gallagher argued. Viewed in this context, it is imperative that the Commission "take a hard look" at the rule and consider if amendments or at least agency or staff guidance is necessary.

Subsequently, Commissioner Luis Aguilar weighed in with comments appropriately titled "The Role of Chief Compliance Officers Must Be Supported." Commissioner Aguilar, who is a former head of compliance, expressed "concern that the recent public dialogue may have unnecessarily created an environment of unwarranted fear in the CCO community . . . [that] is unhelpful, sends the wrong message . . ."

Commissioner Aguilar then pointed out that the SEC has brought "relatively few cases targeting CCOs relating solely to their compliance-related activities." Rather, the "vast majority of these case involved CCOs who 'wore more than one hat'. . ." Citing Commissioner Gallagher's remarks he went on to argue that "those who believe that Rule 206(4)-7 unduly puts a target on the back of CCOs. . ." are simply wrong. Since the adoption of the Rule "enforcement actions against individuals with CCO-only titles and job functions have been rare." Those few cases should not be of concern. Rather, "the Commission has approached CCO cases very carefully. . ." Commissioner Luis Aguilar, "The Role of Chief Compliance Officer Must Be Supported" (June 29, 2015).

> SEC Chair Mary Jo White rounded out the discussion, noting: "To be clear, it is not our intention to use our enforcement program to target compliance professionals. We have tremendous respect for the work you do. You have a

tough job in a complex industry where the stakes are extremely high. That being said, we must, of course, take enforcement action against compliance professionals if we see significant misconduct or failures by them. Being a CCO obviously does not provide immunity from liability, but neither should our enforcement actions be seen by conscientious and diligent compliance professionals as a threat." Chair Mary Jo White, "Opening Remarks at the Compliance Outreach Program for Broker-Dealers" (July 15, 2015).

C. Select cases involving investment advisers

1. *BlackRock* - a focus on conflicts and adequate procedures

In the Matter of BlackRock Advisors, LLC, Adm. Proc. File No. 3-16501 (April 20, 2015) is one of the two cases which touched off the debate among the SEC Commissioners. It centers on conflicts of interest uncovered by the *Wall Street Journal.* Respondent BlackRock Advisers is a registered investment adviser with about $452 billion in assets under management. Respondent Bartholomew Battista is the CCO of BlackRock. Daniel Rice III is a managing director and co-portfolio manager of energy sector assets held in BlackRock registered funds, private funds and separately managed accounts. His compensation derives in part from the management fees of the managed funds and separate accounts.

In December 2006, Mr. Rice formed the Rice Energy Irrevocable Trust to hold interests in Rice Energy, a name given to a then projected series of entities that would be formed. Those entities would be funded with about $2.4 million in gifts and a $23.5 million term loan from Mr. Rice. The next month, Mr. Battista reviewed and discussed the matter with Mr. Rice. BlackRock concluded that the proposal did not present any conflict of interest. In February, Mr. Rice formed the series of companies which were collectively known as Rice Energy.

By March 2010, Rice Energy concluded a deal that traced back to mid-2008. As part of that deal, Foundation Coal, which had recently completed a merger with ANR, entered into a joint venture with Rice Energy. At the time of the deal, funds and separate accounts managed by Mr. Rice held over two million shares of ANR stock. By the end of the second quarter of 2010, ANR acquired Massey Energy whose shares were already held by funds and separate accounts managed by Mr. Rice.

In January 2010, Mr. Rice told BlackRock that he wanted to serve on the board of directors of the joint venture. BlackRock's Legal and Compliance Department reviewed the matter and concluded that there were potential conflicts of interest in entering into the joint venture in view of the portfolio holdings managed by Mr. Rice. The deal also raised concerns regarding access to ANR-specific information that could be beneficial to Mr. Rice, rather than his clients. Nevertheless, BlackRock permitted Mr. Rice to continue under certain restrictions. There was no follow-up by the firm.

BlackRock did not inform the boards of directors of the Rice-managed registered funds or advisory clients about Rice Energy. No disclosure was made until the *Wall Street Journal* published three articles about Mr. Rice and Rice Energy in June 2012.

The SEC Order alleges violations of Advisers Act Sections 206(2), engaging in a course of conduct which constitutes a fraud and deceit, and Section 206(4)-7, failing to adopt and implement reasonable procedures to prevent the violation. In addition, Respondents caused certain BlackRock funds to violate Investment Company Act Rule 38a-1(a) which requires registered investment companies, through their chief compliance officer, to provide a report at least annually to the fund's board of directors addressing each material compliance matter that occurred since the date of the last report.

To resolve the matter, BlackRock agreed to a series of undertakings, including the retention of an independent compliance consultant who will prepare a report with recommendations which the firm will adopt. In addition, BlackRock consented to the entry of a cease-and-desist order based on the Sections cited in the Order. Mr. Battista also consented to the entry of a cease-and-desist order based, instead, on Advisers Act Section 206(4) and a related rule and Investment Company Act Rule 38a-1. The firm agreed to pay a penalty of $12 million and Mr. Battista will pay $60,000. This is the first case to charge a violation of Investment Company Rule 38a-1.

2. *SFX* –centered on the adequacy of procedures

In the Matter of SFX Financial Advisory Management Enterprises, Inc., Adm. Proc. File No 3-16591 (June 15, 2015), and the related action in *In the Matter of Brian J. Ourand,* Adm. Proc. File No. 3-16590 (June 15, 2015), are the other proceedings forming the backdrop to the debate on the role of CCOs.

Respondents in *SFX Financial* were the registered investment adviser, based in the District of Columbia, and Eugene Mason, the firm's CCO since 2004. Brian Ourand, the firm's vice president from 2003 to 2007 and president from 2007- August 2011 when he was terminated, was the Respondent in the second proceeding.

SFX had several clients for whom it had authority to withdraw and deposit assets from bank and brokerage accounts. Mr. Ourand had discretionary authority to trade in client accounts. He also had authority order client bank accounts to pay bills, transfer money and deposit checks.

From 2006 through 2011, Mr. Ourand misappropriated at least $670,000 from client accounts over a period of time, according to the Orders. He did this by writing unauthorized checks and wiring funds to his accounts for his personal use.

SFX had compliance policies and procedures in view of the significant risks that individuals could misappropriate client funds. Those policies included a review of cash flows from client accounts. The firm's Form ADV, Part 2 specified, in part, that client cash accounts used for paying bills were reviewed several times each week by senior management for accuracy and appropriateness. However, the SEC alleged that the firm's procedures were inadequate and the disclosure in its Form ADV was inaccurate:

- The procedures were not reasonably designed to prevent circumvention of secondary review;
- Neither the firm nor Mr. Mason effectively implemented the policy regarding the review of cash flows;
- No one other that Mr. Ourand reviewed the bill-paying accounts over which he had signing authority; and
- SFX failed to conduct its annual compliance review in 2011 in the midst of an internal investigation following the discovery of the misappropriation.

The Order alleged violations of Advisers Act Sections 206(2), 203(e)(6) and 206(4).

SFX and Mr. Mason resolved the proceeding. SFX consented to the entry of a cease and desist order based on Advisers Act Sections 206(2), 206(4) and 207 and to a censure. In addition, the firm agreed to pay a penalty of $150,000. Mr. Mason consented to the entry of a cease and desist order based on Advisers Sections 206(4) and 207. He also agreed to pay a penalty of $25,000.

The Order as to Mr. Ourand alleged violations of Advisers Act Sections 206(1) and 206(2). It will be set for hearing.

3. *Marwood* -- Admissions and the role of the CCO

When the Commission adopted its policy of requiring admissions to settle certain enforcement actions, no bright line test was created. Rather, an array of facts would be assessed on an individual, case-by-case basis. Generally, the factors focused on if the violations were egregious and of wide-spread interest. In *In the Matter of Marwood Group Research, LLC,* Adm. Proc. File No. 3-16970 (November 24, 2015), the SEC has required that a political intelligence firm with inadequate compliance procedures, but where no other actual violation occurred, make admissions of fact as a condition of settlement.

Marwood is a political intelligence firm. It is registered with the Commission as a broker dealer and the State of New York as an investment adviser. Initially its work centered on the healthcare area and was tied to the Center for Medicare and Medicaid Services ("CMS") and the Food and Drug Administration ("FDA").

Generally, the firm writes reports and updates regarding regulatory and legislative issues. It markets its analysis to clients in the financial sector focusing on events that had the potential to impact the share price of a public company's stock.

Account representatives communicated the firm's research to clients. They also participated in drafting the research reports. In some instances, phone calls with government employees were arranged.

The firm had a policy which prohibited insider trading. Its written policies and procedures concerning the use and dissemination of inside information provided for a review process overseeing the preparation and publication of its regulatory and legislative research notes. Those policies required approval by a licensed supervisory principal and submission of the review material through the compliance department. Employees were instructed that if they had doubts, the compliance department should be consulted. Employees were also prohibited from using any material, non-public information they obtained.

The Order alleges two instances in which the firm is alleged to have failed to enforce its existing policies. The first concerned the drug Provenge, an immunotherapy approved by the FDA in 2010 for metastatic prostate cancer. For certain medical items and services CMS may make a National Coverage Determination ("NCD") to determine the criteria for coverage for all Medicare beneficiaries. That process leads to a National Coverage Analysis ("NCA"). A change can impact Medicare coverage.

When this process was initiated for Provenge some clients sought Marwood's views on the reason the NCA had been initiated and the likely outcome. While CMS staff was governed by a confidentiality policy, they were permitted to speak to the public on select topics. A Marwood employee who was a former employee of CMS and had worked in the group responsible for NCAs contacted a person at the agency he knew. From that contact he learned information which provided "color" to the events and which he was cautioned should be kept confidential. Specifically, he understood that there was concern for off-label use and a further belief that CMS would cover on-label use. The information was sent to two managers. No steps were taken to present the information to the CCO. On July 8, 2010, Marwood published a research note predicting CMS's continued coverage and reimbursement of Provenge's on-label usages.

The second instance in the Order centered on the drug Bydureon, an injectable diabetes drug. The sponsoring company submitted a new drug application which was later revised. In response to the refiling, the FDA set a new statutory deadline for a decision.

Some clients sought Marwood's view on the likely outcome of the decision. A firm consultant who was a former high ranking FDA official had a lengthy conversation with Marwood staff during which he discussed information obtained from contacts at the agency. In part, that information revealed that the FDA had continued concerns and there was a debate between safety and reviewers. The consultant specified issues he believed were of concern to the agency. No steps were taken to quarantine the information. Marwood informed clients about the intense debate regarding the drug within the agency.

While Marwood's analysts interacted with government employees who were likely to be in possession of material nonpublic information the firm did not have written policies or procedures that required the CCO be provided with sufficient information to assess the situation. To the contrary, the firm relied largely on line employees. This resulted in violations of Exchange Act Section 15(g) and Advisers Act Section 204A, according to the Order.

To resolve the proceeding, the firm agreed to implement a series of undertakings, including the retention of a consultant. The firm also admitted to the facts detailed in the Order. Marwood consented to the entry of a cease and desist order. It will also pay a penalty of $375,000.

4. *Wolf* -- No sanction for CCO

Amid all the concern regarding the selection by the SEC of an administrative rather than a district court forum for bringing agency enforcement action comes a decision which has the potential to change the tenor of the debate, at least temporarily. Administrative Law Judge Cameron Elliot issued an Initial Decision in which he found a Wells Fargo compliance officer violated Exchange Act Section 17(a) by altering documents during a Commission investigation but declined to impose any remedy or penalty as "overkill." *In the Matter of Judy K. Wolf,* Adm. Proc. File No. 3-016195 (August 5, 2015).

The proceeding involving Ms. Wolf is one of three instituted by the Commission centered on the acquisition of Burger King by 3G Capital Partners. Initially, the agency brought an action against Wells Fargo broker Waldyr Da Silva Prado Neto, who misappropriated inside information about the transaction from a client, tipped others who traded and traded for his own account. *SEC v. Prado,* Civil Action No. 12-7094 (S.D.N.Y. Sept. 20, 2012) (complaint); *see also U.S. v. Prado,* Case No. 13-02201 (S.D.N.Y. Sept. 13, 2013) (complaint). Then the Commission brought an action against Wells Fargo for failing to establish and enforce procedures to prevent the misuse of material, non-public information. *In the Matter of Wells Fargo Advisors, LLC,* Adm. Proc. File No. 3-16153 (Sept. 22, 2014).

The action naming Ms. Wolf follows on these actions. She was a compliance consultant for Wells Fargo Advisors prior to her termination in June 2013. On September 2, 2010, the day the Burger King deal was announced, Ms. Wolf began a review of the trading

surrounding the deal, according to the Order. She concluded that: 1) Mr. Prado and his customers represented the top four positions in Burger King securities firm-wide; 2) Mr. Prado and his customers purchased Burger King stock within 10 days of the announcement; 3) Mr. Prado and his customers each had profits that exceeded the $5,000 threshold specified in the review procedures; 4) Mr. Prado and Burger King were located in Miami; and 5) Mr. Prado, his customers and the acquiring company were all Brazilian. News articles about the event were not printed and included in the file, despite a provision in the procedures requiring this step. The review was closed and not forwarded to the branch manager. Supervisors at Wells Fargo did not learn about the review until two years later when the SEC filed its insider trading action against Mr. Prado.

In July 2012 the Commission requested, as part of its on-going investigation, that Wells Fargo produce its compliance files relating to Mr. Prado. Although the production was eventually certified as complete, it did not include Ms. Wolf's file. When a second request was made in January 2013, that file was included in the production. Ms. Wolf's log stated she opened an investigation on September 2, 2010 and recited the basic stock opening and closing prices, noting a 24% increase over the prior close. The notes also stated that rumors had been circulating for several weeks regarding a private equity group. It cited a price increase in the stock as of "9/2/12."

Ms. Wolf provided contradictory testimony during the investigation. Initially, she testified that the file had not been altered. She claimed that the date of 9/2/12 in the file was a typo. Ms. Wolf stated that the news articles were a primary reason for closing the file. Later Wells Fargo produced documents indicating that the Burger King log entry had been altered on December 28, 2012. A prior version of the log was produced that did not contain the reference to the news articles. The metadata was produced. Following her termination from Wells Fargo, the Commission took Ms. Wolf's testimony a second time. During the testimony she admitted altering the log.

Following a hearing at which Ms. Wolf's testimony was largely consistent with that of her second appearance before the staff during the investigation, she was found to have violated Exchange Act Section 17(a) as alleged in the Order. Wells Fargo had admitted to violations of Exchange Act Section 17(a) and the related rules.

While Ms. Wolf claimed during her testimony that it was not inappropriate to alter compliance records after the fact as long as there was no "intent to mislead." The Initial Decision found this testimony "unconvincing." Ms. Wolf's liability did not hinge on whether she knew about the Burger King acquisition rumors in 2010 when she closed her review. Rather, the critical question was whether "she knew, or recklessly disregarded the risk, that the altered Long [containing added information about the rumors] would ultimately be produced to the Commission, purporting to be the Log that existed in 2010 when she conducted her review. Even assuming that she had in fact reviewed the new articles regarding the acquisition rumors, by failing to note when . . . [the additions were added] to the Log, any viewer of the Log would have the erroneous impression that . . .

[all the material] had been present in the original 2010 Log," the Administrative Law Jude ("ALJ") concluded.

The ALJ also rejected testimony from Ms. Wolf that when she first testified during the staff investigation in 2012 she did not recall having added the two sentences several weeks earlier and assumed they were from 2010. While Ms. Wolf claimed it was common practice to retroactively supplement the Log, if that were the case "when Wolf testified in 2013, Wolf would have had no reason to assume that she must have added the Two Sentences in 2010 . . ." The conclusion that Ms. Wolf acted with scienter is bolstered by her motive. As she became aware that the Commission was expanding its inquiry regarding the Burger King deal, adding the information would make her review appear better.

The critical question was the remedy to be imposed. At the hearing, Ms. Wolf presented testimony regarding her inability to pay. Since being discharged she has been unable to secure employment. Her son has been assisting her and she has been unable to pay her attorney.

Ms. Wolf's former husband is on disability. She generally assists him with the related paper work and sometimes financially. Several assets for which she is listed as a co-owner are actually his. She testified that any fine over $100 would be a burden and anything over $500 would make it difficult for her to continue assisting her ex-husband.

In considering whether a cease and desist order should be entered, the *Steadman* factors were used as a guide. There is no doubt that Ms. Wolf acted with scienter, the ALJ concluded. She also continues to insist that while a better job could have been done "she is not culpable" because there was no intent to deceive. While she regrets the "profound" effect this has had on her, Ms. Wolf "does not recognize the wrongful nature of her misconduct."

Nevertheless, the incident was isolated and Ms. Wolf has provided assurances against future violations. Indeed, she is unlikely to ever be in a position to replicate her conduct.

While at least some factors weigh in favor of a sanction, the ALJ found "that they are decisively outweighed by the remaining public interest factors: egregiousness, degree of harm, and deterrence." Here the violation was not egregious and it did not cause any proven harm to investors in the market place.

The critical question becomes deterrence. Ms. Wolf is a low level employee. While others above her might have been charged and knew of her conduct, she did not attempt to implicate them. If she is sanctioned there is a likelihood that others in the industry would see it as "a bad apple," resulting in no examination of their practices. That would be a "misperception, as the settled proceeding against Wells Fargo demonstrates. Wells Fargo clearly had much deeper and more systemic problems than one bad apple. . . Thus,

any sanction here will not only fail to have the desired general deterrent effect, but may actually be counterproductive."

One final factor is that Ms. Wolf worked in compliance. While those individuals are subject to the securities laws, the risk is much higher for them. "The temptation to look to compliance for the 'low hanging fruit' . . . should be resisted. There is a real risk that excessive focus on violations by compliance personnel will discourage competent persons from going into compliance, and thereby undermine the purpose of compliance programs in general," the ALJ wrote, citing Commissioner Gallagher's comments on charging compliance officials. While "I do not condone Wolf's misconduct . . . it is clear that sanctioning Wolf in any fashion would be overkill. Accordingly, no sanction will be imposed."

5. *Morgan Stanley* -- Advertising

In the Matter of J.P. Morgan, Adm. Proc. File No. 3-17036 (January 6, 2016) centers on the question of false advertising. JPM Securities is a wholly-owned subsidiary of JPMorgan Chase & Co. The firm is a registered broker dealer and investment adviser. It provides brokerage services to a business unit called J.P. Morgan Private Bank which is a marketing name for a segment that provides banking and investment services in the U.S. to high net worth and ultra-high net worth customers.

Over a period of four years beginning in 2009, JPM Securities used marketing materials that were false despite repeated warnings by personnel. Specifically, the materials stated that JPM Securities compensated registered representatives in Private Bank based solely on the performance of investments in customer accounts. In fact, they were paid a salary and a bonus which depended on a number of factors that did not include client account performance. The misrepresentation was made on:

Prospecting card: This was a wallet size card that contained key points about JPM Private Bank. The card was reviewed by internal compliance and received approval from the marketing department.

JPM Private Bank webpage: In June 2010, JPM Private Bank made certain revisions to its website. Those included adding the misrepresentation regarding broker compensation. The page was reviewed by the marketing department and approved by compliance.

Tampa webpage: In February 2011, JPM Private Bank's branch office webpage was revised and a separate one created for Tampa. It included the misrepresentation regarding broker compensation.

Pitch books: In March 2009 the marketing manager worked on a pitch book for Private Bank. The book included the compensation misrepresentation. It was disseminated for internal review prior to release.

Marketing letter: In November, an adviser at JPM Private Bank obtained approval for a marketing letter that was sent to his contacts. It contained the broker compensation misrepresentation.

Over a three year period beginning in 2011, four JPM Securities employees noted that the statement about broker compensation was inaccurate. No changes were made. The Order alleges willful violations of Securities Act Section 17(a)(2).

To resolve the proceeding, Respondent undertook remedial action considered by the Commission. The firm also consented to the entry of a cease-and-desist order based on the Section cited in the Order and to a censure. In addition, JPM Securities will pay a penalty of $4 million.

6. *KKR* – Broken deal expenses

In the Matter of Kohlberg Kravis Robert & Co. L.P.¸ Adm. Proc. File No. 3-16656 (June 29, 2015) is the first action by the SEC centered on "broken deal" expenses, one of the types of fees charged by hedge funds. Respondent Kohlberg Kravis Robert & Co. L.P. ("KKR") is a private equity firm specializing in buyout and other transactions. For its Flagship PE Funds and other advisory clients, the firm advises and sources potential investments. The firm also provides investment management and administrative services to its private equity funds for a management fee. In addition, the firm raises capital from co-investors for its private equity transactions.

KKR incurs significant investment expenses sourcing investment opportunities. The firm is reimbursed directly from portfolio companies for expenses incurred with successful transactions. For broken deal expenses, it is reimbursed through fee sharing arrangements with its funds. Consistent with the applicable limited partnership agreements, and those for the Flagship 2006 Fund LPA, KKR shared a portion of its monitoring, transaction and break-up fess with the 2006 Fund. Under the fee sharing arrangement, KKR received 20% of the fees and economically bore 20% of the broken deal expenses. However, the 2006 Fund's LPA and offering materials did not include any express disclosure that KKR did not allocate broken deal expenses to its co-investors despite the fact that they participated in, and benefited from, KKR's general sourcing transactions.

From 2006 through 2011, KKR allocated broken deal expenses by geographic region where the potential deal was sourced. Thus it allocated broken deal expenses related to potential North American investments to the 2006 Fund. Before 2011, however, the firm did not allocate or attribute any of those expenses to co-investors.

In June 2011, KKR concluded that it lacked a written policy governing its broken deal expenses. Over the next few months a policy was drafted, memorializing its allocation methodology. At the same time the firm decided to make an allocation of broken deal expenses to co-investment vehicles.

In late October 2011, KKR engaged a third party consultant to review its fund expense allocation practice. Effective January 1, 2012, the firm revised its broken deal expense allocation methodology following the consultant's review. A new methodology was implemented which allocated part of the expenses to partner vehicles and other co-investors.

In 2013, OCIE conducted a compliance exam which included a review of expense allocations. During the examination, KKR refunded its Flagship PE Funds a total of $3.26 million in certain broken deal expenses that had been allocated to them from 2009 to 2011.

Prior to the institution of the new policy, KKR did not allocate any share of broken deal expenses to its co-investors, with certain exceptions. Likewise, the firm did not expressly disclose in the limited partnership agreements or related materials that it did not allocate or attribute broken deal expenses to co-investors. As a result KKR misallocated $17.4 million in broken deal expenses between its Flagship PE Funds and co-investors, thereby breaching its fiduciary duty as an investment adviser, according to the Order. The Order alleges violations of Advisers Act Sections 206(2) and 206(4)-7.

Respondent resolved the matter, consenting to the entry of a cease-and-desist order based on the Sections cited in the Order. In addition, they agreed to pay disgorgement of $14,165,968 (net broken deal expenses), prejudgment interest and a penalty of $10 million.

7. Atlantic Asset Management -- Conflicts

Undisclosed conflicts by investment advisers and others is a focus of the current SEC enforcement program. In its most recent action, the conflicts came from a firm with an indirect, undisclosed controlling interest in the adviser. Unlike most of these actions, however, it did not settle at filing and was brought in federal district court as a civil injunctive action rather than as an administrative proceeding. *SEC v. Atlantic Asset Management, LLC* (S.D.N.Y. Filed December 15, 2015).

Atlantic Asset, previously known as Hughes Capital Management, LLC, has been a registered investment adviser since 1993. Hughes changed its name to Atlantic in 2015 after it was merged with another adviser. The firm is a wholly-owned subsidiary of GMT Duncan LLC.

BFG Socially Responsible Investments Ltd. holds a significant interest in GMT, acquired in 2014. The firm had the right under certain agreements to select one member of GMT's board of directors and the Chief Investment Officer ("CIO") for that firm and Hughes.

The 2014 Form ADV for Hughes did not disclose the interest of BFG in the firm. Yet that form requires advisers to identify each controlling person. It also requires the disclosure

of direct and indirect owners. When Hughes filed an amended Form ADV disclosing its acquisition by GMT the adviser stated that the parent had two partners. BFG was not mentioned.

BFG appointed the Hughes CIO. In August 2014 the CIO proposed the acquisition of certain Tribal bonds. An indenture for the bonds stated that the proceeds were to be used primarily to acquire an annuity which would be provided and managed by BFG's parent, the Annuity Provider, for a fee. The placement agent for the bonds would also be paid a fee. Although there were significant questions regarding the Tribal bonds, the CIO invested over $27 million on behalf of nine of the adviser's clients.

Subsequently, several Hughes clients expressed concerns regarding the purchase of the Tribal bonds. Specifically, there were questions regarding their valuation and suitability. A demand was made to unwind the deal. While Hughes assured the investors the Placement Agent had others interested in acquiring the bonds, no purchasers emerged.

In April 2015 a second purchase of Tribal bonds was made. In total the adviser had invested over $40 million in the bonds. While investors again raised questions regarding the transactions the investments were not unwound. Investors were not told about the conflicts or the interest of BFG.

In May 2015 when the adviser filed a Form ADV with the Commission it did not mention the interest of BFG. The complaint alleges violations of Advisers Act Sections 206(1), 206(2), 206(4) and 207. The complaint is pending.

8. *Fenway Partners* -- Conflicts

In the Matter of Fenway Partners, LLC, Adm. Proc. File No. 3-16938 (November 3, 2015) is another proceeding centered on conflicts. Fenway Partners, a Commission registered investment adviser, serves as the adviser to three private equity funds, including Fenway Partners Capital Fund III, L.P. Respondents Peter Lamm and William Smart served as Managing Directors, and had an ownership interest in, the adviser. Respondent Timothy Mayhew was also a Managing Director until his resignation in May 2012 when he joined Fenway Consulting Partners, LLC, an affiliate largely owned by Messrs. Lamm, Smart and Mayhew. Respondent Walter Wiacek served as Vice President, CFO and COO of Fenway Partners.

Fund III had investors which included pension funds, life insurance companies and large institutional investors. Pursuant to its organizational documents — a PPM, Limited Partnership Agreement and Investment Advisory Agreement — the firm operated under an Advisory Board consisting of Limited Partner representatives who were independent.

Fenway Partners had entered into agreements with Portfolio Companies under which monitoring fees were paid. Those monitoring fees were 80% offset against the advisory

fee paid by Fund III. In December 2011, however, Respondents caused four Fund III Portfolio Companies to terminate the agreements under which monitoring fees were paid. Those agreements were then replaced with Consulting Agreements with Fenway Consulting, an affiliate of Fenway Partners. The payments under those agreements were not offset against the Fund III management fees, although the services were largely similar. The Fund III Advisory Board was not informed of the conflict at the time the arrangements were approved. Nor were the arrangements disclosed as related party transactions. Under the agreements, Fenway Consulting was paid $5.74 million.

In January 2012, Fenway Partners sent a capital call notice to the Limited Partners regarding Portfolio Company A. The notice requested $4 million to invest in the firm's securities for capital improvements. Fund III only used $3 million for the securities while $1 million went to pay Fenway Consulting under a consulting agreement executed at the same time as the capital call. The $1 million payment was not disclosed to the Limited Partners in the capital call notice.

Finally, Respondents failed to disclose the conflict in a June 2012 transaction in which Fund III sold its equity interest in a second Portfolio Company, Company B. Mr. Mayhew and two former Fenway Partners were included in the Company B cash incentive plan. As part of the sales transaction the men were paid $15 million under the cash incentive plan from the sale proceeds, reducing the amount received by Fund III. That amount was paid almost entirely for services performed while the men were employees of Fenway Partners. Respondents Fenway Partners, Lamm and Smart also made, and Respondent Wiacek made or caused to be made, material omissions to investors concerning the cash incentive plan payments.

The Order alleges violations of Advisers Act Sections 206(2) and 206(4). To resolve the proceedings, each Respondent consented to the entry of a cease-and-desist order based on the Sections cited in the Order and to a censure (except Mr. Wiacek, who was not censured). In addition, each of the Respondents, except Mr. Wiacek, will, on a joint and several basis, pay disgorgement in the amount of $7,892,000 and prejudgment interest. Each Respondent will pay a civil penalty of: $1 million by the adviser; $150,000 each by Messrs. Lamm, Smart and Mayhew; and $75,000 by Mr. Wiacek.

9. Welhouse & Associates -- Robocop

When the SEC announced its financial fraud task force and a related data initiative to facilitate the identification of situations where the company "cooked the books," many dubbed the data program "Robocop." While the SEC may be continuing to work on that initiative, to date the agency has not created a computer to identify financial fraud. Robocop may, however, be appearing in another form. Not only does the agency use a big data approach to help sort out possible insider trading, but now it has created a program to analyze trading by investment advisers and identify wrongful conduct such as cherry picking. After test running calculations where it appeared an investment adviser

had cherry picked certain option trades, a simulation designed to verify the point was run one million times. The first proceeding based the new program was filed, *In the Matter of Welhouse & Associates, Inc.,* Adm. Proc. File No. 3-16657 (June 29, 2015).

Welhouse & Associates, Inc. is a state registered investment adviser. Respondent Mark Welhouse is its owner, principal and CCO. Custody of client accounts and assets is at a brokerage firm. From at least February 2010, and continuing through January 2013, the firm executed trades in an S&P 500 ETF called SPY for client accounts as well as Mr. Welhouse's personal accounts. Mr. Welhouse told the staff that he created a daily spreadsheet of the trade allocations between client accounts and his which was furnished to the brokerage firm to make the allocations. According to Mr. Welhouse, the trades were allocated on a pro rata basis before 5:00 p.m. each day.

Contrary to Mr. Welhouse's claims, however, an analysis of all of the accounts demonstrates that in fact the allocations were not made on a pro rata basis. For trades that increased in value on the day of purchase, frequently Mr. Welhouse day-traded by selling the options on the day of purchase. A disproportionate share of the profits were then allocated to his accounts. Trades that decreased in value frequently were not sold on the day of purchase. A disproportionate share of these trades were allocated to client accounts. During this period the brokerage firm warned Mr. Welhouse several times regarding the allocations and threatened to terminate its relationship with him and his firm. Mr. Welhouse told the staff that if the allocations were disproportionate it was a mistake.

A statistical analysis of the accounts suggests that there was no mistake. During the period Mr. Welhouse allocated 496 SPY option trades to his personal accounts and 1,127 to his clients. The total cost of the trades was $7.25 million for the personal accounts and $8.46 million for the client accounts. Yet the total first-day profits for the personal accounts was $455,277 in contrast to the total first day losses for the client accounts of $427,190. Stated differently, the first day returns for the personal accounts of Mr. Welhouse was 6.28% in contrast to a -5.05% for client accounts. This compares to a return of 0.18% for all of the first day trade transactions.

The first day returns were statistically significant, according to the Order. This was verified through a simulation run, testing the possibilities. The results showed that the chance of receiving the results shown in the personal accounts was less than one in one million. The simulation was run one million times.

Finally, clients were unaware of the allocation process. Indeed, the firm's Form ADV and related documents stated that Welhouse did not trade for its own account. The firm's written policies and procedures stated that trades were allocated on a pro rata basis. The Order alleges violations of Exchange Act Section 10(b) and Advisers Act Sections 206(1) and 206(2). The proceeding will be set for hearing.

10. *R.T. Jones Capital* -- Cybersecurity

Cybersecurity is one of the current hot topics of discussion. Regulators here and abroad have expressed concern regarding cybersecurity. Breaches are periodically reported in the media. While the SEC had undertaken investigations related to data breaches before, the SEC recently brought its first enforcement action centered on cybersecurity. *In the Matter of R.T. Jones Capital Equities Management, Inc.,* File No. 3-16827 (Sept. 22, 2015).

R.T. Jones is a registered investment adviser based in St. Louis, Missouri. The firm has about 8,400 client accounts and $480 million in regulatory assets under management. The firm provides investment advice to retirement plan participants under various agreements with plan administrators and sponsors. R.T. Jones uses an option called Artesys, through which clients are offered a variety of model portfolios with a range of investment objectives and risk profiles.

Plan participants access Artesys through the R.T. Jones website. Investors enroll through the site by furnishing certain personal information and responding to a questionnaire. Based on that information R.T. Jones recommends a portfolio. If the client agrees, the advisor provides trade instructions to the plan administrator. R.T. Jones does not control or maintain client accounts or information. It does, however, maintain information on all 100,000 plan participants which the firm obtained from the administrator. The information was stored on a third party-hosed server. It was not encrypted.

In July 2013, the firm discovered a potential cybersecurity breach at the server. R.T. Jones retained consulting firms to confirm and assess the scope of the breach. One consultant confirmed that the attack was launched from multiple IP addresses based in China. The consultants could not confirm the scope of the breach or if the personal information of the clients had been compromised. There is no indication to date that clients had suffered any financial harm from the attack.

The SEC's Safeguard Rule, adopted in 2000, requires that every investment adviser adopt policies and procedures with certain protections. Specifically, those include a requirement that the policies and procedures: insure the security and confidentiality of customer records and information, protect against anticipated threats or hazards, and safeguard against unauthorized access. R.T. Jones failed to adopt any written policies and procedures in accord with the Rule. Thus the firm did not conduct periodic risk assessments, employ a firewall to protect the web server, encrypt client personal information or establish procedures for reporting an incident. The Order alleges violations of Rule 30(a), Regulation S-P.

Following the incident R.T. Jones appointed an information security manager to oversee data security. It also adopted and implemented a written information security policy and moved the client personal information to an internal server and encrypted it. The adviser

also retained a cybersecurity firm to provide on-going advice and reports. The firm also cooperated with the staff's investigation.

To resolve the proceeding, Respondent consented to the entry of a cease-and-desist order based on the Rule cited in the Order and to a censure. R.T. Jones will also pay a penalty of $75,000. The Commission considered the firm's remedial actions and cooperation in resolving the action.

11. *Stephen Cohen* -- The impact of *Newman*

In the Matter of Steven A. Cohen, Adm. Proc. File No. 3-15382 (January 8, 2016) is the long running SEC proceeding against the founder of SAC Capital, Steven Cohen. The proceeding sought to bar Mr. Cohen from the securities business; however, that was not the final result. In the settlement, Mr. Cohen consented to the entry of an order which precludes him from being associated in a supervisory capacity with any broker, dealer, or investment adviser until December 31, 2016. He also agreed to comply with certain undertakings. Those include the retention of a consultant, the adoption of the consultant's recommendations and the retention of a monitor until the termination of the bar order.

Mr. Cohen, the founder of SAC Capital, a hugely successful hedge fund he created which at one time managed $15 billion in assets, had long battled the Manhattan U.S. Attorney's Office and the SEC about insider trading allegations. Former and current employees of the fund had been charged and convicted. Affiliates of the hedge fund settled with the SEC, paying over $600 million. The fund and an affiliate paid an additional $1.2 billion to settle criminal charges brought by the Manhattan U.S. Attorney's Office.

The SEC's administrative action against Mr. Cohen was largely viewed as an effort to end the adviser's career. *In the Matter of Steven A. Cohen,* Adm. Proc. File No. 3-15382 (July 19, 2013) was brought shortly after the SEC initiated it admissions-to settle policy. It charged failure to supervise, alleging violations of Exchange Act Section 10(b).

The SEC, however, brought its charges on an unstable foundation — two then pending and unresolved criminal trading cases. Most of the initial Order detailed the allegations against Messrs. Martoma and Steinberg. Little was actually said about Mr. Cohen. One criminal case was against former SAC employee Mathew Martoma. The other charged then current SAC Capital employee Michael Steinberg. The Order claimed that Mr. Cohen failed to take prompt steps to investigate a series of red flags. By not doing so he "failed reasonably to supervise Martoma and Steinberg with a view to preventing their violations of Section 10(b) of the Exchange Act . . ."

By the time of the settlement last week the landscape had changed. Mr. Martoma had in fact been convicted of insider trading. His case is currently on appeal. Mr. Steinberg was

also convicted and sentenced to serve three and a half years in prison. For a time, the Manhattan U.S. attorney was invincible.

Then came the decision in *Newman*. *See* Section II.A., supra. Following *Newman* the conviction of Mr. Steinberg, who was severed from the trial in *Newman,* was dismissed.

With half of its case gone the SEC took what it could get. The Exchange Act Section 10(b) allegation was absent. No cease and desist order was entered. No admissions were made. No penalty will be paid. The limited remedies obtained are clearly not what were sought.

While *Newman* had a significant impact on Mr. Cohen's case, other factors were at work. Charging someone in either a criminal or civil law enforcement action is a very serious matter, inflicting significant harm on those named in the action. *Newman* ultimately traces to the overreaching of the U.S. Attorney's Office despite an incredible winning record at the time. While the SEC's settlement is the byproduct of that decision, it is, in the first instance, a direct result of the Commission's decision to bring charges based not on facts it had gathered but two unproven and unresolved criminal cases. In this regard it is little different that the decision which ultimately resulted in *Newman.* Once can only hope that the real result of the settlement is a more careful charging process in the future.

IV. Venue Selection

A. Trend in venue selection

SEC enforcement is bringing more actions, more administrative proceedings but obtaining lower amounts of penalties and disgorgement, according to a recent report by Cornerstone Research and the NYU Pollack Center for Law Business. Cornerstone Research and the NYU Pollack Center for Law Business, "SEC Enforcement Activity Against Public Company Defendants, Fiscal Years 2010 — 2015" (Jan. 12, 2016).

The number of SEC enforcement actions is increasing according to the Report. Over the last five fiscal years the number of enforcement actions brought by the agency has significantly increased. For example, in fiscal 2010 there were 681 actions filed, while there were 735 brought the next year. By 2014 there were 755 actions filed followed by 807 last year. During the same period the number of enforcement actions brought against public company defendants remained roughly constant, with 33 such actions brought in 2010 and 2015.

The increase in the overall number of SEC enforcement actions brought last year was driven by an increase in number of independent enforcement actions, compared to follow-on administrative proceedings and delinquent filing actions. In fiscal 2015 there 507 independent enforcement actions filed, which is a record. That compares to a range

of 318 to 445 independent actions for the fiscal years 2005 to 2012. At the same time the number of follow-on actions declined.

Venue selection is one of the key topics of discussion regarding the SEC. In recent months a bevy of actions have been brought against the SEC concerning the selection of venue. The statistics in the Report chart the shift. For the period 2010 through 2013, over 65% of the actions against public companies were brought in federal court. Thus, in fiscal year 2010 only 21% of the actions were brought as administrative proceeding while in fiscal year 2011 it was 34%, 2012, 24% and 2013, 35%.

Fiscal years 2014 and 2015 represent a dramatic shift. In 2014, 74% of the actions against public companies were bought as administrative proceedings while only 26% were filed in federal court. The shift continued the next year with 76% of those actions being brought as administrative proceedings and 24% as federal court actions.

The fact that most public companies settle actions with the SEC is well established. At the same time, venue selection may be having an impact. Last year, 82% of the actions brought against public companies were settled at the time of filing. That is consistent with the fact that 85% of those actions were settled on filing in 2014 and 81% in 2013.

The trend of filed at the time of settlement seems to shift with venue, however. In 2015, 96% of the actions filed against public companies as administrative proceedings were settled at the time the action was instituted. That is higher than the 88% in 2014, but less than the 100% recorded in 2013 and 2012.

In contract, in 2015 only 38% of the enforcement actions filed by the SEC against public companies in federal court were settled at the time of filing. The prior year it was 78% and in 2013, 71%. While it is clear that there is a significant increase in the number of actions against public companies being brought as administrative proceedings, the reason that virtually all of those cases are settled at the time of filing is an open question – did the venue selection drive the settlement, the settlement drive the venue selection or was venue selection only a matter of convenience for the agency, as some officials have suggested.

B. Suits against the SEC based on venue

The shifting policy on venue selection by the SEC spawned a series of law suits. *See, e.g., Jarkesy v. SEC,* 809 F. 3d 9, 15 (D.C. Cir. 2015) (collecting cases). Initially these suits focused on allegations centered on claimed violations of equal protection and due process rights.

Another group of cases centered on Appointment Clause claims. Those cases claim that the Administrative Law Judges who hear SEC administrative proceedings were not properly appointed under the clause. Those actions have had mixed results. *See, e.g.,*

Duka v. SEC, No. 15- 357, 2015 WL 1943245 (S.D.N.Y. Apr. 15, 2015), *appeal filed* No. 15-2732 (filed in 2d Cir. Aug. 27, 2015) (district court entered injunction against SEC based on Appointment Clause claim); *Hill v. SEC,* No. 1:15- 1801, 2015 WL 4307088 (N.D. Ga. June 8, 2015, *appeal filed* No. 15-12381 (filed in 11th Cir. July 2, 2015) (same); *but see Jarkesy v. SEC,* 809 F. 3d 9, 15 (D.C. Cir. 2015); *Bebo v. SEC,* 799 F. 3d 765 (7th Cir. 2015).

The SEC typically defends these cases by claiming that the district courts do not have jurisdiction to hear the suits, citing *Thunder Basis Coal Co. v. Reich,* 510 U.S. 200 (1984). That argument centers on Exchange Act Section 25 which provides for review by a circuit court for administrative proceedings. Circuit Courts which have considered this issue have sided with the SEC. *See, e.g., Jarkesy v.* SEC, 809 F.3d 9 (D.C. Cir. 2015). What the courts don't consider is the fact that at the circuit court level the SEC typically argues that its decisions are entitled to deference under *Chevron U.S.A., Inc. v. Natural Resources Defense Council,* 467 U.S. 837 (1984). That effectively insulates the decision from review.

C. The SEC memorandum

In the wake of the lawsuits challenging the discretion of the SEC to bring actions as administrative proceedings and the questioning of Chair White in a recent Senate Subcommittee budget hearing on the topic, the staff posted the "Division of Enforcement Approach to Forum Selection in Contested Actions" on the agency website. This is the first guidance published by the agency (beyond comments made in speeches or at programs).

The overall approach is guided by the mission of the agency which is "to protect investors and the integrity of the markets through strong, effective, and fair enforcement of the federal securities laws." A series of factors which tend to delimit forum selection choices in certain instances are identified. Nevertheless, the forum selection decision is discretionary — there is "no rigid formula dictating the choice of forum." To the contrary, the Division considers "a number of factors . . ." which may differ from case to case, although "in some circumstances a single factor may be sufficiently important to lead to a decision . . ." The list provided is not exhaustive and may not contain factors considered in some instances. Those identified are:

- ***Factor 1:*** "The availability of the desired claims, legal theories, and forms of relief in each forum." The selection of a particular forum might be dictated by the nature of the charges or the relief sought. For example, a failure to supervise charge can only be brought in an administrative forum while a control person liability theory must be pursued in district court, according to the staff. Likewise, the need to seek a TRO or to name a relief defendant would dictate that the forum be district court.

- ***Factor 2:*** "Whether any charged party is a registered entity or an individual associated with a registered entity." These persons have "long been subject to the Commission's regulatory oversight. . ." and an administrative forum provides the agency with additional remedies not available in district court such as "associational bars and suspensions. . ." While it is possible to bring a district court action against these persons and obtain the additional remedies in a tag-a-long administrative proceeding, it may be more efficient to bring one action.
- ***Factor 3:*** "The cost-, resource-, and time-effectiveness of litigation in each forum." The focus here is the efficient use of the SEC's limited resources. Thus, where a quick or "more timely public airing" is necessary, an administrative forum may be the choice. Yet if complete relief may only be obtained by naming a relief defendant, the efficient choice may be district court. Procedure can also be a significant factor. If, for example, a broad range of claims should be addressed through summary judgment, or if there is a particular need for depositions, then the appropriate venue may again be district court.
- ***Factor 4:*** "Fair, consistent, and effective resolution of securities law issues and matters." Where the action is "likely to raise unsettled and complex legal issues under the federal securities laws, or interpretation of the Commission's rules . . ." the expertise of the Commission and the Administrative Law Judges, subject to appellate review, "facilitate development of the law" dictating the choice of an administrative forum. In contrast, if there are questions of state law, other specialized areas of federal law or if "similar charges are being or have been brought against similarly situated parties . . ." then it may be "preferable" to bring the action in the same forum.

While the posting of this memorandum may be a response to the rash of law suits filed against the Commission over forum selection and recent questioning in the Senate it is unlikely to ameliorate the concerns presented. Three points are critical:

First, the memorandum does little to actually define the forum selection process. Much of what it discussed has little significance to the day-to-day forum decisions for most cases. To be sure, there are instances when the nature of the claim or the remedy dictates the choice. This is not most cases however. This is particularly true following Dodd-Frank which added provisions to the statutes which, in part, may be driving the move to the administrative forum. Viewed in this context, the discussion of these factors offers little insight into, or guidance about, the SEC's forum selection process.

Second, citing the Commission's resources as a driving factor adds little to illuminate the opaque process. If speed and cost were the determinative factors, an administrative proceeding would always be the choice since the agency has imposed time limits on most of these actions. All this really tells the public is that after spending whatever time the SEC deems necessary to conduct an investigation, a rush to judgment is the way to go despite a host of factors such as the complexity of the action, difficult credibility issues

which should be resolved by a jury and other factors which might dictate bringing the case in district court.

Third, stating that difficult or unsettled legal issues may dictate the selection of an administrative forum in view of the Commission's expertise and the availability of appellate review raises the prospect of selecting an administrative forum in an effort to avoid having those issues resolved by the courts which has traditionally been the case. This approach may not only permit the agency to avoid trial losses, such as those suffered in recent months, but to side-step developing case law it does not like, e.g., by moving insider trading cases into an administrative forum, the SEC may avoid the requirements of *Newman* regarding the personal benefit test for illegal tipping. Since virtually all insider trading law has been fashioned by the courts, such a move could stilt the development of the law. The prospect of appellate review does not change this point since the SEC will no doubt claim on appeal that the court should defer to its views. Not only will this undermine the development of the law, it creates the perception of unfairness – supposedly one of the key goals of enforcement policy.

While it clearly would be beneficial if the SEC addressed the questions regarding forum selection to reassure the public regarding the fairness of its processes, this memorandum misses the mark. It offers virtually no insight into what can only be viewed as a "black box" process used by the agency to make these critical decisions. Anxiety regarding that process can only be intensified by the prospect that in addition to those actions typically brought in that forum whole new classes of actions may now be brought there to take control of the development of the law. Avoiding the courts in that fashion can only add to the perception of unfairness, undercutting the mission of the agency.

D. U.S. Chamber Proposals

The U.S. Chamber of Commerce published a report regarding the enforcement practices of the SEC titled "Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices, July 2015." The Report contains twenty-nine recommendations for improving the program.

The recommendations are divided into ten categories: The use of administrative proceedings, Wells notices, admissions, what the Report calls duplicative regulatory enforcement, enforcement policy, improving Commission oversight of the enforcement process, the transparency of the enforcement process, streamlining the investigative process, document requests during an investigation, and improving the efficiency of the investigative process. Interestingly, there are no recommendations dealing with remedies and the trend of imposing what some may view as ever increasing monetary penalties, particularly on individuals.

Key recommendations in the Report include:

Administrative proceedings: The first four recommendations in the Report deal with the use of administrative proceedings and specifically selecting an administrative forum rather than brining the action in federal district court. The recommendations include: developing a policy which would guide forum selection; creating a mechanism through which parties could challenge the SEC's forum selection decision; permitting those who wish to have a jury trial to file a notice opting out of an administrative proceeding; and updating the Rules of Practice to increase pre-hearing discovery and permit depositions.

Wells process: Recommendations in this group include a call for a "reverse proffer" under which those who are potential defendants/respondents would be fully informed regarding the evidence prior to making a submission.

Admissions: The recommendations suggest a review of the current policy and, if it is going to continue, the development of guidance on their use.

Duplication in regulatory enforcement: This area addresses the issue of parallel proceedings, recommending that the SEC take a leadership role among regulators and enforcement officials in trying to streamline the use of overlapping and duplicative actions.

Enforcement policy: Comments on enforcement policy focus on broken windows and its focus on eliminating the idea that there is a "small violation" exception to enforcement. To facilitate the policy while conserving resources the Report recommends "the creative use of informal remedies . . ." to deal with smaller violations.

Oversight and transparency: In these areas the Report recommends developing a quarterly management report prepared by the staff for the Commissioners based on metrics developed by the Division of Economic and Risk Analysis. The report would focus on key areas such as significant "National Priority" investigations, those presenting novel or complex question, a post-mortem of unfavorable litigation results and new and emerging areas that may warrant investigation. Transparency would be enhanced by alerting those subject to the regulations of the agency to new interpretations and/or trends, publishing an annual report on the Enforcement Program and providing for public comment.

Facilitation of the enforcement process: This could be aided through several recommendations which include early notice by the Division to those projected to be involved in an investigation to preserve documents and an early dialogue with defense counsel regarding the types and categories of documents that will be sought. Consideration could also be given to establishing access to certain materials for the staff rather than actually producing the documents.

Efficiency of the enforcement process: A final group of recommendations focuses on increasing the efficiency of the enforcement process. These include improving the management of investigations, developing evaluation metrics, requiring departing staff to prepare a transition memorandum, providing closing notices, increasing staff training and increasing the integration of trial attorneys into the investigative process.

The Chamber also developed a legislative proposal regarding venue selection. Under the proposed legislation a Respondent in an administrative proceeding would have the option to have the action dismissed and refiled in federal court.

Finally, the Chamber developed comments on proposed revisions to the SEC's Rule of Practice which govern administrative proceedings. The SEC's proposed Rule changes would: 1) adjust the timing of administrative proceedings; 2) permit parties to take a limited number of depositions under certain circumstances; and 3) provide for electronic service of pleadings. The Chamber has offered comments focused on part on the lack of evidentiary standards in administrative proceedings.

V. Conclusion

As the SEC moves forward and new Commissioners are appointed it will be against a backdrop of partisan disputes on enforcement policy, the standards by which investment advisers, broker dealers and others such as chief compliance officers and others are judged and whether venue selection questions are being driven by an effort to shore up courtroom results or for other reasons. Key issues which emerge from this include:

Collegiality*:* With the addition of new Commissioners, will the agency once again achieve a spirit of collegiality built on shared goals and the compromise necessary to effectively implement its statutory mandate? In the recent past many commentators have decried the politicization of an agency which once prided itself on being non-political. The impact can be seen in a series of 3-2 votes on questions ranging from rulemaking to sanctions and enforcement actions. Increased collegiality might permit the Commission to move forward with a more robust agenda and away from the current disharmony.

Venue selection*:* The announcement that more enforcement actions will be brought as administrative proceedings spurred a series of suits against the agency. Those suits raise a number of key constitutional issues. The SEC typically defends these cases by claiming that those charged can effectively present the issues in an administrative process which culminates with an appeal to an Article III court. In advancing this argument the SEC does not mention the fact that once the case reaches the circuit court, the Commission will argue that the court should defer to its decision under *Chevron,* thus ending any effective review. Although the U.S. Chamber of Commerce is lobbying Congress for relief on this issue, that seems unlikely. It is time for the SEC to step-up, regardless of the outcome in the courts and Congress. Moreover, it is time for the agency to stop trying to win enforcement actions through venue selection and demonstrate that it is a fair, even-

handed regulator, not an agency which seeks to win at all costs. That begins by bringing actions in the forum in which they have traditionally been brought. This would reflect the kind of fundamental fairness that is critical to an effective enforcement program.

Broken windows*:* The initiation of this program has driven the numbers-sanctions-publicity approach of the current program. While it may be an effective approach for the New York police department, it has no real application in SEC enforcement. If, for example, a New York City police officer walks a beat and strictly enforces the law on all matters it is reasonable to expect that his or her presence on the street taking such actions will have a deterrent effect on a would-be bank robber, burglar or street corner drug seller. In contrast, there is no reason to believe that if SEC enforcement generates a headline in *The New York Times, Washington Post* or *Wall Street Journal* by packaging-up a group of Rule 105 short selling violations and trumpeting the large total fine that it will have any deterrent impact on the CFO of a public company who is considering cooking the books to make the numbers or the executive who is about to tell his or her best friend about a potential take-over of the company so the person can trade and make large profits.

Fair application of the law: SEC enforcement actions should be just what the name implies – the enforcement of existing law, not rewriting it. It is axiomatic that those charged with violations of the law are entitled to fair notice and an opportunity to defend. This issue presents itself in a number of areas. For example, in insider trading a critical question in advance of the *Salman* ruling is how the agency will deal with *Newman.* In the past the agency has tried to avoid unfavorable interpretations of the law as it did with its ill-fated decision in *In the Matter of John W. Lawton*, Admin. Proc. File No. 3-14162 (Dec. 13, 2012), which utilized a sophistic argument to claim that the backdated application of new sanctions was not impermissibly retroactive, a decision struck down by the D.C. Circuit (full disclosure, the author was counsel to Respondents in that case). *See also Flannery v. SEC,* No. 15-1080(1st Cir. 2015)(reversing decision of the SEC for a lack of evidence where the agency found Respondents engaged in fraud despite an ALJ ruling to the contrary). The fundamentally unfair positions taken at times by the SEC only serves to undercut the credibility of the enforcement program, painting it as overreaching and not trustworthy.

The common thread through each of these points is the necessity for a dedication by the Commission – the five Commissioners working together – to effectively police the markets and market place through an enforcement program bottomed on fundamental fairness. That approach lends credibility to the program, encouraging market participants to trust the agency and staff and cooperate. While 2016 can serve as a new beginning for SEC enforcement, the predicate must be fundamental fairness – that approach engenders the trust of those dealing with the agency that it will do the right thing.

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Federal Enforcement Forum:

FERC and CFTC Enforcement for 2016

Moderator:
Joe Hall, Co-Chair of Energy Industry Group, Dorsey & Whitney LLP

Panelists:
Tom Gorman, Government Enforcement and Investigations Group, Dorsey & Whitney LLP

Nathan B. Ploener, KPMG LLP

Shaun Ledgerwood, The Brattle Group

Introduction – Three Goals for Today

- Update on FERC Enforcement
- Update on CFTC Enforcement
- We expect both FERC and the CFTC to get more aggressive in 2016 – what does this mean?

Part 1 - Overview of FERC Enforcement Initiatives

- 2015 Enforcement Information
  - As of Nov. 2015, counting all pending federal court and administrative law judge litigation, FERC Enforcement has sought to recover $544,600,000 in civil penalties and $42,242,999 in unjust profits through seven litigation proceedings.
  - FERC Enforcement has never had this many litigation proceedings over the course of one year.
  - In FY2015, FERC Enforcement assessed civil penalties in all four investigations for which it had issued Orders to Show Cause in the end of FY2014 (*Powhatan*) and FY2015.
    - *See 2015 Report on Enforcement*, Docket No. AD07-13-009, at 6 (Nov. 19, 2015).
- Potential impact of Commissioner Moeller and Commissioner Clark departures.

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FERC – Recent Rulemakings/Orders to Monitor

- Connected Entities Notice of Proposed Rulemaking
  - FERC proposes to obtain information to understand the ownership, employment, debt, and contractual relationships of market participants in RTOs/ISOs.
    - RTOs/ISOs would provide the market participants' information to FERC.
  - Purpose
    - Understanding the undisclosed relationships between market participants would allow FERC to identify behavior that is manipulative, abusive, or fraudulent.
    - Market participants share relationships that are not revealed through existing affiliate disclosure requirements.
    - Market participants may be undertaking transactions that benefit entities with whom there is no publicly documented relationship.
  - Proceeding to Monitor
    - *Collection of Connected Entity Data from Regional Transmission Organizations and Independent System Operators*, 152 FERC ¶ 61,219 (2015).

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Overview of Recent FERC Enforcement Decisions

- PJM UTC/MLSA proceedings
  - *City Power Marketing, LLC and K. Stephen Tsingas*, 150 FERC ¶ 61,176 (2015).
  - *Coaltrain Energy*, 154 FERC ¶ 61,002 (2016).
  - *Houlian Chen, Powhatan Energy Fund, LLC, et al.*, 149 FERC ¶ 61,261 (2014).
- *ETRACOM LLC and Michael Rosenberg*, 153 FERC ¶ 61,314 (2015).

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Pending FERC Federal District Court Cases (filed from late 2013 to late 2015)

- *FERC v. City Power Marketing, LLC,* No. 15-cv-01428 (D.D.C.) (pending since Sep. 1, 2015).
- *FERC v. Powhatan Energy Fund, LLC*, No. 3:15-cv-00452 (E.D. Va.) (pending since Jul. 31, 2015).
- *FERC v. Maxim Power Corporation*, No. 15-cv-30113 (D. Mass.) (pending since Jul. 1, 2015).
- *FERC v. Lincoln Paper & Tissue, Inc.*, No. 1:13-cv-13056 (D. Mass.) & *FERC v. Silkman*, No. 1:13-cv-13054 (D. Mass.) (pending since Dec. 2, 2013).
- *FERC v. Barclays Bank, PLC,* No. 2:13-cv-2093 (E.D. Cal.) (pending since Oct. 9, 2013).

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Legal Issues That Are Subject to Pending FERC Federal District Court Cases

- Meaning of *de novo* review and *Chevron* deference
- Statute of limitations
- Liability of specific individuals as "entities" subject to civil penalties under the Federal Power Act
- FERC jurisdiction vs. CFTC jurisdiction
- Venue

Part 2 - CFTC Overview of Enforcement Initiatives

- For FY2015, the CFTC filed 69 enforcement actions involving reporting violations, manipulation, attempted manipulation, spoofing, and fraud, among others.
  - The CFTC issued a record $3.144 billion in civil monetary penalties in 2015.
- CFTC's enforcement of its market manipulation authority focused on curbing spoofing practices.

CFTC Rulemakings/Orders to Watch

- Regulation AT
  - Proposed regulation of algorithmic trading
  - Requires new controls, compliance testing, reporting and new categories of registration
  - Very broad definition
  - Adopted because of increase of spoofing and perceived negative impact of high frequency trading
- *De minimis* exception to swap dealer registration requirements
  - Threshold will decrease from $8 billion to $3 billion on Dec. 31, 2017, if no change or relief granted by the CFTC.
- Position limits on energy contracts
  - On the docket for a while and may be pushed off further due to low oil prices and election year politics.
- Orders/rulings to watch: *Kraft* and *DRW*

CFTC v. Kraft
(Civil Action No. 15-cv-02881)
(*Complaint filed Apr. 1, 2015, N.D. Ill.*)

- Alleged market manipulation
- Background
  - Kraft is a large buyer of #2 Soft Red Winter Wheat, procured from two primary sources: cash market and Chicago Board of Trade (CBOT) wheat futures contracts.
  - Kraft acquired future contracts to buy (long futures contracts) on the CBOT for Dec. 2011 and futures contracts to sell (short futures contracts) for Mar. 2012.
  - By Nov. 29, 2011, Kraft allegedly bought $93.5 million of CBOT wheat futures in the Dec. 2011 contract, representing $15.75 million bushels.
  - The CFTC asserted that Kraft ultimately took delivery of only 660,000 bushels of this wheat, unwinding the rest.
  - Kraft alleged to have no intent to take delivery of the remaining grain.

CFTC v. Kraft
(Civil Action No. 15-cv-02881)
(*Complaint filed Apr. 1, 2015, N.D. Ill.*) *cont'd*

- Allegations of CFTC Complaint
  - Kraft developed a scheme to decrease the price of wheat on the cash market and inflate its price on the futures market.
  - Kraft had a two-part plan:
    - Decrease prices on cash wheat near Toledo by signaling to the market that it would be buying all its wheat in December from the CBOT.
    - Increase the value of December futures contracts for wheat and reduce the premium for March futures over December wheat.

CFTC v. Kraft
(Civil Action No. 15-cv-02881)
(*Complaint filed Apr. 1, 2015, N.D. Ill.*) *cont'd*

- Single trigger (deliberate overbuying of the Dec. 2011 contract) is alleged to have affected two nexuses:
  - Nexus 1: Kraft's futures purchases tanked the Toledo cash market price.
  - Nexus 2: Kraft's purchases drove up the price of Dec. 2011 futures.
- This allegedly benefited two manipulation targets:
  - Kraft continued to buy grain daily in the cash market at market prices that were suppressed due to its large futures purchase.
  - Kraft's spread position benefited from the increased price of the Dec. 2011 futures contract.
- Kraft moved to dismiss the CFTC's complaint on the basis that its interpretation of Rule 180.1 is inconsistent with SEC Rule 10b-5.

CFTC v. Kraft
(Civil Action No. 15-cv-02881)
(*Complaint filed Apr. 1, 2015, N.D. Ill.*) *cont'd*

- Outcome of *Kraft*
  - On Dec. 18, 2015, the court rejected the CFTC's claim that Rule180.1 prohibits manipulative conduct in the absence of fraud.
  - The CFTC is required to meet the heightened pleading standard for fraud claims.
  - Kraft's motion to dismiss was still denied.
    - The court found that the CFTC's complaint alleged a plausible violation of Rule 180.1 under the heightened pleading standards.

CFTC v. Kraft
(Civil Action No. 15-cv-02881)
(*Complaint filed Apr. 1, 2015, N.D. Ill.*) *cont'd*

- Outcome of *Kraft*
  - The court broadly construed the types of schemes that may be considered fraudulent.
  - Fraud-based manipulation could include:
    - Traditional fraud by misrepresentation or omission, *or*
    - Deceiving market participants by artificially affecting prices through open-market transactions.
  - Kraft filed for discretionary appeal with the 7th Circuit Court of Appeals.

CFTC v. Donald R. Wilson and DRW Investments, LLC
(Civil Action No. 13-cv-7884)
(*Complaint filed in Nov. 2013 SDNY*)

- Allegations of CFTC Complaint
- "Banging the Close"
- From at least Jan. 2011 through Aug. 2011, DRW allegedly manipulated the price of a futures contract, namely the IDEX USD Three-Month Interest Rate Swap Futures Contract.
  - Over a period of at least 118 trading days, DRW placed electronic bids at higher interest rates than the corresponding rates that otherwise would control the contract price, and subsequently withdrew such bids.
  - DRW acquired a large long (fixed rate) position in the Three-Month Contract with a net notional value in excess of $350 million.

CFTC v. Donald R. Wilson and DRW Investments, LLC
(Civil Action No. 13-cv-7884)
(*Complaint filed in Nov. 2013 SDNY*) *cont'd*

- The CFTC moved for summary judgment on its attempted price-manipulation claim (Rule 180.2), arguing that it need only prove the defendants:
  - (i) intended to affect the price of a commodity (but not to create an artificial price); and
  - (ii) took an overt act in furtherance of that intent.
- DRW countered that the CFTC's statement of the law contradicts 2nd Circuit precedent and the CFTC's own prior administrative decisions.
  - The CFTC must prove the same intent standard for both attempted and completed manipulation (i.e., the defendant specifically intended to create an artificial price).

CFTC v. Donald R. Wilson and DRW Investments, LLC

(Civil Action No. 13-cv-7884)
(*Complaint filed in Nov. 2013 SDNY*) *cont'd*

- Notably, several recent CFTC administrative orders finding manipulative intent have relied heavily on traders' statements related to trading to affect price — even if not to an artificial level.
- The DRW court could follow suit and uphold the CFTC's recent efforts to lower the manipulation standard, or reaffirm that artificial price is a necessary element of a claim for attempted price manipulation.

Will the CFTC increase its policing of agricultural commodities in 2016?

- In addition to *Kraft*, the CFTC issued several orders in 2015 relating to agricultural commodities:
  - **Marubeni**
    - Improper hedge exemption reporting (fined $800,000).
  - **Olam International**
    - Violated position limits for cocoa futures traded on ICE Futures U.S. Inc., and unlawfully executed noncompetitive exchange of futures for physical transactions opposite each other. They were ordered to pay a $3 million penalty.
  - **Kent Woods**
    - Floor broker in the soybean commodity futures pit at CBOT who failed to comply with applicable record-keeping and audit trail rules and engaged in unauthorized trading.
    - Created after-the-fact trading records containing fictitious information that were submitted for clearing.
    - Failed to supervise employees of Futures International LLC (FI), an Introducing Broker of which he was a principal.
    - Woods was ordered to pay a $200,000 penalty. The CFTC obtained a $500,000 penalty in settling the related civil injunctive action against FI and its Chief Operating Officer, Amadeo Cerrone, over violations arising from the same underlying set of facts in the Woods order.

Will the CFTC increase its policing of agricultural commodities in 2016? *cont'd*

- Agricultural products are sufficiently related to the public interest to warrant policing and will continue to be on the CFTC's radar.
- What can we expect in 2016-2018?
- CFTC will continue its supervision of the agricultural markets and bring enforcement actions relating to manipulation, supervisory failures, and reporting violations.

Part 3 - What does more aggressive enforcement of fraud-based statutes look like in 2016?

- Both FERC and the CFTC apply fraud–based statutes to police potential market manipulation.
- Basic statutory elements to establish market manipulation:
  - A device, schedule, mechanism (including an omission when there is a duty to tell the truth)
  - Implemented with deceptive intent (scienter)
  - Action involves a FERC/CFTC (or perhaps both) jurisdictional market.

How does a regulator establish deceptive intent?

- Documentary evidence (emails, instant messages, memos)
- Depositions and cross-examination at trial (including testimony from “rats”)
- Analysis of transactions and trading activity to impute deceptive intent from alleged uneconomic activity

Common Evidence of Intent

- Actions inconsistent with supply and demand
- Differences in patterns between “legitimate” transactions and “manipulative” transactions
- “False denials”
- Implausible explanations

“Informal” Discussions

- There is no such thing as an informal discussion with regulators.

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What have we seen over the last two years?

- Over-enforcement versus effective enforcement?
- Discussion of Brattle Group presentation

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Over-Enforcement versus Effective Enforcement in Manipulation Cases

Presented to:

Dorsey & Whitney Second Annual Federal Enforcement Forum

Presented by:

Shaun D. Ledgerwood

February 24, 2016

THE Brattle GROUP

The need for fraud-based anti-manipulation rules

- **Three components of a market manipulation:**
  - *Trigger:* Act(s) designed to bias a market outcome (cause)
  - *Nexus:* Market outcome biased by the Trigger (linkage)
  - *Target:* Position(s) benefitting from the bias created (effect)
- **More components = more manipulation concerns:**
  - Proliferation of targets (e.g., derivatives, indexed products):
    - More leverage = greater incentive to manipulate
  - More nexuses (more market seams/flaws, more linked products):
    - Nexuses made stronger by less liquidity
  - Innovative triggers (uneconomic trading, outright fraud)
- **Existing laws insufficient to curb the behavior:**
  - Market power rules (regulatory/antitrust) are often insufficient:
    - Enron,
  - Artificial price rule is difficult to enforce:
    - Must prove actual harm
    - Only one successful prosecution

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The tension between under and over-enforcement

- **Manipulation can bring inefficiency to markets:**
  - Distortions inhibit valid price formation and discovery
  - Can inhibit efficient long-term investment decisions
  - Results in unwarranted wealth transfers
- **Robust market participation can maximize efficiency:**
  - Legitimate profit-seeking drives economic efficiency:
    - Maximizes the gains from trade
    - Price convergence
  - Liquidity of trades on indices is essential to deter manipulation:
    - Reduces the ability of uneconomic trades to move the index
    - "Liquidity" from manipulative trades is unwelcome
- **There is an "optimal" amount of enforcement:**
  - Would effectively deter manipulation – few "false negatives"
  - Would minimize "false positives" to promote market participation
  - Optimal enforcement requires balancing these two objectives

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Example-based enforcement could work in theory…

- **Agencies are focused on using settlements as the key mechanism for informing the market as to what behavior is manipulative**
- **Settlements obtained to date have involved two types of behavior:**
  - Uneconomic trading (transactional fraud)
  - Outright fraud
- **Manipulation cases can also be brought for using market power (withholding) to benefit cross-market positions**
- **The settlements obtained to date generally pursued behavior that was inefficient:**
  - *J.P. Morgan:* Alleged running of inefficient power plants out-of-merit
  - *KeySpan-Ravenswood:* Alleged withholding to benefit bilateral swap
  - *Rumford Paper:* Allegedly fraudulent setting of DR baseline
- **<u>Consistent</u> enforcement over time provides clarity as to behavior that is illegal, thus assisting compliance:**
  - Uncertainty re manipulative behavior diminishes, improving compliance
  - Certainty re legitimate behavior improves market transparency & liquidity

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…IF the definition of "fraud" is consistent over time

- **Consider the oft-cited language in *Deutsche Bank*:**
  - "…profitability is not determinative on the question of manipulation and does not inoculate trading from any potential manipulation claim (although profitability may be relevant in assessing the conduct)." DBET settlement, ¶ 20.
- **Two alternative interpretations of this language:**
  - Trades that are profitable on an accounting basis can nevertheless be considered uneconomic if they ignore the trader's opportunity costs (*e.g.*, FERC's allegations against BP)
  - Whether trades are profitable or not is irrelevant; if the intent of the trader is to affect the value of another position, the behavior is prosecutable as a market manipulation
- **The latter interpretation is *highly* problematic:**
  - Tantamount to a ***per se* rule**, where the agency unilaterally can determine (and adjust) what it considers "fraud"
  - Lack of explicit safe harbors leaves traders to forego profitable trading opportunities for fear of reprisals
  - This robs the firms of profits and the market of efficiency

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An example: The danger of a per se approach

- **Consider the following three transactions, all of which assume that an identical, profitable physical transaction is made in good faith to make the best available profits:**
  - **Jack** buys power at hub A and sells power at hub B for a $10,000 gain, holding no benefitting positions:
    - Jack cannot be found guilty of manipulation, for there is no position to manipulate
  - **Jill** executes the same A-to-B sale, not cognizant that her firm also holds a financial position that is short to the price at hub B:
    - Jill cannot be found guilty of manipulation, for there is no intent to manipulate
  - **Johnny** executes the same A-to-B sale, fully-cognizant that he also holds a financial position that is short to the price at hub B that may benefit from the sale:
    - Johnny is potentially liable for market manipulation for he knowingly executed a trade that he knew could manipulate the value of his related position

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Per se approach illogically thwarts legitimate trades

- **The fact is, in all three of these circumstances, the A-to-B physical trade at issue would be made by any rational, profit-maximizing market participant:**
  - This trade would enhance economic efficiency by transferring the power to the hub where it is most valued
- **If the economic assumptions of competition actually applied:**
  - It would be guaranteed that some market participant would make the same physical trade
  - If Jack or Jill places the trade, the exact same benefit to Johnny's financial position will accrue
- **That one market participant is allowed to pursue a profit-seeking, efficient transaction while another is precluded is an economically unsupportable proposition:**
  - Needlessly drives liquidity from the marketplace
  - Robs all market participants of the benefits competition provides
- **Such transactions are neither fraudulent (FERC, CFTC) nor do they create an artificial price (CFTC):**
  - Thus, the market manipulation rules do not (should not) attach

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Per se approach reflects over-enforcement

- **The string of settlements garnered thus far by the agencies can be useful to furthering long-term compliance:**
  - Clarity as to the behavior that is viewed as manipulative:
    - Caveat: Settlements arise for many reasons & have no legal effect
  - Less clarity as to what behavior is legitimate
- **However, such example-based enforcement is far less useful if the bar of what is considered "fraud" continues to move:**
  - Settlements (perceived by the agency as wins) embolden pushing the envelope further toward a per se enforcement posture
  - Per se approach circumvents the need for questioning the legitimate business/economic purpose (intent) behind trades
  - Lack of certainty regarding how far the bar will continue to be pushed deters legitimate trading & frustrates compliance
- **The only likely solution to this issue is litigation:**
  - Current cases in court may not adequately address these concerns
  - Several pending public/non-public cases may

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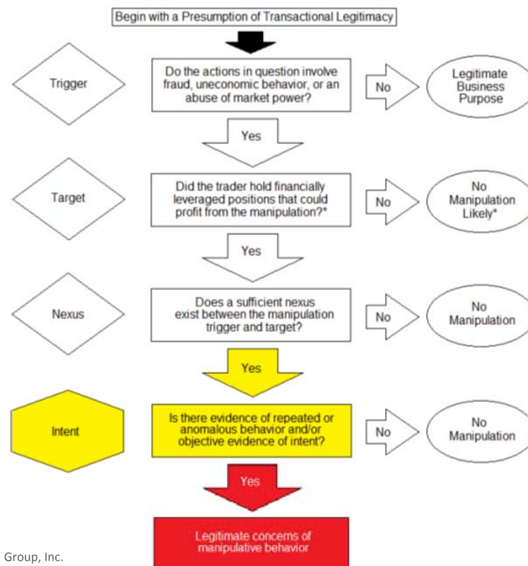
A framework for analyzing market manipulation



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Additional Resources

- "Enron's California schemes haunt regulators 15 years later." Coauthored with Gary Taylor. *Energy Risk Magazine* (January 2016).
- *Market Power and Market Manipulation in Energy Markets: From the California Crisis to the Present*. Coauthored with G. Taylor, R. Broehm and P. Fox-Penner. PUR Inc. (May 2015).
- "Market manipulation and the compliance chasm." Coauthored with J. Tsoukalis. *Energy Risk Magazine* (February 2015).
- "Using Virtual Bids to Manipulate the Value of Financial Transmission Rights." Coauthored with H. Pfeifenberger. *The Electricity Journal*, vol. 26, issue 9, pp. 9-25 (November 2013).
- "Uneconomic trading and market manipulation." *Energy Risk Magazine*, p. 32 (July 2013).
- "A Framework for Analyzing Market Manipulation." Coauthored with P. Carpenter. *Review of Law & Economics*, vol. 8, issue 1, pp. 253–295 (September 2012).
- "A Comparison of Anti-Manipulation Rules in U.S. and EU Electricity and Natural Gas Markets: A Proposal for a Common Standard." Coauthored with D. Harris. *Energy Law Journal*, vol. 33, p.1 (April 2012).
- Other documents are available at www.brattle.com.

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Dr. Ledgerwood specializes in issues of market competitiveness with an emphasis on the economic analysis of market manipulation. He previously served as an economist and attorney for the FERC in its enforcement proceedings involving Energy Transfer Partners, L.P., Amaranth Advisors, LLC, and several other cases. He has built upon these experiences to develop a framework for defining, detecting and analyzing manipulative behavior. He has worked as a professor, economic consultant, attorney, and market advisor to the regulated industries for over twenty years, focusing on issues including ratemaking, power supply, resource planning, and electric asset valuations. In his broader practice, he specializes on issues in the analysis of liability and damages for actions based in tort, contract or fraud. He has testified as an expert witness before state utility commissions and in federal court.

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We are distinguished by our credibility and the clarity of our insights, which arise from the stature of our experts, affiliations with leading international academics and industry specialists, and thoughtful, timely, and transparent work. Our clients value our commitment to providing clear, independent results that withstand critical review.

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How is the case law developing relative to SEC precedent?

- How do the FERC/CFTC cases compare to the SEC precedent so far?
- What are the main differences?

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Establishing Market Manipulation Based on "Smoking Gun" Evidence of Deceptive Intent

- FERC and CFTC regulations include "catch all" provisions relating to material false statements.
  - A false statement provides a leverage point to a regulator.
  - Potential criminal liability for knowing/willing material false statements under 18 U.S.C. §1001.

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What happens if there are no "smoking gun" documents and market manipulation must be established entirely by an analysis of transactions and trading activity?

- Is it reasonable to review transactions and trading activity with "20-20 hindsight" years after a transaction or trade takes place?
- Can a transaction be less than optimal but nevertheless still implement a legitimate business purpose?
- Was the relevant party working from incorrect facts and did not know it?
- What about if the trading platform was experiencing an error?

What is the proper economic measure of gaming?

- What part of a company's trading portfolio should be analyzed?
  - What markets relate to each other?
  - What if a company trades products across multiple industries?
- What makes a trade uneconomic?
  - Example: a company enters into a virtual transaction that impacts a physical position and there is a "transaction" cost for the virtual transaction.
  - What is the proper measure of the profit resulting from the physical position?

What is the proper measure of the economics of two potentially related transactions?

- Should the regulator subtract the "transaction" cost from the virtual position or the physical trade when establishing the economics of the trade?

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Different Characterizations of UTC Trade: FERC's Characterization

	UTC		Costs	MLSA
Pays:	$P_{DA(A)}$	$P_{DA(B)}$	Market Charges ($0.05)	Pro Rata Share of MLSA Pool
Paid:	$P_{DA(B)}$	$P_{DA(A)}$	AS Charges ($0.20)	
			Transmission ($0.75)	
Assume Revenue = $0.30			Cost = $1.00	Revenue = $1.70

UTC Profit of -$0.70 (Uneconomic) + Revenue = $1.70
= $1.00 (Net Profit)

FERC's analysis would group all transaction costs with the UTC. Because transmission costs are included, the UTCs appear uneconomic.

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Different Characterizations of UTC Trade: Alternative Characterization

<u>UTC</u>

Pays: $P_{DA(A)}$ $P_{DA(B)}$

Paid: $P_{DA(B)}$ $P_{DA(A}$

<u>Costs</u>

Market Charges ($0.05)
AS Charges ($0.20)

Transmission ($0.75)

<u>MLSA</u>

Pro Rata Share of MLSA Pool

Assume Revenue = $0.30 Cost to UTC = $0.25

Transmission = $0.75 Revenue = $1.70

UTC Profit of $0.05 (Economic) + MLSA Net Profit = $0.95 = $1.00 (Net Profit)

By comparison, the transmission costs could be grouped with the MLSA. Now there is no manipulation because the UTCs are profitable.

How is a legitimate business purpose a defense to an allegation of market manipulation?

- Legitimate transactions have no deceptive intent.
- Is there a “loophole” defense if a transaction has a legitimate business purpose of profitability?
- Is the answer to this question the same if a case is litigated in a jury trial?

What are the benefits of litigating market manipulation in federal court?

- Assume full *de novo* review and due process rights.
- What are the differences between the federal court process and the administrative process?
- How does this compare to the SEC experience?

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How can prosecutors overplay a case?

- **Material misrepresentations**
- **Providing evidence out of context**

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Conclusion

- In 2016, FERC/CFTC will continue to aggressively prosecute market manipulation.
- CFTC
  - Aggressive enforcement with incentivized settlements, rewarding cooperation, and more emphasis on whistleblowers.
- FERC
  - Federal court cases will begin to provide more guidance on a party's ability to seek judicial review of FERC decisions.

Speaker

Joseph Hall – Dorsey & Whitney LLP

Joe Hall is a Partner and Co-Chair of Dorsey's Energy Industry Group. Mr. Hall's practice focuses on the power industry, with an emphasis on industry participant responses to competition. He has extensive experience representing electric utilities, independent power producers, power marketers, industrial customers, private equity firms, and other entities in regulatory matters concerning, among other things: participation in Energy Markets, including Regional Transmission Organizations; "Open Access" policies; Transmission Planning and Cost Allocation; Mergers and Acquisitions; Market-Based Rate Authority; Standards of Conduct; Affiliate Restrictions; Rate Cases (transmission and wholesale power); Public Utility Regulatory Policies Act ("PURPA") (federal and state); Merchant Generation; Power Purchase Agreements; Renewable Generation and Integration (including distributed generation); FERC Enforcement and Compliance; FERC Litigation; and NERC Reliability. He can be contacted via email at hall.joseph@dorsey.com or at (202) 442-3506.

Speaker

Thomas O. Gorman – Dorsey & Whitney LLP

Tom Gorman is a Partner in Dorsey's Government Enforcement & Corporate Investigation Group. He has defended public companies and individuals in regulatory actions involving insider trading, market manipulation, financial fraud, corporate governance matters, accounting and auditing issues, FCPA issues, and similar matters. He has also defended securities class action and derivative suits and led teams conducting internal investigations focused on financial fraud and other securities law issues. Mr. Gorman regularly speaks on, and publishes articles regarding, securities litigation issues including the FCPA, internal investigations, financial fraud and insider trading. Mr. Gorman's practice regularly includes other complex business litigation matters arising under the securities, commodities, antitrust laws and the federal racketeering statutes. He can be contacted via email at gorman.tom@dorsey.com or at (202) 442-3507.

Speaker

Nathan B. Ploener – KPMG LLP

Nathan Ploener is a Managing Director in the New York City office of KPMG's U.S. Forensic Advisory Services practice. Mr. Ploener is a skilled professional with more than 29 years of experience in several sectors within risk consulting including energy, financial services, metals, and agriculture. He comes to KPMG with an impressive track record that includes high-profile regulatory matters such as false reporting, fraud, market manipulation, and market abuse. Prior to joining KPMG, Mr. Ploener spent nine years at the U.S. Commodity Futures Trading Commission (CFTC) as a Senior Trial Attorney, where he focused on conducting regulatory investigations of potential Commodity Exchange Act violations, market manipulation, fraud, trade practice violations and compliance failures. He was an active member of the manipulation and disruptive trading practice squad at the CFTC and managed high profile, complex investigations in market manipulation and spoofing. At the CFTC, Mr. Ploener was responsible for bringing the first spoofing case under the Dodd Frank Act against Panther Energy Trading.

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Federal Enforcement Forum:

Federal Financial Services Enforcement—Current Developments

Moderator:
Joseph T. Lynyak III, Dorsey & Whitney LLP

Panelists:
David J. Kogut, Charles River Associates

Jenny Lee, Dorsey & Whitney LLP

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Agenda

- Enforcement Distinctions—
  - Prudential Banking Regulators Versus the CFPB
- Fair Lending Enforcement and Defense
  - Revised HMDA Data and Statistical Analysis

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Overview

- Two Primary Categories of Federal Financial Regulators
  - Federal Prudential Regulators
    - Federal Reserve Board
    - Office of the Comptroller of the Currency
    - Federal Deposit Insurance Corporation
    - National Credit Union Administration
  - Federal Non-Prudential Regulators
    - Consumer Financial Protection Bureau
    - Federal Trade Commission
    - Commodity Futures Trade Commission
    - Securities and Exchange Commission
    - FinCEN, OFAC and other specialized agencies

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Distinctions Between the Prudential Regulators and the CFPB

- The Prudential Regulators care about the survival of an FDIC-Insured Bank and its affiliates (collectively, a “Bank”)
  - The Federal Deposit Insurance Act requires an investigation of the examiners when a bank fails
  - Any penalty imposed results in a diminution of required bank capital or holding company capital—and hence always a hesitation to impose CMPs
    - Historically CMPs used as an effective lever to achieve compliance—but actually few CMPs assessed

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Distinctions Between the Prudential Regulators and the CFPB

- **The CFPB could care less**
  - **Brags that it has so far imposed greater than $11.2 billion in penalties and redress**
  - **Has adopted the FTC approach—if they put you out of business—too bad**
- **The CFPB's statutory mission is to protect consumers**

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Distinctions Between the Prudential Regulators and the CFPB

- **The CFPB is not concerned with a "Safety and Soundness" regulatory approach—safety and soundness is defined as commonly accepted financial practices that do not present an unacceptable risk of loss to the bank**
  - **Critical factors are capable management and adequate capital**
  - **Most consumer violations do not present safety and soundness concerns**
  - **In other words—it is an entirely different paradigm**

    "We have a somewhat different approach here. We are now examining institutions for how they treat consumers. It's not about the institution itself. It's about the impact on consumers."

    – CFPB Director Richard Cordray, Jul. 2012

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The Big Stick—Compare Section 8(i) of the FDI Act with Section 1055(c) of the Dodd-Frank Act—

CIVIL MONEY PENALTY IN COURT AND ADMINISTRATIVE ACTIONS.—

(1) IN GENERAL.—Any person that violates, through any act or omission, any provision of Federal consumer financial law shall forfeit and pay a civil penalty pursuant to this subsection.

(2) PENALTY AMOUNTS.—

(A) FIRST TIER.—For any violation of a law, rule, or final order or condition imposed in writing by the Bureau, a civil penalty may not exceed $5,000 for each day during which such violation or failure to pay continues.

I HAVE A BIG STICK

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CFPB's Mitigating Factors for CMPs

- **CFPB or a court shall take into account the following when deciding CMPs:**
  - **Size of financial resources & good faith of person charged**
  - **Gravity of the violation or failure to pay**
  - **Severity of risks to or losses of consumer, which may take into account the number of products or services sold**
  - **History of previous violations; and**
  - **Such other matters as justice may require**
- **Case-by-case determination, with consistency sought within markets and similar products**

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Relief That CFPB is Authorized to Obtain

- Rescission or reformation of contracts
- Refund of moneys or return of real property
- Restitution
- Disgorgement or compensation for unjust enrichment
- Payment of damages or other monetary relief
- Public notification regarding the violation, including costs of notification
- Limits on the activities or functions of the business or individual
- Civil money penalties

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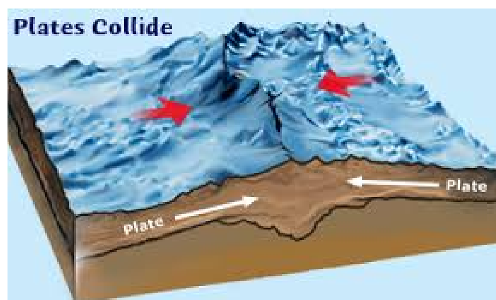
CFPB Enforcement vs Pre-Dodd Frank Regulatory Framework



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CFPB Timeline: July 21, 2011 to February 24, 2016

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2011 to Now: CFPB vs Prudential Regulators

Key distinguishing characteristics begin with jurisdiction

- CFPB Authority to Supervise Two Groups of Entities (**defined by market**):
  - (1) Insured depository institutions or credit unions with $10 billion or more in total assets (or any affiliates); and their service providers
  - (2) Non-depository institutions that have been (a) designated by statute or (b) defined by the Bureau rule making as a "larger participant" of a CFS market; and their service providers
    - **By statute**: mortgage bankers; foreclosure rescue service providers; private education loan companies; payday lenders
    - **By "larger participant" rule**: credit bureaus; debt collectors; student loan servicers; international money transmission companies; nonbank auto lenders.
- CFPB Authority to Conduct Enforcement Investigation Over Broader Groups of Entities (**defined by conduct**):
  - (1) Covered persons ("any person that engages in offering or providing a consumer financial product or service"); (2) their affiliates who act as service providers; (3) facilitators and assistors

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CFPB Investigation

- Defined as any inquiry conducted by a CFPB investigator for purposes of ascertaining whether any person is or has been engaged in conduct that is a violation of federal consumer financial law.
- Investigation can only be commenced by the Director, the Assistant Director of Enforcement or any deputy director of the Office of Enforcement.

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CFPB Investigation

- Bureau's primary tool is the Civil Investigative Demand.
  - Includes documents, written reports (non existent), and oral testimony
- Bureau's CID Rule is modeled on investigative procedures of other law enforcement agencies, including the FTC.
- Bureau may issue a CID whenever it "has reason to believe" that "any person" may have documents, items, or information "relevant to a violation."
- A "violation" is "any act or omission that, if proved, would constitute a violation of any provision of the Federal consumer financial law."

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Laws and Regulations Enforced by CFPB

- 18 Enumerated Statutes, including FDCPA, FCRA, EFTA, GLB Act, TILA, RESPA and others
- Military Lending Act
- Prohibition of Unfair, Deceptive and Abusive Practices (UDAAP)

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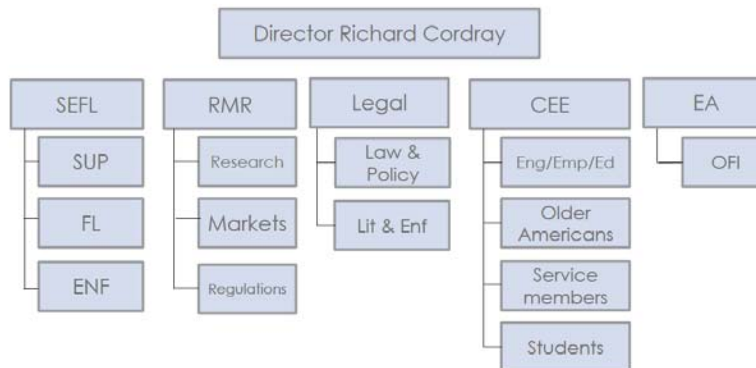
CFPB Components



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Upcoming CFPB Regulations

- Arbitration
- Debt Collection
- Payday Lending (Small-Dollar, Short-term Lending)
- HMDA (final rule put out)
- TRID (final rule put out)
- Other ongoing initiatives:
  - Office hours
  - Informal feedback meetings for industry's benefit
  - Project Catalyst
  - No Action Letters

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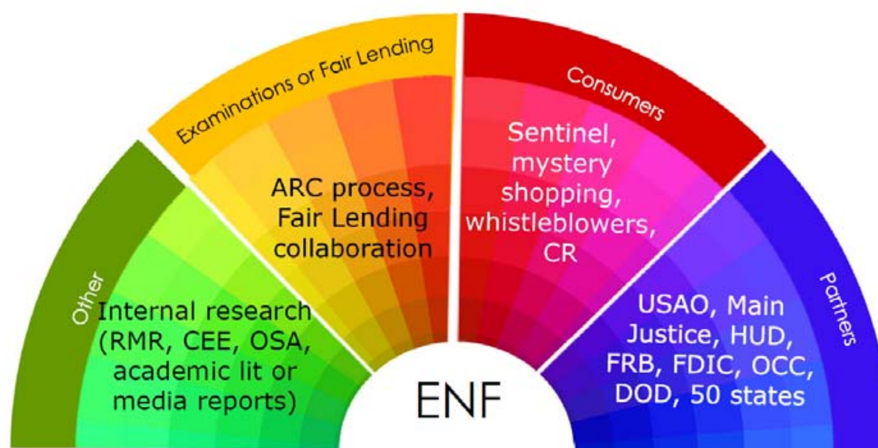
Possible Catalysts for a CFPB Investigation



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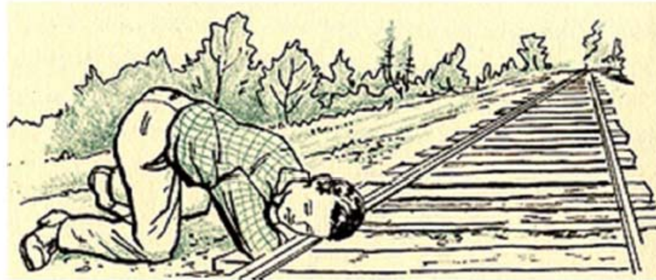
CFPB Enforcement Mandate to Have an "Ear to the Ground"



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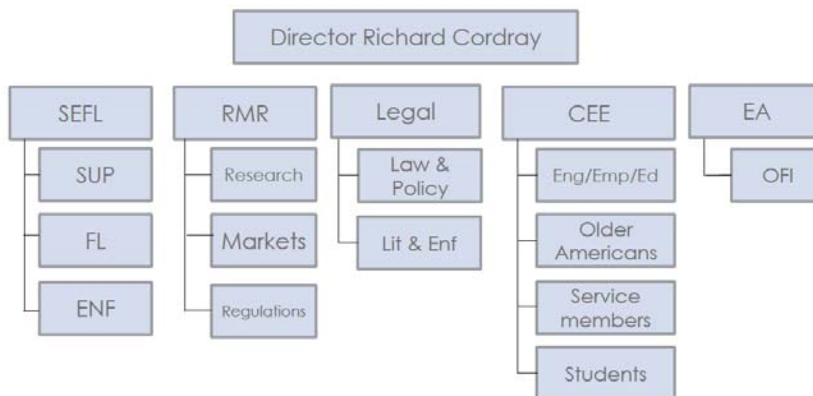
Possible Interim Consultations with Other Components Before, During or After Investigations



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CFPB Investigations – 10 tips

(1) Think bigger picture than just the investigation as a thing
- What is the CFPB really thinking? What is the agency's attitude?
- How are the products and issues prioritized or viewed within the agency?

(2) Consult publicly available CFPB materials and perform an internal investigation
- Managed by counsel and cloaked with privilege

(3) Understand the novel theories that the CFPB will use, including indirect liability theories

(4) Review Consumer Complaints (Self and Competitors)

(5) Head start on NORA

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CFPB Investigations – 10 tips

(6) Strategize re Responsible Conduct Bulletin Policy

(7) Be patient

(8) Plan ahead for multi-faceted consequences from investigation
- Staff accountability
- Servicing systems issues
- Legacy systems from long-standing vendors
- Training and quality control
- Customer complaints
- Relationships with CFPB plus state agencies and prudential regulator
- Corporate reputation/shareholders
- Governance and reporting issues

(9) Leverage broader themes and aspects of the CFPB

(10) Respect the Major Nuances

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CFPB Investigations

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Fair Lending Enforcement

- **The CFPB always includes a fair lending analysis in its examinations**
  - **The prudential regulators are not as aggressive**
  - **When accused of discriminatory lending behavior—lenders have to prove a negative**
  - **Enormous short-term expenses**
  - **Virtual certainty of a forced settlement**
- **In regard to fair lending claims—defense is an obligatory, full-time task**

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The Theories of Liability under the Fair Lending Laws

- Generally, lending discrimination may be established in one of three ways:
  - Overt evidence that the lender intentionally discriminated against members of a protected group or class
  - Circumstantial evidence that the lender intentionally subjected members of a protected group to "disparate treatment," or
  - Evidence that a lender's policies and practices – although facially neutral – produced discriminatory effects, or had a "disparate impact," on members of a protected class

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Disparate Treatment Theory

- Under this theory, the plaintiff must first make a *prima facie* showing that members of a protected class have been accorded different treatment. The burden then shifts to the defendant to produce evidence that the challenged action was based on a legitimate, nondiscriminatory reason
- If the defendant meets this burden, the plaintiff must then prove:
  - the defendant's justification was merely a pretext for discrimination, and
  - that a discriminatory reason more likely than not motivated the defendant's conduct

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Disparate Impact Theory

- The plaintiff must show the bank has a facially neutral lending policy or practice that has a disproportionate negative impact on members of a protected class
- The defendant must then show that the policy or practice was "necessary to achieve a valid interest," which may include "practical business choices and profit-related decisions."
- If the defendant is able to demonstrate a sufficient justification, the burden shifts back to the plaintiff to show "that there is 'an available alternative . . . practice that has less disparate impact and serves the [entity's] legitimate needs.'"

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Disparate Impact Theory

- In most disparate impact cases, the plaintiff will attempt to establish a *prima facie* case through statistical evidence. To make that showing, the plaintiff generally is required to demonstrate that the statistical analysis is based on a proper sample and shows a substantial disparate effect on the basis of race or another prohibited criterion
  - Disparate treatment claims may also be proven by the use of statistical evidence

Available Data is the Touchstone of Fair Lending Claims and Defenses

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HMDA and Regulation C

- The Home Mortgage Disclosure Act ("HMDA") is implemented by Regulation C
  - 12 C.F.R Part 1003
- Expanded coverage included over the years
- Complicated coverage rules but most mortgage lenders included
- Section 1094 of the Dodd-Frank Act
- Directed CFPB to update and expand HMDA reporting to include additional information
- 80 Fed. Reg. 66128 (October 28, 2015)
- http://www.gpo.gov/fdsys/pkg/FR-2015-10-28/pdf/2015-26607.pdf
- Modifies—
  - Types of transactions subject to Regulation C
  - Categories of institutions subject to Regulation C
  - Substantially revised data elements to be collected and reported
  - Adopts modified reporting and disclosure requirements

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Revised Data Elements

- Revised Regulation C modifies—and substantially increases—data elements required to be reported for covered loans
- Data elements include information relating to—
  - Applicants/borrowers
  - Underwriting process
  - Real property security
  - Loan terms, and
  - Loan and lender identifiers

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The Final Scores—

- Unchanged Data Elements—6
- Modified Data Elements—12
- Newly Adopted Data Elements—25

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Additional HMDA Reportable Data

- Applicant/Borrower Characteristics
  - Applicant/Borrower Age
  - Co-Applicant/Co-Borrowers
- Collateral Characteristics
  - Detailed Property Type – 1-Unit, 2-4 Units, 5+ Units
  - Detailed Occupancy Status – Differentiate b/w Investor Property & Second Home
- Underwriting/Pricing Factors
  - Applicant/Borrower Credit Score
  - Debt-to-Income Ratio
  - Loan-to-Value Ratio *(via Property Type)*
  - Combined Loan-to-Value Ratio
  - AUS Recommendation

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Additional HMDA Reportable Data

- Loan Characteristics
  - Detailed Loan Purpose – Differentiate b/w Rate/Term & Cash-Out Refinance
  - ARM Features – Initial Fixed Rate Period
  - Prepayment Penalty Terms
  - Loan Term
  - Non-Amortizing Features – Balloon Loans, Interest Only Loans, etc.
  - Reverse Mortgages
  - HELOCs
  - Business Channel – Retail, Broker, Correspondent
- Rates & Fees
  - Note Rate
  - Total Points & Fees
  - Origination Charges
  - Discount Points
  - Lender Credits

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Currently Problematic Fields for Some Lenders

- Debt-to-Income Ratio
  - Current data often reflects unverified income reported by applicant
  - Field is not systematically updated to reflect verified income
  - "Actual" DTI based on verified income much higher than reported DTI
- Loan-to-Value Ratio
  - Current data often reflects estimated value reported by applicant
  - Field is not systematically updated to reflect appraised value
  - "Actual" LTV based on appraised value often much higher than reported LTV
- AUS Recommendation
  - Current data often reflects counteroffers that were not accepted by applicant
  - Field is not updated to reflect AUS Recommendation per terms originally requested
  - Causes situations where denied applications are reported as "Approve/Eligible"

Inaccurate Data Can Cause "False Positives" in Statistical Analyses

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Overview of Fair Lending Analyses

- Statistical Analyses
  - Underwriting – Approval vs. Denial
  - Pricing – Level of APR
  - Fees – Broker Compensation and Overages/Underages
  - Redlining
  - Loss Mitigation & Servicing Outcomes
- Comparative File Review
- Peer Analysis

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Statistical Analysis of Underwriting and Pricing

Based upon a review of underwriting guidelines and rate sheets, develop customized statistical models that may control for factors such as the following:

Underwriting Analysis

- Detailed Loan Purpose
- Detailed Occupancy Status
- Detailed Property Type
- Loan Amount
- Debt-to-Income Ratio
- Loan-to-Value Ratio
- Combined Loan-to-Value Ratio
- Applicant Credit Score
- Automated Underwriting Decision
- Detailed Loan Product
- Business Channel

Pricing Analysis

- Detailed Loan Purpose
- Detailed Occupancy Status
- Detailed Property Type
- Loan Amount
- Rate Lock Week
- Loan-to-Value Ratio
- Combined Loan-to-Value Ratio
- Borrower Credit Score
- Detailed Loan Product
- Business Channel
- MSA

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Hypothetical Lending Institution
Fair Lending Analysis of HMDA Data - 2014
Distribution of Loan Applications by Applicant Race/Ethnicity and Action Taken

Applicant Race/Ethnicity	Action Taken							
	Total		Originated		Approved But Not Accepted		Denied	
	Count	% of Total	Count	% of Total	Count	% of Total	Count	% of Total
Conventional Mortgage Applications								
Asian	2,042	100.0%	1,174	57.5%	317	15.5%	551	27.0%
African American	3,008	100.0%	1,109	36.9%	406	13.5%	1,493	49.6%
Hispanic	3,999	100.0%	1,994	49.9%	572	14.3%	1,433	35.8%
Non-Hispanic White	44,126	100.0%	26,222	59.4%	6,445	14.6%	11,459	26.0%
Other	1,398	100.0%	691	49.4%	176	12.6%	531	38.0%
Missing/Not Applicable	10,028	100.0%	5,562	55.5%	1,610	16.1%	2,856	28.5%
Total	63,810	100.0%	36,383	57.0%	9,429	14.8%	17,998	28.2%

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Hypothetical Lending Institution
Fair Lending Analysis of HMDA Data - 2014
Average APR for Originated Loans by Applicant Race/Ethnicity

Borrower Race/Ethnicity	Loan Count	Average APR
Conventional Morgages		
Asian	1,174	4.55%
African American	1,109	4.71%
Hispanic	1,994	4.65%
Non-Hispanic White	26,222	4.57%
Other	691	4.61%
Missing/Not Applicable	5,562	4.57%
Total	36,383	4.58%

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Hypothetical Lending Institution

Fair Lending Analysis of HMDA Data - 2014

Selected Results from Logistic Analysis of Incidence of Denial by Applicant Race/Ethnicity

Protected Class	Model	Comparator Group Total	Comparator Group Denials	Protected Class Total	Protected Class Denials	Odds Ratio	p-Value	Pseudo R-Squared
Conventional Mortgage Applications								
African American	Raw	44,126	11,459	3,008	1,493	2.810	0.000	0.013
	Controlled	44,074	11,408	3,001	1,487	1.335	0.000	0.359
Hispanic	Raw	44,126	11,459	3,999	1,433	1.592	0.000	0.003
	Controlled	44,078	11,412	3,989	1,423	1.143	0.002	0.353

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Hypothetical Lending Institution

Fair Lending Analysis of HMDA Data - 2014

Selected Results from Regression Analysis of Level of APR by Borrower Race/Ethnicity

Protected Class	Model	Comparator Group Loan Count	Protected Class Loan Count	Coefficient (bps)	p-Value	Adjusted R-Squared
Conventional First Lien Mortgages						
African American	Raw	26,222	1,109	13.62	0.000	0.003
	Controlled	26,222	1,109	3.32	0.000	0.765
Hispanic	Raw	26,222	1,994	7.97	0.000	0.001
	Controlled	26,222	1,994	1.27	0.016	0.767

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Monitoring of Redlining Risk

- There is no standard monitoring approach, but all involve an assessment of the distribution of own institution's ***lending activity*** during a given time period within a defined ***geographic area*** versus a benchmark.
- For own institution's lending activity within the defined geographic area determine the proportion that involved properties located in census tracts with ***relatively high concentrations*** of ***minority residents.***
- Compare own institution's proportion with that of lending activity for ***other lending institutions*** operating in the same defined geographic area using publicly available HMDA data from the same time period.
- Prior to public release of HMDA data for given time period, monitor trends by comparing own institution's proportion during given time period with own institution's proportion during prior time period.

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Hypothetical Lending Institution
Redlining Risk Assessment
Origination Activity in Geographic Area #1 During 2014

Lender Name	Total Loans	Loans in Majority Minority Tracts	Share in Majority Minority Tracts
Institution A	40,000	2,400	6.0%
Institution B	35,000	2,275	6.5%
Institution C	30,000	1,500	5.0%
Institution D	24,500	1,470	6.0%
Institution E	13,750	688	5.0%
Institution F	12,500	563	4.5%
OWN INSTITUTION	7,000	210	3.0%
Institution G	6,500	488	7.5%
Institution H	3,750	113	3.0%
Institution I	3,500	350	10.0%
Institution J	3,500	525	15.0%
Institution K	1,250	63	5.0%
Institution L	750	68	9.0%
All Other Lenders	**175,000**	**10,500**	**6.0%**
Lenders with Similar Volumes	**36,500**	**1,850**	**5.1%**

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Hypothetical Lending Institution
Statistical Analysis of Differences in
Proportions of Lending in Majority Minority Census Tracts

Lender Name	Total Loans	Loans in Majority Minority Tracts	Share in Majority Minority Tracts	Odds Ratio	p-Value
OWN INSTITUTION	7,000	210	3.0%	-	-
All Other Lenders	175,000	10,500	6.0%	0.485	0.000
Lenders with Similar Volumes	36,500	1,850	5.1%	0.836	0.000

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The Likely Impact of the New Amendments to Regulation C on Litigation

- The new HMDA data will be mainly used to support disparate impact theories under fair lending laws
  - This gives the government and private parties more data to support fair lending claims
  - The ease of access through the CFPB's website may also advantage complaining parties
- Conversely, a defendant will also have more data – including credit characteristics – to respond to a complaint
  - Relying on the *Inclusive Communities* burden-shifting test—this may give defendants a better chance of dismissing the action at an early stage
- Using history as a guide—the revised Regulation C will likely lead to increased discrimination claims
  - Increased fair lending analyses by lenders will be required

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Inclusive Communities Decision

- **Addresses the problem of "abusive disparate impact claims"— announced rules when litigating disparate impact litigation:**
  - **Courts must promptly assess the viability of a case**
  - **A mere "showing of a statistical disparity" is insufficient, as disparate impact litigation is not meant to impose "racial quotas"**
  - **This is a significant requirement favoring lenders**
  - **The plaintiff must show that a statistical disparity was caused by the defendant's policies and practices—*causality required***
  - **The defendant may defeat a *prima facie* disparate impact claim by showing that the policy or practice at issue was "necessary to achieve a valid interest," which may include "practical business choices and profit-related decisions"**
  - **If the defendant identifies such a valid interest, the burden shifts back to the plaintiff to show "that there is 'an available alternative . . . practice that has less disparate impact and serves the [entity's] legitimate needs.'"**

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QUESTIONS?