2014 Mid-Year Report
Securities Litigation and Regulatory Enforcement

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Welcome to the 2014 Mid-Year Report from the BakerHostetler Securities Litigation and Regulatory Enforcement Practice Team. Its purpose is to provide a periodic survey, apart from our team Executive Alerts, on matters we believe of interest to sophisticated General Counsel, Chief Compliance Officers, Compliance Departments, Legal Departments, and members of the securities and commodities industries at financial institutions, private investment funds, and public companies.

We issue this Securities Litigation and Regulatory Enforcement Report at mid-year and shortly after year-end. We hope you find the information and commentary useful and welcome your comments and suggestions. We encourage you to contact any of the practice team members listed at the end of the Report.

This Report highlights recent significant developments in:

- ***Supreme Court cases***, including *Halliburton*'s upholding the "fraud on the market" theory while allowing it to be rebutted at the class certification stage, *Troice*'s narrowing of the "in connection with" requirement under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), *Dudenhoeffer*'s reversing the longstanding "presumption of prudence" in "stock drop" ERISA class action cases, and pending decisions that may have significant implications on litigation under Sections 11 and 13 of the Securities Act of 1933;

- ***Securities law cases***, including cases interpreting the safe harbor for forward-looking statements under the Private Securities Litigation Reform Act ("PSLRA"), further explaining "puffery," extending *Morrison*'s extraterritoriality interpretation, and placing the burden on the United States Securities and Exchange Commission ("SEC") to allege that enforcement claims are timely;

- ***Insider trading cases***, including high-profile trial defeats suffered by the SEC and further developments with respect to the federal government's enforcement proceedings relating to SAC Capital;

- ***Civil and regulatory settlements***, including the approval on appeal of SEC settlements that do not require a defendant to admit, nor permit the defendant to deny, the factual allegations against them;
- ***Investment adviser and hedge fund cases***, including enforcement actions involving fraudulent conduct;
- ***Commodities and futures regulation and cases***, including the first-ever whistleblower award paid out by the Commodity Futures Trading Commission ("CFTC") and the settlement of a London Interbank Offered Rate ("LIBOR") manipulation case;
- ***Securities policy and regulatory developments***, including a risk alert on alternative investment due diligence for investment advisers, a new initiative to examine investment advisers that have not yet been examined, and guidance on how investment advisers may use social media to advertise; and
- ***The SEC's Cooperation Program***, including an initiative to encourage municipal issuers and underwriters to self-report, the announcements of another cooperation agreement with an individual and another deferred prosecution agreement with an entity, and the first-ever enforcement action against an employer for taking adverse employment actions against a whistleblower.

I. Supreme Court Case Review

In the first half of 2014, the United States Supreme Court issued three landmark federal securities decisions, dealing with (1) the "fraud on the market" theory and class certification; (2) the "presumption of prudence" in ERISA "stock drop" cases; and (3) the scope of the SLUSA. Additionally, there are two more cases that are pending before the Supreme Court that may have significant implications on litigation under Sections 11 and 13 of the Securities Act of 1933 ("Securities Act").

A. Landmark Decisions

Halliburton Co. v. Erica P. John Fund, Inc., et al.

On June 23, 2014, the Court issued its highly anticipated *Halliburton* decision, unanimously holding that: (i) securities plaintiffs may still invoke the "fraud on the market" theory; and (ii) securities defendants may rebut this theory at the class certification stage (as discussed in our previous Executive Alert). [1]

The plaintiffs are Halliburton stockholders who brought a Rule 10b-5 class action against defendants for allegedly making a series of misrepresentations about Halliburton's potential liability in asbestos litigation, among other things. They alleged that these misrepresentations inflated the price of the Halliburton stock, which induced them to purchase shares to their ultimate detriment.

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[1] 134 S.Ct. 2394 (2014).

The Court first encountered this litigation in 2011 and held that, unlike in individual lawsuits, securities plaintiffs did not have to prove that the alleged fraud caused them to lose money in order to proceed as a class action. On remand, the district court certified the class action. Defendants appealed this decision and argued that plaintiffs cannot proceed as a class action because they failed to establish that they relied on the alleged fraud when purchasing their shares.

Essentially, the Defendants sought a repeal of the "fraud on the market" theory, which the Court first ratified more than 25 years ago in *Basic v. Levinson*.[2] There, the Court held that reliance—a requirement to any securities fraud claim—is presumed where a stockholder traded a security in an open market. This presumption rests on the theory that, in open markets, the stock price incorporates all public, material information (including material misstatements). Thus, the *Basic* decision allowed stockholders to bring securities fraud claims without a showing of individual reliance on the alleged misrepresentations or omissions.

In a decision by Chief Justice John G. Roberts, Jr., the Court unanimously rejected Halliburton's invitation to overrule *Basic*. In so doing, it recognized that the "fraud on the market" theory is "a substantive doctrine of federal securities-fraud law" for which no "special justification" exists to undo it. Accordingly, class action plaintiffs will still benefit from the reliance presumption, ensuring that the securities class action will remain a significant and popular tool in securities litigation.

Nevertheless, the *Halliburton* decision now provides defendants with an opportunity to rebut the reliance presumption at the class certification stage. Before *Halliburton*, federal courts rejected defendants' attempts to present evidence at the class certification stage that the alleged fraud had no impact on the price of the stock. The Court made clear in *Halliburton*, however, that courts must consider such evidence at this stage because price impact is an "essential precondition" for any securities fraud class action.

Ultimately, the *Halliburton* decision is a significant win for security class action defendants. Although the "fraud on the market" theory still stands, defendants now have the ability

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[2] 485 U.S. 224 (1988).

to rebut it at the class certification stage. This opportunity gives defendants one more chance to avoid class certification, which is often the death knell of securities fraud class actions because it exposes defendants to extensive liability and, usually, forces settlement.

Chadbourne & Parke LLP, et al. v. Troice, et al.

On February 26, 2014, the Court issued its decision in *Troice*, which limited the scope of SLUSA.[3] SLUSA bars state law class action claims predicated on fraudulent conduct in connection with the purchase or sale of covered securities. In *Troice*, the Court specified that, for the SLUSA bar to apply, the misrepresentation or omission at issue must correspond to the purchase or sale of a covered security.

The *Troice* litigation consisted of three cases arising out of the Allen Stanford Ponzi scheme. The plaintiffs purchased certificates of deposit based on the defendants' representations that they were backed by covered securities. After the Ponzi scheme became public, the value of the certificates plummeted and the plaintiffs brought state law class action claims against the defendants.

The defendants argued that SLUSA barred the state law claims because the alleged misconduct was generally "in connection with" the defendants' purported trading of covered securities. In a 7-2 decision, the Court disagreed and held that the "crux" of the litigation regarded the inducement to buy bank certificates, which were not covered securities. The fact that these certificates were purportedly backed by covered securities was not enough to trigger the SLUSA bar.

This narrow interpretation of the phrase "in connection with" may have ramifications that go beyond the application of SLUSA. Certain private rights of action under the federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), utilize this language in describing actionable misconduct. Previously, the Supreme Court interpreted the phrase "in connection with" under these private rights of action more broadly, requiring only that the misrepresentation or omission "coincided" with a purchase or sale of a covered security.[4]

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[3] 134 S.Ct. 1058 (2014).

[4] *See, e.g.*, *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S.71, 85 (2006).

Hence, it remains to be seen how this holding will affect plaintiffs who bring federal securities claims against defendants in instances where they purchased or sold a non-covered security that was backed by or exposed to a covered security.

Fifth Third Bancorp, et al. v. Dudenhoeffer, et al.

On June 25, 2014, the Court issued its decision in *Dudenhoeffer* (as discussed in our previous Executive Alert).[5] This landmark decision overturns the longstanding "presumption of prudence" in "stock drop" ERISA class action jurisprudence. Nevertheless, it also set a high bar for plaintiffs looking to bring prudence-based claims.

For nearly two decades, lower courts have acknowledged that fiduciaries of employee stock ownership plans ("ESOPs") are entitled to a defense-friendly standard called the "presumption of prudence." This presumption applies in stock-drop cases, where the plaintiffs argue that the defendant fiduciaries knew about the employer's poor financial condition and still chose to keep the employees' retirement fund invested in the employer's stock. The courts have held that, in these situations, the fiduciaries' investment decisions are presumed to be prudent unless plaintiffs can show that the fiduciaries knew that the employer was on the brink of collapse.

In a unanimous opinion, the Court discarded this presumption. Relying primarily on ERISA's plain text, the Court held that while ERISA provides that ESOP fiduciaries have no duty to diversify, they are not entitled to a "special presumption of prudence."

Still, the *Dudenhoeffer* decision may not be a complete loss for ERISA class action defendants in stock drop cases. Noting the very real threat of meritless stock drop claims, the Court heightened the pleading requirements for plaintiffs in these cases. Specifically, to state a breach of fiduciary duty claim under ERISA, plaintiffs must allege: (i) an alternative action that the defendant could have taken; (ii) that would have been consistent with securities laws; and (iii) that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than help it.

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[5] 134 S.Ct. 2459.

These heightened pleading requirements will present a high hurdle for plaintiffs looking to assert prudence-based claims in the ERISA stock-drop context.

B. Pending Supreme Court Matters

There are two notable federal securities cases pending before the Court.

Omnicare, Inc., et al. v. Laborers Dist. Council Constr. Indus. Pension Fund, et al.

On March 3, 2014, the Court granted *certiorari* in *Omnicare*[6] on the issue of whether an untrue statement of opinion is actionable under Section 11 of the Securities Act ("Section 11") irrespective of whether the defendants actually believed the statement was true at the time it was made.[7]

Section 11 provides a private remedy for purchasers of securities issued under a registration statement that "contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statement therein not misleading." Currently, there is a split amongst the United States Courts of Appeals as to whether the opinion at issue must be subjectively false (*i.e.*, the defendant knew it was untrue) to trigger liability under Section 11. In *Omnicare*, the United States Court of Appeals for the Sixth Circuit departed from the United States Courts of Appeal for the Second, Third, and Ninth Circuits in holding that an opinion statement is actionable under Section 11 if it is objectively false.

This case is important to issuers, directors, underwriters, accountants, and other actors covered by Section 11 because of the *in terrorem* nature of the statute. Specifically, these actors are strictly liable under Section 11 so long as the plaintiff can prove that the registration statement contained a false statement.

The Court will consider and decide the *Omnicare* appeal in its October 2014 term.

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[6] 134 S.Ct. 1490 (2014).

[7] Petition for a Writ of Certiorari, *Omnicare, Inc. v. The Laborers Dist. Council*, 2013 WL 5532735 (Oct. 4, 2013).

Pub. Emps.' Ret. Sys. of Ms. v. IndyMac MBS Inc.

On March 10, 2014, the Court granted *certiorari* in *IndyMac*[8] on the issue of whether the filing of a putative class action effectively tolls, under *Am. Pipe & Constr. Co. v. Utah*,[9] the statute of repose codified under Section 13 of the Securities Act ("Section 13").[10]

Section 13 contains a statute of limitations and a statute of repose. The former requires Securities Act plaintiffs to bring a claim within a year after discovery of a claim, whereas the latter prohibits the same plaintiffs from bringing a claim more than three years after the security at issue was offered to the public. In 1974, the Court held in *Am. Pipe* that the filing of a putative class action effectively tolls any statute of limitations.

At issue here is whether the tolling principles under *Am. Pipe* also apply to statutes of repose. The United States Court of Appeals for the Second Circuit found to the contrary and dismissed plaintiffs' claims as untimely under Section 13. This decision, however, is in direct conflict with a Tenth Circuit opinion that extended *Am. Pipe* to Section 13's statute of repose.

This case is yet another instance where the Supreme Court can interpret the scope of the federal securities laws and, in particular, whether the courts should be lenient with plaintiffs who seek recompense under them.

The Court will consider and decide the *IndyMac* appeal in its October 2014 term.

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[8] 134 S.Ct. 1515 (2014).

[9] 414 U.S. 538 (1974).

[10] Petition for a Writ of Certiorari, *Public Employees' Retirement System of Mississippi v. IndyMac MBS, Inc., et al.*, 2013 WL 6185615 (Nov. 22, 2013).

II. Securities Law Cases

In addition to the Supreme Court litigation described above, the first half 2014 has seen other notable securities law decisions issued from the United States Court of Appeals for the Second Circuit and the United States District Courts for the District of Columbia and the Southern District of Florida.

In re Harman Int'l Inds., Inc. Secs. Litig.

On January 17, 2014, the United States District Court for the District of Columbia followed the majority of United States Courts of Appeal in dismissing a securities fraud class action and holding, among other things, that a defendant's state of mind is irrelevant in determining whether a cautionary statement is sufficiently "meaningful" in the context of applying the PSLRA's safe harbor for forward-looking statements.[11]

According to the PSLRA, defendants are not liable for a forward-looking statement if, among other things, it is "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[12]

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[11] No. 07-1757(RC), 2014 WL 197919 (D.D.C. Jan. 17, 2014).

[12] 15 U.S.C. § 78u-5(c)(1).

The Court in *Harman* noted that a split existed between the United States Courts of Appeal as to whether a defendant's state of mind should be considered when interpreting this subsection of the PSLRA. While the United States Courts of Appeal for the Sixth, Ninth, and Eleventh Circuits have held that a defendant's state of mind is irrelevant, the United States Courts of Appeals for the Second and Seventh Circuits have held that a defendant's state of mind may inform a reading of this subsection.

Noting that its appellate court—the United States Court of Appeals for the D.C. Circuit—had not "yet weighed in on this thorny issue," the Court decided to follow the majority position reasoning that (i) the plain text and legislative history of the PSLRA are explicit that a defendant's state of mind is irrelevant in interpreting this subsection, and (ii) considering a defendant's state of mind would impermissibly collapse this subsection with other subsections that should be considered separately.

Carpenters Pension Trust Fund of St. Louis v. Barclays PLC

City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG

On April 25, 2014, the United States Court of Appeals for the Second Circuit issued its decision in *Carpenters Pension* clarifying the scope of statements giving rise to actionable misrepresentation claims under Section 10(b) of the Exchange Act.[13] The securities class action plaintiffs in *Carpenters Pension* had alleged that Barclay's PLC's statements in SEC filings that "[m]inimum control requirements [had] been established for all key areas of identified risk" constituted misrepresentations where Barclay's later admitted to making false LIBOR submissions in the same period. The Court held that general statements by a corporation about its internal controls were generic "puffery" and could not serve as the basis for misrepresentation claims regarding a specific area in which misconduct was alleged to have occurred.

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[13] No. 12-2678-cv (2d Cir. Apr. 25, 2014), http://docs.justia.com/cases/federal/appellate-courts/ca2/13-2678/13-2678-2014-04-25.pdf.

Only a few days later, the Second Circuit likewise rejected the plaintiffs' arguments in *City of Pontiac* that general statements by UBS AG regarding its corporate ethics, integrity, and reputation were actionable misrepresentations under Sections 11 and 12(a)(2) of the Securities Act.[14] The plaintiffs alleged that UBS had inflated the value of certain holdings and illegally advised Americans how best to evade paying taxes. As in *Carpenters Pension*, the Court found that, even if false when made, such "general statements about reputation, integrity and compliance with ethical norms are inactionable 'puffery,'" or merely exaggerated opinions used in selling a good or service, as opposed to factual misrepresentations subject to securities claims for misrepresentation.

In *City of Pontiac*, the Second Circuit also addressed the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), which limited application of Section 10(b) of the Exchange Act to "(1) transactions in securities listed on domestic exchanges, and (2) domestic transactions in other securities." Here, the Second Circuit found that the *Morrison* decision barred extraterritorial application of the Exchange Act for claims by purchasers of shares of a foreign issuer on a foreign exchange, even where such shares were cross-listed on a United States exchange and even where the order itself was placed in the United States but executed on a foreign exchange.

SEC v. Graham et al.

On May 12, 2014, the United States District Court for the Southern District of Florida ruled that 28 U.S.C. § 2462, which sets a five-year statute of limitations for the commencement of an action seeking a civil fine, penalty, or forfeiture, removes the federal courts' subject matter jurisdiction over late-filed cases.[15] The SEC had not provided evidence that the Ponzi scheme at issue in the case was still in operation less than five years before the filing of the complaint. In finding that Section 2462 stripped the Court of subject matter jurisdiction to hear the claims after the five year statute of limitations had lapsed, the Court found that it was the SEC's affirmative burden to prove that the action had been commenced within the statute of limitations, rather than the defendant's burden to

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[14] No. 12-4355-cv (2d Cir. May 6, 2014), http://caselaw.findlaw.com/us-2nd-circuit/1665489.html.

[15] No. 13-10011 (S.D. Fla. May 12, 2014).

establish that the action was untimely. Moreover, the Court held that the five-year statute of limitations was applicable to actions for disgorgement, injunctions, or declaratory relief, despite these actions not being specified in the statute.

III. Insider Trading

In the first half of 2014, the SEC and Department of Justice ("DOJ") continued to actively pursue insider trading cases against individuals and entities in the financial industry, including hedge fund managers and investment advisers. During this time, the SEC experienced mixed results at trial and high profile losses in *SEC v. Obus* and *SEC v. Moshayedi*, which have put the SEC's programmatic emphasis on insider trading in the spotlight.

As evidenced by recent remarks by SEC Chair Mary Jo White,[16] the SEC continues to make insider trading cases a priority. Chair White emphasized the "importance of all-encompassing enforcement of SEC laws" through the "vigorous use of criminal, civil and regulatory tools," including cooperation between the SEC and criminal authorities in parallel investigations, as well as bringing standalone SEC cases, which have "unique remedies to protect investors." In discussing the SEC's enforcement program, Chair White focused on insider trading, which has "historically been a staple for both the SEC and criminal prosecutors." Chair White noted the SEC's "very impressive" record in both settling insider trading cases and bringing those cases to trial. Chair White also noted that standalone cases, which are often based on "indirect

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[16] Keynote Address, U.S. Securities and Exchange Commission, All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets by SEC Chair Mary Jo White before SIFMA Compliance & Legal Society Annual Seminar (Mar. 31, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370541342996.

evidence" and therefore more challenging, are "very important because strong deterrence requires that there be punitive consequences for insider trading even if the evidence is insufficient to criminally prosecute and difficult to successfully try civilly."

The DOJ, in particular the U.S. Attorney's Office for the Southern District of New York, also continued to prosecute insider trading cases in the first half of 2014. Through the end of June 2014, U.S. Attorney Preet Bharara has overseen 85 convictions or guilty pleas for insider trading cases since taking office in 2009.

A. 2014 Setbacks for the SEC

The SEC has suffered some notable courtroom losses on insider trading cases in the first half of 2014, including a case that spanned twelve years against hedge fund manager Nelson Obus. While the SEC maintains that it will continue to actively pursue insider trading cases even after recent defeats,[17] the SEC's response to these "setbacks" will be closely followed as many observers begin to question the efficacy of the SEC's enforcement agenda. The SEC may seek more administrative proceedings, or it may seek to manage risks and SEC resources by reconsidering which cases to bring to trial based on the level of evidence obtained. Defendants, on the other hand, in light of a string of successes, may be emboldened to go to trial rather than settle with the SEC.

SEC v. Obus

The SEC investigation into the alleged insider trading at Wynnefield Capital, Inc., a hedge fund managed by Nelson Obus, stretches back to 2002. The SEC filed an insider trading action in 2006,[18] alleging that Nelson Obus traded on non-public information obtained from T. Bradley Strickland, an assistant vice president and underwriter at

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[17] For example, in response to the acquittal in *SEC v. Moshayedi*, SEC spokesman John Nester stated: "We respect the jury's verdict but will continue to aggressively enforce the law when we believe the evidence supports the allegations." *SEC Loses Latest Insider-Trading Trial to Former STEC CEO*, Bloomberg (June 7, 2014), http://www.bloomberg.com/news/2014-06-06/sec-loses-latest-insider-trading-trial-to-former-stec-ceo.html.

[18] Release, U.S. Securities and Exchange Commission, SEC Charges Hedge Fund Manager Nelson Obus and Two Others with Insider Trading Prior to SunSource, Inc. Merger Announcement, Rel. No. 19667 (Apr. 25, 2006), http://www.sec.gov/litigation/litreleases/2006/lr19667.htm.

General Electric Capital Corporation, and Peter Black, an analyst at Wynnefield, about a planned merger in 2001 between SunSource, Inc. and Allied Capital Corporation. The SEC also named as relief defendants three funds managed by Wynnefield: Wynnefield Parnters Small Cap Value L.P., Wynefield Partners Small Cap Value L.P. I, and Wynnefield Partners Small Cap Value Offshore Funds, Ltd.

The SEC alleged that Strickland, in his capacity as employee of GE Capital, learned of the material, non-public information while performing due diligence on SunSource in connection with the proposed merger. Strickland then allegedly tipped his college friend, Black, about the planned merger. Black then allegedly told his boss, Obus, about the merger. The SEC argued that Obus essentially confessed to obtaining an illegal tip when he called the CEO of SunSource to tell him that "a little birdie" alerted him to the planned merger.[19] The SEC alleged that Obus used this inside tip and directed Wynnefield to purchase SunSource stock in advance of that merger, making an illegal profit of $1,335,700, which was deposited into relief defendants' accounts.

The defendants claimed that there was no illegal tip because Black knew that Wynnefield was a SunSource shareholder and Black alerted Obus that SunSource was possibly entering into a merger to dilute shareholders. U.S. District Judge Daniels granted the defendants' motion for summary judgment,[20] finding that the SEC failed to prove that "Strickland breached a duty to his employer, nor has it demonstrated the requisite degree of deceptive conduct on the part of any defendant." Judge Daniels relied on the fact that GE Capital's internal investigation found that Strickland did not breach his duty to GE. Judge Daniels' decision was reversed by the Second Circuit on appeal, [21] and the case proceeded.

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[19] Complaint, *SEC v. Obus*, 06-cv-3150 (S.D.N.Y. Apr. 25, 2006), http://www.sec.gov/litigation/complaints/2006/comp19667.pdf.

[20] *SEC v. Obus*, 2010 WL 3703846, at *16 (S.D.N.Y. Sept. 20, 2010).

[21] *SEC v. Obus*, 693 F.3d 276 (2d Cir. Sept. 6, 2012).

The defendants refused to settle and the case went to trial on May 19, 2014. Obus testified at trial that he did not trade on an illegal tip and relied on his own research to complete the trade.[22] On May 30, 2014, a federal jury in New York acquitted Strickland, Black, and Obus of insider trading charges.[23]

SEC v. Moshayedi

In July 2012, the SEC brought charges against Manouchehr Moshayedi,[24] the CEO of a computer storage device company sTec Inc., alleging insider trading in connection with a secondary offering of shares of sTec. In July 2009, sTec announced a supply contract with its customer, EMC Corporation, for the purchase of $120 million worth of its flash-drive memory product, ZeusIOPS, in the third and fourth quarter of 2009. STec's stock rose 800% between January and August of 2009. The SEC alleged that Moshayedi sought to benefit from this stock increase by engaging in a secondary offering of their stock. This secondary offering was set to occur at the time of the company's release of the second quarter 2009 financial results and the third quarter 2009 revenue guidance. In August 2009, prior to the secondary offering, Moshayedi allegedly obtained non-public information about EMC's decrease in demand for the product. Instead of cancelling the offering, Moshayedi allegedly entered into a fraudulent side agreement with EMC Corp. to take $55 million of the product in the third quarter of 2009, with a $2 million discount, which allowed the company to meet third quarter earnings estimates.

The SEC argued that Moshayedi exploited the knowledge that he obtained in the course of his duties as a CEO, that he withheld the information in order to maintain a strong earnings outlook for the third quarter, and made an illegal profit of over $260 million.

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[22] *SEC Loses Insider-Trading Case*, WSJ (May 30, 2014), http://online.wsj.com/articles/sec-loses-case-against-hedge-fund-manager-1401485752.

[23] Release, U.S. Securities and Exchange Commission, Jury Finds T. Bradley Strickland, Peter Black, and Nelson Obus Not Liable for Insider Trading, Rel. No. 23011 (June 2, 2014), http://www.sec.gov/litigation/litreleases/2014/lr23011.htm.

[24] Press Release No. 2012-141, U.S. Securities and Exchange Commission, SEC Charges CEO With Insider Trading in Secondary Offering of Company Stock (July 19, 2012), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483406.

Moshayedi denied the allegations. The case went to trial in the United States District Court for the Central District of California on May 22, 2014. On the first day of deliberations, a federal jury acquitted Moshayedi of charges of insider trading.[25]

B. SAC Capital Insider Trading Proceedings

The SEC and DOJ continued to pursue employees of SAC Capital and its affiliates in 2014 (as discussed more broadly in our 2013 Year-End Report). The government's insider trading settlements with SAC Capital, which changed its name to Point72 Asset Management LP in April 2014 and now focuses solely on managing the Cohen family's money, were approved this year. On April 10, 2014, U.S. District Judge Laura Swain accepted the defendants' guilty pleas and approved the $1.8 billion settlement—$900 million to settle the criminal case and a $900 million fine for the civil forfeiture suit—between SAC Capital Advisors LP and the DOJ and SEC.[26] On June 18, 2014, as discussed more fully in the Settlements Section below, U.S. District Judge Victor Marrero approved the $600 million "no admit, no deny" insider trading settlement between the SEC and CR Intrinsic Investors LLC and SAC Capital Advisors LP's affiliates.

Mathew Martoma

As discussed in our 2013 Year-End Report, Mathew Martoma was charged with insider trading by the SEC in November 2012 and the DOJ in December 2012. On February 6, 2014, Martoma was convicted on two counts of securities fraud and one count of conspiracy,[27] and

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[25] *SEC Loses Latest Insider-Trading Trial to Former STEC CEO*, Bloomberg (June 7, 2014), http://www.bloomberg.com/news/2014-06-06/sec-loses-latest-insider-trading-trial-to-former-stec-ceo.html.

[26] Release, U.S. Department of Justice, U.S. Attorney's Office of the Southern District of New York, SAC Capital Management Companies Sentenced In Manhattan Federal Court For Insider Trading (April 10, 2014), http://www.justice.gov/usao/nys/pressreleases/April14/SACSentencingPR.php.

[27] Release, U.S. Department of Justice, SAC Capital Portfolio Manager Mathew Martoma Found Guilty In Manhattan Federal Court of Insider Trading Charges (Feb. 6, 2014), http://www.justice.gov/usao/nys/pressreleases/February14/MathewMartomaVerdictPR.php.

is the eighth employee of SAC Capital to be convicted of or plead guilty to insider trading. Martoma faces a maximum sentence of 20 years for each securities fraud count, and 5 years for one count of conspiracy. His sentencing is set for July 28, 2014.

Michael Steinberg

As discussed in our 2013 Year-End Report, Michael Steinberg, a former portfolio manager at SAC Capital, was convicted of insider trading in December 2013. On May 16, 2014, U.S. District Judge Richard Sullivan sentenced Steinberg to 42 months in prison, and required him to pay a $2 million fine.[28] Judge Sullivan stayed Steinberg's sentence, pending the appeal of his conviction.

The appeal in another high profile insider trading case, *U.S. v. Newman and Chiasson*,[29] which addresses the issue of whether the government must prove the tippee's knowledge that the original tipper benefited from the provision of inside information, may have a determinative effect on the viability of Steinberg's conviction. Todd Newman, a portfolio manager at Diamondback Capital Management, and Anthony Chiasson, a co-founder of hedge fund Level Global Investors LP, were convicted separately of securities fraud and sentenced to 78[30] and 54[31] years, respectively, for trading on material, non-public information relating to shares of Dell Inc. and NVIDIA Corporation in advance of earnings reports. Newman and Chiasson are downstream tippees in that they did not receive the information directly from the tipper insider. Newman and Chiasson appealed

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[28] Release, U.S. Department of Justice, U.S. Attorney's Office of the Southern District of New York, SAC Capital Portfolio Manager Michael Steinberg Sentenced in Manhattan Federal Court to 42 Months in Prison for Insider Trading (May 16, 2014), http://www.justice.gov/usao/nys/pressreleases/May14/SteinbergMichaelSentencingPR.php.

[29] *U.S. v. Newman*, No. 13-1837 (2d Cir.).

[30] Release, U.S. Department of Justice, U.S. Attorney's Office of the Southern District of New York, Former Hedge Fund Co-Founder, Anthony Chiasson, Sentenced In Manhattan Federal Court To 78 Months In Prison For Insider Trading (May 13, 2013), http://www.justice.gov/usao/nys/pressreleases/May13/ChiassonAnthonySentencingPR.php.

[31] Press Release, U.S. Department of Justice, U.S. Attorney's Office of the Southern District of New York, Former Hedge Fund Manager, Todd Newman, Sentenced In Manhattan Federal Court To 54 Months In Prison (May 2, 2013), http://www.justice.gov/usao/nys/pressreleases/May13/ToddNewmanSentencing.php.

their convictions, and the cases were consolidated. At issue is Judge Sullivan's instruction to the jury, in the underlying trials, that it must find the defendant tippee knew the information it received was material and non-public, and that the tipper breached a fiduciary duty. Judge Sullivan's instruction did not require proof of the tippee's knowledge that the tipper received a "personal benefit" for providing the information.

Judge Sullivan gave the same jury instruction in the trial of Steinberg, who is also a downstream tippee. As a result, the decision could have immediate ramifications. The *Newman* issue was argued before the United States Court of Appeals for the Second Circuit on April 22, 2014, and the decision is pending.

Ronald Dennis

In March 2014, the SEC charged[32] Ronald Dennis, a former analyst who worked for an SAC Capital affiliate, with insider trading. The SEC alleged that Dennis received non-public inside information from hedge fund analysts Jesse Tortola of Diamondback Capital and Matthew Teeple of Artis Capital Management regarding upcoming earnings announcements of Dell Inc. and Foundry Networks. The SEC alleged that Dennis caused SAC Capital and CR Intrinsic to trade on that information, gaining illegal profits in the amounts of $3.2 million for trades involving Dell, and $550,000 for trades involving Foundry. Dennis settled with the SEC, without admitting any wrongdoing, and paid a $200,000 fine. Prior to approving the SEC's "no admit, no deny" settlement with Dennis, U.S. District Judge Harold Baer asked the SEC to explain why it entered into a settlement agreement with Dennis that did not require an admission of wrongdoing,[33] but ultimately approved the settlement on April 22, 2014.

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[32] Release, U.S. Securities and Exchange Commission, SEC Charges CR Intrinsic Analyst with Insider Trading, Rel. No. 22942, (March 13, 2014), http://www.sec.gov/litigation/litreleases/2014/lr22942.htm.

[33] Judge Questions SEC 'No Admit' Pact With Ex-SAC Analyst, Law360 (April 9, 2014), http://www.law360.com/articles/526861/judge-questions-sec-no-admit-pact-with-ex-sac-analyst.

IV. Settlements

The first half of 2014 witnessed significant settlement activity and developments, including circuit court approval of the SEC's admissions policy with respect to settlements, additional SEC settlements requiring admissions by defendants, and additional settlements relating to suits resulting from the Financial Crisis.

A. SEC's Admissions Policy

On June 4, 2014, the United States Court of Appeals for the Second Circuit issued its long-awaited decision in *SEC v. Citigroup Global Markets, Inc.*,[34] reaffirming the SEC's practice of routinely settling cases and obtaining consent judgments that do not require a defendant to admit, nor permit the defendant to deny, the factual allegations in the SEC's Complaint or Order Instituting Proceedings (as discussed in our previous Executive Alert). The Second Circuit held that the proper standard for a district court's review of a proposed settlement involving an enforcement agency is "whether the proposed consent decree is fair and reasonable, with the additional requirement that the public interest would not be disserved in the event that the decree includes injunctive relief." This holding omitted the judicial evaluation of "adequacy" that was previously a part of judicial review of settlements.[35]

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[34] *SEC v. Citigroup Global Markets, Inc.*, No. 11-5227-cv(L), 11-5375-cv(con), 11-5232-cv(xap), 2014 WL 2486793 (2d Cir. June 4, 2014).

[35] *Id.* at 19.

Two weeks later, on June 18, 2014, Judge Victor Marrero of the United States District Court for the Southern District of New York approved the SEC's $600 million consent judgments resolving an insider trading action against affiliates of CR Intrinsic Investors LLC and SAC Capital Advisors LP.[36]

B. Civil Settlements

FHFA Mortgage Backed Securities Settlements

The Federal Housing Finance Agency ("FHFA") reached an additional eight settlements this year, for a total of 15, out of the 18 private-label securities lawsuits related to the sales of mortgage-backed securities ("MBS") to Fannie Mae and Freddie Mac after recovering nearly $8 billion in 2013 from settlements with seven large banks to settle litigation.[37] The FHFA, which serves as the conservator for Fannie Mae and Freddie Mac, sued 18 financial institutions in September 2011 regarding the quality of $182 billion in mortgages underlying securities sold to Fannie and Freddie.

On February 4, 2014, Morgan Stanley disclosed in a regulatory filing that it agreed to pay $1.25 billion to settle FHFA's claims.[38] On February 27, 2014, SG Americas and four other subsidiaries of Societe Generale agreed to pay $122 million to settle claims that they misrepresented the quality of loans underlying four MBS offerings sold to the government lenders.[39] Credit Suisse followed on March 21, 2014, agreeing to pay $885 million, with approximately $234 million going to Fannie Mae and approximately $651 million to Freddie Mac, to settle claims in connection with the sale of approximately $16.6 billion of MBS between

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[36] *SEC v. CR Intrinsic Investors LLC et al.,* 2014 WL 2768054 (S.D.N.Y. June 18, 2014)

[37] Evan Weinberger, *FHFA Recovered $8B from Banks in 2014 MBS Settlements*, Law360 (Jan. 2, 2014) http://www.law360.com/articles/498214/fhfa-recovered-8b-from-banks-in-2013-mbs-settlements

[38] News Release, FHFA Announces $1.25 Billion Settlement With Morgan Stanley (Feb. 7, 2014), http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-$1-25-Billion-Settlement-With-Morgan-Stanley.aspx. The case is *Federal Housing Finance Agency v. Morgan Stanley et al.,* No. 1:11-cv-06739 (S.D.N.Y.).

[39] News Release, FHFA Announces $122 Million Settlement With Societe Generale (Feb. 27, 2014), http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-$122-Million-Settlement-With-Soci%C3%A9t%C3%A9-G%C3%A9n%C3%A9rale.aspx. The case is *Federal Housing Finance Agency v. SG Americas Inc. et al.*, No. 1:11-cv-06203 (S.D.N.Y.).

2005 and 2007.[40] On March 26, 2014, FHFA announced a $5.83 billion settlement in cases involving Bank of America, Countrywide Financial, and Merrill Lynch.[41] The agreement also included the purchase of another $3.2 billion in MBS by Bank of America from Fannie Mae and Freddie Mac. On April 24, 2014, Barclays Bank PLC agreed to pay $280 million, with $227 million going to Freddie Mac and $53 million to Fannie Mae, to settle claims in two lawsuits by FHFA.[42] On April 29, 2014, FHFA reached a deal with First Horizon National Corporation and three of its former executives to settle its claims for $110 million.[43] Finally, on June 19, 2014, FHFA announced a $99.5 million settlement with RBS Securities, Inc.[44]

FHFA still has actions pending against Goldman Sachs & Co., HSBC PLC, Morgan Stanley, Nomura Holding America, Inc., and The Royal Bank of Scotland Group.

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[40] News Release, FHFA Announces $885 Million Settlement With Credit Suisse (Mar. 21, 2014), http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-$885-Million-Settlement-With-Credit-Suisse.aspx; The case is *Federal Housing Finance Agency v. Credit Suisse Holdings (USA) Inc. et al.*, No. 1:11-cv-06200 (S.D.N.Y.).

[41] News Release, FHFA Announces $9.3 Billion Settlement With Bank of America Corporation (Mar. 26, 2014), http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-$9-3-Billion-Settlement-With-Bank-of-America-Corporation.aspx. The cases are *Federal Housing Finance Agency v. Bank of America Corp., et al.,*No. 1-11-cv-06195 (S.D.N.Y.), *Federal Housing Finance Agency v. Countrywide Financial Corp., et al.*, No. 12-cv-1059 (C.D. Cal.), *Federal Housing Finance Agency v. Merrill Lynch & Co., Inc., et al.*, No. 11-cv-06202 (S.D.N.Y.), and *Federal Housing Finance Agency v. First Horizon National Corp.*, No. 11-cv-06193 (S.D.N.Y.).

[42] News Release, FHFA Announces $280 Million Settlement with Barclays Bank PLC (Apr. 24, 2014), http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-$280-Million-Settlement-with-Barclays-Bank-PLC.aspx. The cases are *Federal Housing Finance Agency v. Barclays Bank PLC et al.,* No. 11-cv-06190 (S.D.N.Y.) and *Federal Housing Finance Agency v. Ally Financial Inc. et al*., No. 11-cv-07010 (S.D.N.Y.).

[43] News Release, FHFA Announces $110 Million Settlement with First Horizon National Corporation (Apr. 29, 2014), http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-$110-Million-Settlement-with-First-Horizon-National-Corporation.aspx. The case is *Federal Housing Finance Agency v. First Horizon National Corporation et al.*, No. 11-cv-06193 (S.D.N.Y.).

[44] News Release, FHFA Announces Settlement with RBS (Jun 19, 2014), http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Settlement-with-RBS.aspx; The case is *Federal Housing Finance Agency v. Ally Financial Inc. et al.*, No. 11-cv-07010 (S.D.N.Y.).

Plumbers' & Pipefitters' Local #562 Supplemental Plan & Trust v. J.P. Morgan Acceptance Corp. I, No. 2:08-cv-01713 (E.D.N.Y.)

On May 2, 2014, the United States District Court for the Eastern District of New York approved a $280 million settlement to resolve a long-running consolidated class action against JP Morgan Chase & Co. affiliates, alleging that they misled investors into buying $36.8 billion worth of MBS.[45] The class consisted of more than 2,850 investors who bought pass-through certificates in 26 offerings between May 2006 and September 2007. On the motion to dismiss, the lead plaintiff, Public Employees' Retirement System of Mississippi (MissPers), who only purchased eight of the certificates issued by JPMorgan, argued that it could sue on all of the offerings because its ability to bring claims on behalf of absent members was a question of fitness to represent a defined class that should be decided as part of a class certification and not a motion to dismiss. In December 2011, the court ruled that MissPers did not have standing to pursue claims over certificates that it had never held. However, the court modified its ruling after the Second Circuit's decision in *NECA-IBEW Health & Welfare Fund v. Goldman Sachs*, 693 F.3d 145 (2d Cir. 2012), which found that the putative lead plaintiff had standing to assert claims on behalf of other of purchasers in other offerings if the plaintiff alleges a common misstatement.

C. Regulatory Settlements

In the Matter of KPMG LLP, Proc. No. 3-15687

On January 24, 2014, the SEC charged KPMG LLP with violating auditor independence rules by providing bookkeeping and other non-audit services to affiliates of companies KPMG audited from 2007 through 2011.[46] According to the SEC, some KPMG personnel owned stock in companies or affiliates that were KPMG audit clients. KPMG did not admit or deny the allegations, but agreed to pay $8.2 million to settle the charges.

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[45] Kurt Orzeck, *JPMorgan $280M MBS Settlement Preliminarily Approved*, Law360 (May 2, 2014), http://www.law360.com/securities/articles/534303/jpmorgan-280m-mbs-settlement-preliminarily-approved.

[46] Release, U.S. Securities and Exchange Commission, SEC Charges KPMG With Violating Auditor Independence Rules, Rel. No. 2014-12 (Jan. 24, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540667080.

The SEC also investigated KPMG's practice of loaning employees to assist clients with tax compliance work under the direction and supervision of the client's management. The SEC did not bring an enforcement action against KPMG for the practice, but issued a report reminding auditing firms that auditor independence can be impaired when the accountant acts as an employee of the audit client.[47]

In the Matter of Scottrade, Inc., Proc. No. 3-15702

On January 29, 2014, Scottrade Inc. became another defendant to admit to wrongdoing since the SEC broke from its long-standing "no admit, no deny" policy.[48] Scottrade agreed to pay a $2.5 million penalty and admitted it violated the recordkeeping provisions of federal securities laws because it failed between March 2006 and April 2012 to provide the SEC with accurate "blue sheets," which detail the trading activity of a firm and its customers. According to Director of Enforcement Andrew J. Ceresney, "[b]lue sheet information is the lifeblood of many SEC investigations and examinations." The issue arose in December 2011 after the SEC requested blue sheets in connection with an investigation into suspicious trades. The SEC discovered that Scottrade's submission was incomplete because a computing coding error resulted in the omission of trades on 1,231 occasions.

In the Matter of Worldwide Capital Inc. et al., Proc. No. 3-15772

On March 5, 2014, the SEC announced the largest-ever monetary sanction to settle charges for Rule 105 short selling violations, as discussed in our previous Executive Alert.[49] Worldwide Capital and its owner and president, Jeffrey Lynn, agreed to pay $7.2 million, without admitting or denying the charges. Rule 105 of Regulation M prohibits

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[47] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: KPMG, LLP, Release No. 71390 (Jan. 24, 2014), http://www.sec.gov/litigation/investreport/34-71390.pdf.

[48] Release, U.S. Securities and Exchange Commission, Scottrade Agrees to Pay $2.5 Million and Admits Providing Flawed "Blue Sheet" Trading Data, Release No. 2014-14 (Jan. 29, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540696906.

[49] Release, U.S. Securities and Exchange Commission, SEC Announces Largest Monetary Sanction for Rule 105 Short Selling Violations, Release No. 2014-43 (Mar. 5, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540883326.

short selling of an equity security during a restricted period and the subsequent purchase of that same security through the offering. The SEC alleged that Worldwide Capital bought and sold stock in 60 public offerings during the restricted period.

State of New York v. Bank of America Corp. et al., No. 450115/2010

On March 26, 2014, Bank of America and its former CEO, Kenneth Lewis, entered into a $25 million settlement with the New York Attorney General to resolve claims that Lewis misled shareholders by concealing mounting losses at Merrill Lynch prior to the vote on a merger and manipulated the federal government into providing massive financial assistance claiming a material adverse change in Merrill's financial condition.[50] Bank of America and Lewis agreed to pay a $15 million and $10 million penalty, respectively. Lewis is barred from serving as an officer or director of a public company for three years.

On April 17, 2014, Bank of America's former CFO, Joe L. Price, agreed to pay $7.5 million and to be banned for 18 months from serving as an officer or director of a public company to resolve the charges against him.[51]

U.S. v. SAC Capital Advisors LP, No. 1:13-cr-00541 (S.D.N.Y.)

In the Matter of SAC Capital Advisors LP et al., Proc. No. 3-15950

On April 10, 2014, U.S. District Judge Laura Taylor Swain accepted the guilty pleas on securities and wire fraud charges by SAC Capital Advisors L.P., SAC Capital Advisors LLC, CR Intrinsic Investors LLC, and Sigma Capital Management, LLC, which were responsible for the management of an affiliated group of hedge funds.[52] The court imposed a sentence that included a criminal fine of

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[50] Stewart Bishop, BofA, Ex-CEO to Pay $25M to End Suit Over Merrill Deal, Law360 (Mar. 26, 2014), http://www.law360.com/articles/522348/bofa-ex-ceo-to-pay-25m-to-end-suit-over-merrill-deal.

[51] Pete Brush, Former BofA CFO Strikes $7.5M Deal in Merrill Merger Case, Law360 (Apr. 25, 2014), http://www.law360.com/articles/531859/former-bofa-cfo-strikes-7-5m-deal-in-merrill-merger-case.

[52] Press Release, SAC Capital Management Companies Sentenced in Manhattan Federal Court for Insider Trading (Apr. 10, 2014), http://www.justice.gov/usao/nys/pressreleases/April14/SACSentencingPR.php.

$900 million, part of a $1.2 billion financial penalty that is the largest fine ever in an insider trading case, announced in November 2013. SAC Capital also agreed to pay the SEC $616 million.

On June 27, 2014, SAC Capital Advisors LP and its affiliates settled a SEC administrative proceeding that winds down their operations as investment advisers, converting them to a "family office" to manage the personal wealth of Steven A. Cohen.[53] SAC's registration as an investment adviser will be revoked on December 31, 2015, allowing the firm time to manage illiquid investments so they can be properly disbursed.

In the Matter of TL Ventures Inc., Proc. No. 3-15940

On June 20, 2014, the SEC brought its first-ever pay-to-play case against an investment adviser.[54] The pay-to-play rules prohibit investment advisers from providing services to a government entity for two years after the firm or key individuals make campaign contributions to a candidate or official who could influence the selection or retention of advisers to manage public pension funds or other government assets. The SEC charged TL Ventures Inc. with continuing to accept investment fees from two public pension funds even after an employee made political contributions to a Philadelphia mayoral candidate and to the governor of Pennsylvania. TL Ventures agreed to pay $295,000 in sanctions without admitting or denying liability.

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[53] Release No. 3864, *In the Matter of SAC Capital Advisors, L.P. et al.*, Proc. No. 3-15950 (Jun. 27, 2014).

[54] Release, U.S. Securities and Exchange Commission, SEC Charges Private Equity Firm with Pay-to-Play Violations Involving Political Campaign Contributions in Pennsylvania, Release No. 2014-120 (Jun. 20, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542119853.

V. Investment Adviser and Hedge Fund Cases

Andrew J. Bowden, the Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), recently noted that the SEC typically encounters the most serious problems when investment advisers: (1) "lie, cheat, and steal"; (2) act recklessly; or (3) fail to act fairly because their judgment is clouded by conflicts of interest.[55] A review of the cases brought by the SEC in the first half of 2014 shows that each category is well represented.

SEC v. Kalucha et al.

On May 5, 2014, the SEC filed fraud charges and sought emergency relief against New York-based investment advisory firm Aphelion Fund Management ("Aphelion") and two of its executives, George Palathinkal, Aphelion's chief financial officer, and Vineet Kalucha, Aphelion's managing partner, majority owner, and chief investment officer.[56]

According to the SEC, Aphelion's outside auditor's report showed an investment loss of more than 3% during a 15-month period in an account that Kalucha managed. However, Kalucha changed this loss into a gain of 30%, and the phony gain was included in the auditor report. Kalucha also fabricated emails that appeared to be from the auditor blessing the new report. Palathinkal reviewed and knew of Kalucha's

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[55] Speech, U.S. Securities and Exchange Commission, People Handling Other Peoples' Money (Mar. 6, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370541260300.

[56] Complaint, *S.E.C. v. Kalucha*, No. 14 cv 3247 (S.D.N.Y. May 5, 2014), http://www.sec.gov/litigation/complaints/2014/comp-pr2014-92.pdf.

alterations, but permitted the report to be distributed to investors.

The SEC also claimed that Aphelion, Kalucha, and Palathinkal misled investors about Aphelion's assets under management. In particular, in 2013, the company never managed any more than $5 million in assets at any one time, yet Kalucha and Palathinkal repeatedly stated to investors that the company handled more than $15 million. According to the SEC's complaint, the three defendants also misused investor funds. For example, they raised $1.5 million in investments by representing to investors that the funds would be used for Aphelion's operating expenses. However, a substantial portion of these funds were used by Kalucha for his personal benefit, including settlement of a foreclosure action on his home, settlement of a breach of contract action filed against him in his personal capacity, down payment of a BMW, and payment for tax and accounting services for his personal finances. All of these withdrawals were approved by Palathinkal. The SEC also alleged that the defendants misrepresented Kalucha's litigation history to investors.

The SEC's complaint charged (i) Aphelion, Kalucha, and Palathinkal with violations of the antifraud provisions of the Securities Act and the Exchange Act, (ii) Kalucha and Aphelion with violation of the Investment Advisers Act of 1940 ("Advisers Act"), and (iii) Palathinkal with aiding and abetting those violations.

The SEC also requested and received emergency relief for investors. A temporary restraining order was issued by the court, imposing an asset freeze to protect client assets, and temporarily prohibiting the defendants from soliciting new investors or additional investments from existing investors.[57]

SEC v. Weston Capital Asset Management LLC

On June 23, 2014, Florida-based Weston Capital Asset Management LLC ("Weston") and several current and former executives settled the SEC's claims that they secretly transferred more than $17 million from one investment to another while pocketing some of the proceeds.[58]

Weston managed more than a dozen unregistered hedge funds with combined assets of $230 million. Weston's portfolio

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[57] Release, U.S. Securities and Exchange Commission, *SEC v. Kalucha*, No. 14 cv 3247 (May 16, 2014), http://www.sec.gov/litigation/litreleases/2014/lr22994.htm.

[58] Complaint, *SEC v. Weston Cap. Asset Mgmt. LLC*, No. 14-cv-80823 (S.D. Fla. June 23, 2014), http://www.sec.gov/litigation/complaints/2014/comp-pr2014-121.pdf.

at issue was required to invest all investor monies in one specific hedge fund that itself invested in short-term, low-risk interest bearing accounts and U.S. Treasury bills. The SEC alleged that, without telling investors, Weston and Albert Hallac, Weston's founder and president, redeemed that portfolio's entire investment and, contrary to the stated investment strategy, transferred the money to Swartz IP Services Group Inc. ("Swartz"). Investors consistently received account statements falsely reflecting their investment was performing as well, if not better, than before. However, according to the SEC, the portfolio began losing money immediately after the transfer and, by July of 2012, only $15,000 of the $17.7 million transferred to Swartz remained in its accounts. The SEC also alleged that Hallac, Keith Wellner, Weston's former general counsel, chief compliance officer, and chief operating officer, and Jeffrey Hallac, Hallac's son, collectively received $750,000 in personal payments from Swartz. The SEC further alleged that Weston and Hallac used $3.5 million to pay down a portion of a loan from another fund managed by the firm.

The SEC's complaint charged that Weston and Hallac violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) and (c) thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The complaint further charged Wellner with aiding and abetting Weston and Hallac's violations of Sections 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8(a)(2) thereunder. Jeffrey Hallac was named as a relief defendant only.

Without admitting or denying wrongdoing, Weston, Albert Hallac, and Wellner consented to the entry of a judgment barring them from future violations of federal anti-fraud laws and rules and the Advisers Act, according to the SEC. Wellner and Jeffrey Hallac each agreed to pay $120,000 in disgorgement. The court will determine monetary sanctions for Weston and the elder Hallac at a later date.

"Investment advisers owe their clients a fiduciary duty of utmost good faith and full disclosure about what they're doing with their money," Eric I. Bustillo, director of the SEC's Miami Regional Office, said in a statement. "Weston and [Albert] Hallac dishonored that duty with Wellner's assistance by

secretly steering investor proceeds to a third party and then pocketing some of those funds."[59]

In re Credit Suisse Group AG

In February 2014, the SEC ordered Credit Suisse Group AG ("Credit Suisse") to pay $196 million as part of a settlement over unregistered brokers who illegally provided advice to U.S. clients.[60]

According to the SEC, Credit Suisse violated the federal securities laws by providing cross-border brokerage and investment advisory services to U.S. clients without first registering with the SEC. Credit Suisse started conducting cross-border advisory and brokerage services for U.S. clients as early as 2002. The bank's relationship managers made approximately 107 trips to the U.S. during a seven-year period, and provided broker-dealer and advisory services to hundreds of clients they visited. Over the years, Credit Suisse amassed as many as 8,500 U.S. client accounts containing approximately $5.6 billion in assets. However, these relationship managers were not registered to provide brokerage or advisory services, nor were they affiliated with a registered entity. It was not until October 2008, after a much-publicized civil and criminal investigation into similar conduct by Swiss-based UBS, that Credit Suisse began to take steps to exit the business of providing cross-border advisory and brokerage services to U.S. clients. Credit Suisse did not exit the market completely until the middle of 2013.

The SEC's order found that Credit Suisse willfully violated Section 15(a) of the Exchange Act and Section 203(a) of the Advisers Act. "As a multinational firm with a significant U.S. presence, Credit Suisse was well aware of the steps that a firm needs to take to legally conduct advisory or brokerage business with U.S. clients," said Scott W. Friestad, an Associate Director in the SEC's Division of Enforcement. "Credit Suisse failed to effectively implement internal controls designed to keep its employees from crossing the line and being non-compliant with the federal securities laws." [61]

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[59] Release, U.S. Securities and Exchange Commission, SEC Charges Hedge Fund Advisory Firm and Others in South Florida-Based Scheme to Misuse Investor Proceeds, (June 23, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542137996.

[60] Order, *In re Credit Suisse Group AG*, File No. 3-15763, U.S. Securities and Exchange Commission (Feb. 21, 2014), http://www.sec.gov/litigation/admin/2014/34-71593.pdf.

[61] Release, U.S. Securities and Exchange Commissions, Credit Suisse Agrees to Pay $196 Million and Admits Wrongdoing in Providing Unregistered Services to U.S.

Credit Suisse admitted the facts in the SEC's order, acknowledged that its conduct violated the federal securities laws, accepted a censure and a cease-and-desist order, and agreed to retain an independent consultant. Credit Suisse agreed to pay $82,170,990 in disgorgement, $64,340,024 in prejudgment interest, and a $50 million penalty.

In May 2014, Credit Suisse pleaded guilty to federal charges brought by the DOJ that the bank illegally allowed U.S. clients to evade their taxes.[62] Credit Suisse admitted it conspired to aid tax evasion and agreed to pay $100 million to the Federal Reserve, more than $715 million to the New York Department of Financial Services, and nearly $1.8 billion to the DOJ. Credit Suisse did, however, receive assurances from state and federal regulators that they would not take punitive measures (*e.g.*, stripping the bank of its ability to operate domestically). The SEC also granted the bank temporary reprieve from a rule that would have stripped the bank of its ability to act as an investment adviser.[63]

In re Navigator Money Management, Inc. et al.

In February 2014, Navigator Money Management ("NMM"), a New York-based money management firm, and Mark A. Grimaldi, the firm's majority owner, president, and chief compliance officer, settled the SEC's charges that they made false claims about the success of their investment advice and a mutual fund they manage.[64]

In a December 2011 advertisement, the SEC claims, defendants advertised Sector Rotation Fund ("Sector"), a mutual fund managed by NMM, was "ranked number 1 out of 375 World Allocation funds tracked by Morningstar." However, a time period of October 13, 2010, to October 12, 2011, was cherry-picked to broadly tout that ranking; Sector had a much poorer performance during other time periods. From February 2009 through 2013, defendants touted NMM as a "five-star

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Clients (Feb. 21, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540816517.

[62] Release, U.S. Department of Justice, Credit Suisse Pleads Guilty to Conspiracy to Aid and Assist U.S. Taxpayers in Filing False Returns (May 19, 2014), http://www.justice.gov/opa/pr/2014/May/14-ag-531.html.

[63] Response of the Office of Chief Counsel Division of Investment Management, U.S. Securities and Exchange Commission, IM Ref. No. 20145131846 (May 20, 2014), http://www.sec.gov/divisions/investment/noaction/2014/creditsuisse-052014.htm.

[64] Order, U.S. Securities and Exchange Commission, *In re Navigator Money Management*, Nos. 3-15707 (Jan. 30, 2014) ("NMM Order"), https://www.sec.gov/litigation/admin/2014/33-9521.pdf.

(Morningstar) money manager." The SEC claimed that this claim was materially misleading because Morningstar rates mutual funds not investment advisers such as NMM. Moreover, NMM had not been the manager of any mutual funds with a five-star Morningstar rating since February 2009. Finally, the SEC found that Grimaldi misleadingly claimed responsibility for model portfolios that "doubled the S&P 500 the last 10 years." The SEC found that Grimaldi had no involvement in the model portfolio performance for the first three years.

The SEC's order found that NMM violated Sections 17(a) of the Securities Act, Sections 206(1), 206(2), and 206(4) of the Advisers Act, and Rules 206(4)-1(a)(2), 206(4)-1(a)(5), 206(4)-7, and 206(4)-8, as well as Section 34(b) of the Investment Company Act of 1940. Grimaldi violated many of the same provisions and aided and abetted and caused NMM's violations.

"The securities laws require investment advisers to be honest and fully forthcoming in their advertising to give investors the full picture," said Sanjay Wadhwa, senior associate director for enforcement in the SEC's New York Regional Office. "Grimaldi and his firm are being held accountable for using social media and widely disseminated newsletters to cherry-pick information and make misleading claims about their success in an effort to attract more business."[65]

Without admitting or denying the SEC's findings, Grimaldi agreed to pay a penalty of $100,000, and he and the firm agreed to be censured and comply with certain undertakings including the retention of an independent compliance consultant for three years. NMM and Grimaldi are required to cease and desist from future violations of these sections of the securities laws.[66]

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[65] Release, U.S. Securities and Exchange Commission, SEC Charges N.Y.-Based Money Manager and Firm for Misleading Advertisements, Rel. No. 2014-18 (Jan. 30, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540701988.

[66] NMM Order, at 12-14.

In re Transamerica Financial Advisors, Inc.

In April 2014, the SEC brought claims against Transamerica Financial Advisors ("Transamerica"), a Florida-based financial services firm, for improperly calculating advisory fees and overcharging clients.[67]

Transamerica offered fee reductions to clients when they increased their assets in certain investment programs. The firm permitted clients to aggregate the values of related accounts in order to get the discounts. However, the SEC alleged that Transamerica failed to process every aggregation request and had conflicting policies on when those requests would be granted. As a result, the firm overcharged certain clients by failing to apply the discounts and failed to have adequate policies and procedures to ensure that the firm was properly calculating its fees.

"Transamerica failed to properly aggregate client accounts so that they could receive a fee discount, and this systemic breakdown caused retail investors to overpay for advisory services in thousands of client accounts," said Julie M. Riewe, co-chief of the SEC Enforcement Division's Asset Management Unit.[68]

The SEC's order found that Transamerica willfully violated Sections 206(2), 206(4), and 207 of the Advisers Act, and Rule 206(4)-7.[69]

Transamerica agreed to settle the SEC's charges without admitting or denying the SEC's findings. It reimbursed 2,304 current and former client accounts with refunds and credits totaling $553,624 including interest and agreed to pay an additional $553,624 penalty. Transamerica also agreed to cease and desist from committing or causing any further violations of those provisions of the federal securities laws and agreed to retain an independent consultant to review its policies and procedures pertaining to its account opening forms, fee schedules, and fee computation methodologies as well as the firm's account aggregation process for breakpoints.

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[67] Order, *In re Transamerica Financial Advisors, Inv.*, File No. 3-15822, U.S. Securities and Exchange Commission (Apr. 3, 2014) ("Transamerica Order"), http://www.sec.gov/litigation/admin/2014/34-71850.pdf.

[68] Release, U.S. Securities and Exchange Commission, SEC Charges Transamerica Financial Advisors With Improperly Calculating Advisory fees and Overcharging Clients Rel No. 2014-64 (Apr. 3, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541392449.

[69] Transamerica Order, at 6.

The SEC's order indicated that the settlement reflected Transamerica's cooperation with the SEC's Staff and its prompt remedial action, including conducting a firm-wide review of client accounts, notifying clients and former clients of this review, and providing refunds and credits to clients who were overcharged as a result of the improper calculations.

In re Total Wealth Management, Inc. et al.

On April 15, 2014, the SEC announced charges against a San Diego-based investment advisory firm, Total Wealth Management ("Total Wealth"), Jacob Cooper, its co-founder, owner, and CEO, Nathan McNamee, the president and chief compliance officer, and David Shoemaker, the co-founder and former chief compliance officer. The SEC alleged that defendants mislead investors and breached their fiduciary duties to clients.[70]

According to the SEC, Total Wealth put around 75% of its 481 client accounts into a family of proprietary funds known as Altus Funds. These assets were then invested into outside funds with which the firm had established a revenue-sharing agreements. Defendants received substantial kickbacks as a result of these agreements, but failed to disclose them to investors. Cooper, McNamee and Shoemaker also created business entities to conceal the fact that they were receiving the payments, according to the SEC's complaint. In addition, the SEC alleged, Cooper mislead investors about the level of due diligence Total Wealth was conducting on investments.

The SEC alleged that McNamee and Shoemaker breached their fiduciary duties and defrauded clients by failing to disclose conflicts of interest and concealing the kickbacks they received from the investments they recommended. The SEC charged Total Wealth and Cooper with willfully violating the antifraud provisions of the federal securities laws, and McNamee and Shoemaker with violating or aiding and abetting violations of the antifraud provisions. All four defendants were charged with violations of Form ADV disclosure rules and the custody rule. The SEC's order sought return of allegedly ill-gotten gains plus interest, financial penalties, an accounting, and remedial relief.

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[70] Order, *In re Total Wealth Management Inc.*, Securities and Exchange Commission (Apr. 15, 2014), http://www.sec.gov/litigation/admin/2014/33-9575.pdf.

"Investment advisers owe a fiduciary duty of utmost good faith and full and fair disclosure to their clients," said Michele Wein Layne, director of the SEC's Los Angeles Regional Office. "Total Wealth violated that duty with its pervasive practice of placing clients in funds holding risky investments while concealing the revenue sharing fees they paid themselves."[71]

Going Forward

As the year continues, the SEC likely will continue to pursue cases involving blatantly dishonest, or even reckless, behavior by investment advisers. Director Bowden has stated that one of the areas where the SEC may begin to focus on specifically is the alternative mutual fund space, the "bright, shiny object" of the investment adviser arena. Bowden also cautions that the SEC will increase its attention on dually registered firms that move their clients' assets from commission-based brokerage accounts to fee-based wrap accounts.[72]

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[71] Release, U.S. Securities and Exchange Commission, SEC Charges San Diego-Based Investment Adviser (Apr. 15, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541502917.

[72] Speech, U.S. Securities and Exchange Commission, People Handling Other Peoples' Money (Mar. 6, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370541260300.

VI. CFTC Cases and Developments

The first half of 2014 witnessed significant developments from the CFTC with regard to its implementation of Dodd-Frank and continued litigation of some of its most high-profile cases in recent years. As detailed more fully below, in addition to issuing its first ever whistleblower award under Dodd-Frank, the CFTC settled another action with respect to its LIBOR manipulation investigations, and received court-approval for a $645 million fine in its action against Peregrine Financial Group and its founder.

CFTC Issues First Ever Whistleblower Award Under Dodd-Frank

In May 2014, the CFTC announced that it made its first ever award to a whistleblower in connection with its Whistleblower Program, which was created by Dodd-Frank.[73] The anonymous individual who reported information regarding violations of the Commodity Exchange Act of 1936 ("Commodity Exchange Act") will receive approximately $240,000. The CFTC's announcement did not release the name of the connected organization, the type of wrongdoing, or the considerations in determining the amount that the whistleblower received.

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[73] Release, Commodity Futures Trading Commission, CFTC Issues First Whistleblower Award, Rel No. PR6933-14 (May 20, 2014), http://www.cftc.gov/PressRoom/PressReleases/pr6933-14.

Under Dodd-Frank, the CFTC's Whistleblower Program provides monetary awards to those who provide original information about violations of the Commodity Exchange Act if the information leads to an action resulting in more than $1 million in monetary sanctions.[74] Whistleblowers are eligible for 10% to 30% of monies collected.[75] The CFTC also is able to pay awards based on monetary sanctions collected by other authorities in actions that are related to a successful CFTC action and are based on information provided by a CFTC regulator.

To date the tips received by the CFTC typically involve allegations of market manipulation, misrepresentations to customers, and investment scams. Last year the CFTC received 138 tips,[76] which was more than double the amount of tips received in 2012[77] but still much fewer than the 3,238 tips the SEC received in 2013.[78]

CFTC Settles Additional LIBOR Manipulation Charges

On May 15, 2014, the CFTC issued an order against RP Martin Holdings Limited and its subsidiary, Martin Brokers (UK) Limited, an interdealer broker, filing and settling charges in connection with its investigations into manipulations of LIBOR.[79] The order requires RP Martin to, among things, pay a $1.2 million civil monetary penalty and take steps to ensure the integrity and reliability of benchmark interest rate-related market information disseminated by them.

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[74] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), Public Law 111-203, 124 Stat. 1376, Part 165 (2010), http://www.cftc.gov/ucm/groups/public/@whistleblowernotices/documents/file/whistleblowerrules17cfr165.pdf.

[75] CFTC Whistleblower Program, http://www.cftc.gov/ConsumerProtection/WhistleblowerProgram/index.htm.

[76] CFTC Annual Report on the Whistlebower Program and Customer Education Initiatives (Oct. 2013), http://www.cftc.gov/ucm/groups/public/@whistleblowernotices/documents/file/wb_fy2013reporttocongress.pdf.

[77] CFTC Annual Report on the Whistlebower Program and Customer Education Initiatives (Oct. 2012), http://www.cftc.gov/ucm/groups/public/@whistleblowernotices/documents/file/wb_fy2012reporttocongress.pdf.

[78] Release, U.S. Securities and Exchange Commission, SEC Announces Enforcement Results for FY 2013, Rel No. 2013-264 (Dec. 17, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540503617.

[79] Release, Commodity Futures Trading Commission, CFTC Charges RP Martin Holdings Limited and Its Subsidiary, Martin Brokers (UK) Limited, With Manipulation and Attempted Manipulation of Yen Libor, Rel No. PR6930-14 (May 15, 2014), http://www.cftc.gov/PressRoom/PressReleases/pr6930-14.

As detailed in our 2012 Year-End Report and 2013 Year-End Report, LIBOR is an interest rate supplied by the British Bankers Association ("BBA") that affects how consumers and companies around the world spend money, and is one of the most important benchmark interest rates in the world. Various member banks submit a daily estimate to the BBA of the rate at which they estimate they can borrow money. In the midst of the Financial Crisis, LIBOR took on new significance as a measure of bank health. The CFTC regulates futures and swaps that are priced based on benchmark rates such as LIBOR.

The CFTC brought and settled charges against RP Martin Holdings Limited and Martin Brokers (UK) Limited for manipulation, attempted manipulation, false reporting, and aiding and abetting derivatives traders' acts of manipulation and attempted manipulation of the London Interbank Offered Rate (LIBOR) for Yen.[80] According to the Order, a senior Yen trader asked RP Martin's Yen brokers to exploit relationships with submitters and traders at Yen LIBOR panel banks to manipulate the daily Yen LIBOR. In return for their assistance, the RP Martin brokers accepted payments totaling more than $400,000 in the form of "wash trades" that resulted in a net zero trading position for each but generated commissions.

With this Order the CFTC has now brought a total of six actions and imposed penalties of $1.766 billion on entities for manipulative conduct with respect to LIBOR submissions and other benchmark interest rates.

CFTC Receives Court Approval For $645 Million Fine In Peregrine Action

On April 30, 2014, a federal judge for the Northern District of Illinois approved a $645 million fine levelled jointly and severally on Peregrine Financial Group ("Peregrine") and its founder, Russell Wasendorf Sr. ("Wasendorf").[81]

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[80] Order Instituting Proceedings Pursuant To Sections 6(c) and 6(d) of the Commodity Exchange Act Making Findings and Imposing Remedial Sactions, *In the Matter of RP Martin Holdings Limited and Martin Brokers (UK) Ltd.*, http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfrpmartinorder051514.pdf.

[81] Supplemental Default Judgment Assessing Civil Monetary Penalties Against Defendants, *Commodity Futures Trading Comm'n v. Peregrine Financial Group, Inc. and Russell Wasendorf, Sr.*, No. 1:12-cv-05383 (N.D. Ill. April 30, 2014), http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/enforcementaction/enfperegrinesuppdeforder043014.pdf.

As detailed in our 2012 Year-End Report, the CFTC filed an against futures broker Peregrine and Wasendorf for fraud, customer funds violations, and making false statements. The National Futures Association ("NFA") was responsible for "front-line" oversight of Peregrine, with the CFTC supervising the NFA's execution of their duties. Wasendorf allegedly provided the NFA and Peregrine's auditors with doctored bank statements. Wasendorf was the sole person with access to Peregrine's bank accounts and would give counterfeit statements to Peregrine's accounting department. The fraud unraveled when the NFA, in response to MF Global (discussed in our 2013 Year-End Report), required customer-fund reports to be filed electronically. Wasendorf attempted suicide, leaving a note detailing how he defrauded clients out of over $200 million over the course of nearly two decades.

The court approved the $645 million fine, which was sought by the CFTC, because it was three times the amount of restitution still due to Peregrine's customers over the course of the nearly 20-year scheme. The court noted that "the extreme gravity and breadth of the defendants' blatant fraud justifies imposition of this significant amount."

VII. SEC Policy and Regulatory Developments

The SEC continued to focus on the regulation of investment advisers in the first half of 2014 by issuing a risk alert relating to alternative investment due diligence, announcing an initiative to examine investment advisers that have not yet been examined, and providing guidance on how investment advisers may advertise on social media.

OCIE's Risk Alert on Alternative Investment Due Diligence

In January 2014, OCIE issued a risk alert to highlight the risks and issues that it identified in the course of examining over ten investment advisers with respect to their due diligence processes for selecting alternative investments and alternative investment managers.[82] Given the fact that investment advisers are increasingly investing in alternative investments, OCIE Director Drew Bowden stated "it was important to assess advisers' due diligence processes and to promote compliance with existing legal requirements, including the duty to ensure that such investments or recommendations are consistent with client objectives."

The risk alert stressed that investment advisers are fiduciaries and are required to determine whether an alternative investment meets its client's investment objectives and is consistent with the investment principles and strategies disclosed by the adviser to the client.[83] To "provide greater

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[82] Release, U.S. Securities and Exchange Commission, SEC Issues Risk Alert on Investment Advisers' Due Diligence Processes for Selecting Alternative Investments, Rel. No. 2014-14 (Jan. 28, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540687024.

[83] National Exam Program Risk Alert, U.S. Securities and Exchange Commission, Investment Adviser Due Diligence Processes for Selecting Alternative Investments and their Respective Managers (Jan. 28, 2014), http://www.sec.gov/about/offices/ocie/adviser-due-diligence-alternative-investments.pdf.

transparency," the risk alert recommended that investment advisers incorporate the following alternative investment due diligence practices:

- Using separate accounts instead of pooled investment structures to increase position level transparency and decrease the chances of misappropriation;
- Receiving reports issued by an independent fund administrator;
- Verifying relationships with critical service providers (*e.g.*, administrators, custodians, and auditors);
- Confirming existence of assets;
- Conducting on-site reviews to understand the culture of the manager, detect inadequate controls, and allow for greater ability to review documents and communicate with manager's personnel;
- Emphasizing operational due diligence, including review and approval of valuation policies and procedures; and
- Conducting comprehensive background checks, including employment history, legal and regulatory matters, news sources, and independent reference checks.

The risk alert explained that due diligence is an iterative process that requires further investigation when a risk indicator, like any of the following, is identified:

- Unwillingness by an investment manager to provide portfolio holding transparency;
- Lack of correlation between performance returns and investment strategy or an investment strategy that appeared to drift over time;
- Lack of sophistication and processes relating to compliance, valuation, research, investment, and/or control with respect to custody, accounting, and administration;
- Investments in highly complex, concentrated, and/or opaque positions; and
- Identification of undisclosed conflicts of interest or unfavorable background or legal history.

While the risk alert contains valuable guidance for investment advisers relating to alternative investment due diligence, it is not exhaustive. The risk alert itself cautions that "[o]ther factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business." In this sense, it is important for an investment adviser to consider the guidance of this risk alert in the context of its own operations and the alternative investments in which it invests.

OCIE's Never-Before Examined Initiative

In February 2014, OCIE announced that, as part of its 2014 examinations priorities, it was launching an initiative to conduct examinations of a significant percentage of investment advisers that have not yet been examined since they became registered.[84]

National Associate Director of OCIE's Investment Adviser/Investment Company Examination Program Jane Jarcho explained that, pursuant to this initiative, these examinations "will focus on areas most important to protecting investors," including the advisers' compliance programs, filings and disclosure, marketing, portfolio management, and safekeeping of client assets.

OCIE's announcement included a letter from National Associate Director Jarcho that was sent to every "never-before examined" investment adviser explaining the initiative and the higher-risk areas on which the examinations will focus, in particular:[85]

- Evaluating compliance programs and books and records to determine if an investment adviser has adequately identified conflicts of interest and compliance related risks, adopted appropriate policies and procedures to mitigate and manage those conflicts and risks, and empowered a CCO to administer the compliance program;

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[84] Release, U.S. Securities and Exchange Commission, SEC Announces Initiative Directed at Never-Before Examined Registered Investment Advisers, Rel. No. 2014-35 (Feb. 20, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540814042.

[85] Letter, U.S. Securities and Exchange Commission (Feb. 20, 2014), http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf.

- Analyzing filings and disclosures to determine whether conflicts or potential conflicts of interest and the full scope of the investment adviser's business and investment activities have been identified;

- Reviewing marketing materials to identify whether they contain any material misstatements or omissions;

- Evaluating the investment adviser's portfolio decision-making practices, including the allocation of investment opportunities and whether the adviser's practices are consistent with disclosures provided to clients; and

- Reviewing compliance with the "custody rule" of the Advisers Act.

This letter explained that not every "never-before examined" investment adviser will be examined and that OCIE will contact the investment adviser separately if it had been selected for an examination.

Guidance on the Testimonial Rule and Social Media

In March 2014, the SEC's Division of Investment Management issued guidance concerning registered investment advisers' use of social media and their publication of advertisements that feature public commentary about them that appears on independent, third-party social media sites.[86] Noting the increasing use of social media and how it facilitates the ability of consumers to conduct their own due diligence, the guidance sought to clarify how an investment adviser or an investment advisory representative ("Adviser") may develop policies and procedures regarding social media use in compliance with Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(1) thereunder (the "Testimonial Rule").

The Testimonial Rule states that: "It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business … for any investment adviser registered or required to be registered under [the Advisers Act], directly or indirectly, to publish, circulate, or distribute any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser."

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[86] Guidance, U.S. Securities and Exchange Commission, Guidance on the Testimonial Rule and Social Media, No. 2014-04 (Mar. 2014), http://www.sec.gov/investment/im-guidance-2014-04.pdf.

The guidance explained that the applicability of the Testimonial Rule depends on the facts and circumstances of an Adviser's social media use. To illuminate the facts and circumstances that may be relevant to this analysis, the guidance included questions and answers indicating:

- An Adviser may not publish public commentary that is an explicit or implicit statement of a client's experience with or endorsement of the Adviser on the Adviser's social media site;

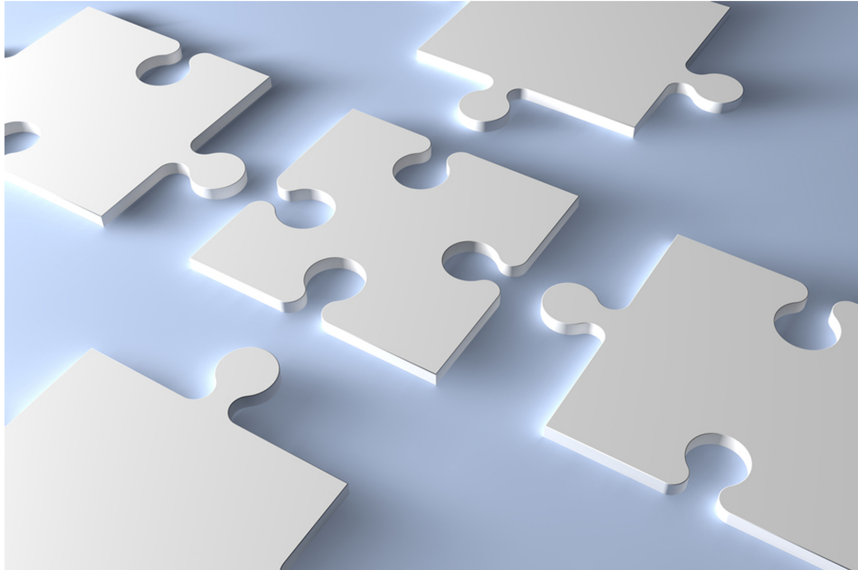
- Notwithstanding the above, an Adviser may publish public commentary on the Adviser's social media site if (i) that commentary is presented on an independent social media site, (ii) the commentator's ability to include commentary is not restricted, and (iii) the independent social media site allows for the viewing of all public commentary and updating of new commentary on a real-time basis;

- An Adviser may publish testimonials from an independent social media site that include a mathematical average of the commentary so long as the commenters rate the Adviser based on a system that is not designed to elicit any pre-determined results and the Adviser does not provide any subjective analysis of the commentary;

- An Adviser may advertise on such a site so long as the Adviser did not in any way prioritize, remove, or edit the public commentary and the advertisement is easily recognizable as a sponsored statement;

- An Adviser may reference the fact that public commentary regarding it may be found on an independent social media site; and

- An Adviser may not publish any testimonials from the independent social media site in its own advertisement.



VIII. Cooperation

The first half of 2014 witnessed the following significant developments in the ongoing implementation of the SEC's Cooperation Program:

- A new cooperation initiative—the Municipalities Continuing Disclosure Cooperation Initiative ("MCDC Initiative")—to encourage issuers and underwriters of municipal securities to self-report violations of continuing disclosure obligations;
- A cooperation agreement and settled order with a former chief financial officer of an animal feed company in connection with alleged accounting fraud violations by the company and its top executives ("Clayton T. Marshall Cooperation Agreement");
- A deferred prosecution agreement ("DPA") with a publicly-traded holding company in connection with alleged accounting control violations ("Regions Bank DPA"); and
- While not an official part of the SEC's Cooperation Program, a recent enforcement action against an investment adviser for retaliating against a whistleblower illustrating the "sticks" associated with acting uncooperatively with an investigation ("Paradigm Retaliation Order").

These developments (described more fully below) offer significant insight into the framework in which the SEC analyzes and rewards cooperation (or punishes uncooperative conduct), including how this program intersects with the SEC's Whistleblower Program and with its policy on admissions (as discussed in our previous Executive Alert and our 2013 Year-End Report).

As these developments indicate, cooperation continues to be a programmatic focus for the SEC. In a recent speech,[87] SEC Chair Mary Jo White emphasized that cooperation in general and self-reporting in particular are "especially important." To encourage cooperation, Chair White explained that cooperation oftentimes yields significant benefits, including "a reduced penalty, or, at times, no penalty or even not proceeding in an exceptional case." However, as Chair White also explained, the "quality" of cooperation affects these benefits. In this sense, Chair White noted that both holding employees accountable for their misconduct and communicating in a "forthcoming" and "candid" way with the Staff factor into how cooperation is judged. Conversely, Chair White noted that "[h]olding back information, perhaps out of a desire to keep options open as the investigation develops, can, in fact, foreclose the opportunity for cooperation credit" because the SEC may learn of the totality of the misconduct through other avenues, including its Whistleblower Program. Significantly, Chair White also noted that self-reporting applies not only to material events that must be disclosed to investors, but may also apply to serious, non-material events (*e.g.*, "a rogue employee in a small foreign subsidiary has been bribing a foreign official in violation of the Foreign Corrupt Practices Act").

Given the SEC's continued emphasis on cooperation, companies and individuals alike would be well-advised to take note of these developments when considering whether, and how, to cooperate with an SEC investigation.

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[87] Speech, A Few Things Directors Should Know About the SEC, Delivered by SEC Chair Mary Jo White before Stanford University Rock Center for Corporate Governance Twentieth Annual Stanford Directors' College (June 23, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370542148863.

The MCDC Initiative[88]

In March 2014, the SEC announced its MCDC Initiative because it was concerned that there are widespread disclosure deficiencies in the municipal securities market. According to this initiative, for those issuers and underwriters that complete a self-report questionnaire[89] and submit it to the SEC no later than September 1, 2014, the Division of Enforcement "will recommend standardized favorable settlement terms to municipal issuers and underwriters who self-report that they have made inaccurate statements about their prior compliance with continuing disclosure obligations specified in Rule 15c2-12 under the Securities Exchange Act of 1934."

In particular, for eligible issuers and underwriters, the Division of Enforcement will recommend that the SEC accept a settlement of non-scienter violations (*i.e.*, Section 17(a)(2) of the Securities Act of 1933) in which the issuer or underwriter neither admits nor denies the findings and is subject to certain undertakings to update and strengthen its compliance programs.[90] While the Division of Enforcement will recommend that a settlement not include a civil penalty for an eligible issuer, the Division will recommend that an eligible underwriter pay a civil penalty depending on the amount of the municipal offering with a maximum civil penalty of $500,000.

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[88] Release, U.S. Securities and Exchange Commission, SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters, Rel. No. 2014-46 (Mar. 10, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828.

[89] MCDC Initiative Questionnaire, U.S. Securities and Exchange Commission, http://www.sec.gov/divisions/enforce/mcdc-initiative-questionnaire.pdf.

[90] Announcement, U.S. Securities and Exchange Commission, Municipalities Continuing Disclosure Initiative, http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml.

Director of the Division of Enforcement Andrew J. Ceresney warned that "[t]hose who do not self-report and instead decide to take their chances can expect to face increased sanctions for violations."[91] By encouraging self-reporting in this way, the SEC has established a prisoner's dilemma between municipal issuers and underwriters because both could be liable for a disclosure deficiency.

Significantly, the MCDC Initiative does not cover individuals associated with issuers or underwriters (*e.g.*, municipal officials) and, as a result, the Division of Enforcement "may recommend enforcement action against such individuals and may seek remedies beyond those available through the MCDC Initiative" depending on "a case-by-case assessment of specific facts and circumstances, including evidence regarding the level of intent and other factors such as cooperation by the individual."[92]

Clayton T. Marshall Cooperation Agreement[93]

In March 2014, the SEC announced that it had entered into a cooperation agreement with Clayton T. Marshall, the former chief financial officer of Agfeed Industries Inc., an animal feed company alleged to have reported approximately $239 million in false revenues from its operations in China from approximately mid-2008 through June 30, 2011.[94] Pursuant to the cooperation agreement, Marshall consented to the entry of an administrative order, without admitting or denying its findings, alleging that he violated Section 17 of the Securities Act and Rules 13a-14,

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[91] Release, U.S. Securities and Exchange Commission, SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters, Rel. No. 2014-46 (Mar. 10, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541090828.

[92] Announcement, U.S. Securities and Exchange Commission, Municipalities Continuing Disclosure Initiative, http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml.

[93] *In the Matter of Clayton T. Marshall*, Securities Act Rel. No. 9557, Order Instituting Public Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933, Sections 4C and 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order and Notice of Hearing (Mar. 11, 2014), http://www.sec.gov/litigation/admin/2014/33-9557.pdf.

[94] Release, U.S. Securities and Exchange Commission, SEC Charges Animal Feed Company and Top Executives in China and U.S. With Accounting Fraud, Rel. No. 2014-47 (Mar. 11, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541102314.

13b2-1, and 13b2-2 thereunder and caused Agfeed's violations of Section 13 of the Exchange Act and Rules 12b-20 and 13a-13 thereunder. The settled order required that Marshall cease and desist from further violations of those securities laws and barred Marshall from appearing or practicing before the SEC as an accountant with the ability to apply for reinstatement in five years. Like previous settled orders with cooperating individuals who are scheduled to testify against co-defendants at a later date, the settled order left open whether a civil penalty will be imposed. Consistent with this, the release accompanying Marshall's settled order indicated that the "terms of his settlement reflect his assistance in the SEC's investigation and anticipated cooperation in the pending court action." The SEC's civil action against Agfeed is still pending.

Regions Bank DPA[95]

In June 2014, the SEC announced that it entered into a DPA with Regions Financial Corporation ("Regions Bank") for failing to maintain adequate accounting controls that resulted in the material overstatement of its income before taxes by approximately $16 million in disclosures filed with the SEC in 2009. The Regions Bank DPA includes all the customary provisions described in the SEC's Enforcement Manual[96] and is similar in many respects to the DPAs into which the SEC had previously entered (as discussed in our 2013 Year-End Report). In particular, the Regions Bank DPA required Regions Bank to, among other things: (i) admit certain facts of wrongdoing; (ii) cooperate with the SEC; and (iii) refrain from violating certain federal securities laws and making statements inconsistent with the DPA.

Unlike respondents in the SEC's previous DPAs, Regions Bank was required to pay a civil penalty in the amount of $26 million and refrain from seeking or accepting any tax credit, reimbursement, or indemnification on this penalty. Also, unlike the SEC's previous DPA with Scott Jonathan Herckis that had a term of five years,[97] the Regions Bank

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[95] Deferred Prosecution Agreement between Regions Financial Corporation and the U.S. Securities and Exchange Commission (June 19, 2014), http://www.sec.gov/news/press/2014/2014-125-dpa.pdf.

[96] Enforcement Manual, U.S. Securities and Exchange Commission at 127-29 (Oct. 9, 2013) (hereinafter "Enforcement Manual"), http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

[97] Deferred Prosecution Agreement between Scott Jonathan Herckis and the U.S. Securities and Exchange Commission (Nov. 8, 2013), http://www.sec.gov/news/press/2013/2013-241-dpa.pdf.

DPA has a term of two years. The length of the term is identical to the SEC's previous DPAs with other entities.[98]

In entering into the DPA, the SEC recognized Regions Bank's remedial actions, including:

- Replacing its chief executive officer, chief financial officer, general counsel, chief credit officer, and the senior managers responsible for the misconduct;

- Creating an ethics council, a regulatory operations team within the enterprise risk management group, and a new organizational structure for its credit group;

- Revising and enhancing its ethics policy, code of conduct, policies and procedures relating to credit review and problem assets, including enhancing its loan portfolio analytics capabilities; and

- Increasing corporate governance and board oversight.

The SEC also recognized Regions Bank's "extensive cooperation" that enabled the SEC to conduct its investigation in "a highly efficient manner," including:

- Creating documents and providing presentations in a highly customized manner at the request of the SEC;

- Creating accounting analyses to benefit the SEC; and

- Making employees and senior executives promptly available for formal and informal interviews by the SEC.

The remedial actions and cooperation outlined in the Regions Bank DPA cover nearly all of the factors included in the Seaboard Report except for self-reporting and self-policing.[99] Given the SEC's recent emphasis on self-

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[98] *See* Deferred Prosecution Agreement between the Amish Helping Fund and the U.S. Securities and Exchange Commission (July 17, 2012), http://www.sec.gov/news/press/2012/2012-138-dpa.pdf; Deferred Prosecution Agreement between Tenaris S.A. and the U.S. Securities and Exchange Commission (May 17, 2011), http://www.sec.gov/news/press/2011/2011-112-dpa.pdf.

[99] Release, U.S. Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities exchange Act of 1934 and Commission

reporting, these missing pieces may have kept the SEC from entering into a non-prosecution agreement with Regions Bank or foregoing an enforcement action altogether like Ralph Lauren Corporation was able to do last year (as we discussed in our 2013 Mid-Year Report).

Paradigm Retaliation Order[100]

In June 2014, the SEC brought its first ever retaliation enforcement action for adverse employment actions taken against a whistleblower for reporting potential securities law violations to the SEC.[101] According to the allegations in the settled order, in March 2012, the former head trader of Paradigm Capital Management ("Paradigm") made a whistleblower submission to the SEC reporting that Paradigm, a registered investment adviser, engaged in prohibited principal transactions with an affiliated broker-dealer. After learning of the whistleblower submission, Paradigm allegedly engaged in a series of retaliatory actions that ultimately led to his resignation, including, among other things, removing him from his position, tasking him with investigating the misconduct, and otherwise marginalizing him.

Paradigm and its founder consented, without admitting or denying its findings, to the entry of the order alleging that it violated, among other federal securities laws, Section 21F(h) of the Exchange Act. Pursuant to the settled order, Paradigm and its founder agreed to cease and desist from committing or causing certain violations of the Exchange Act and Advisers Act and to jointly and severally pay disgorgement in the amount of $1.7 million for distribution to their current and former investors and a civil penalty of $300,000. Paradigm also agreed to retain an independent compliance consultant.

Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Rel. No. 4969 (Oct. 23, 2001), http://www.sec.gov/litigation/investreport/34-44969.htm.

[100] *In the Matter of Paradigm Capital Management, Inc. and Candace King Weir*, Exchange Act Rel. No. 72393, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order (June 16, 2014), https://www.sec.gov/litigation/admin/2014/34-72393.pdf.

[101] Release, U.S. Securities and Exchange Commission, SEC Charges Hedge Fund Adviser With Conducting Conflicted Transactions and Retaliating Against Whistleblower, Rel. No. 2014-118 (June 16, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307.

In announcing the settled order, the Chief of the SEC's Office of the Whistleblower Sean McKessy emphasized: "We will continue to exercise our anti-retaliation authority in these and other types of situations where a whistleblower is wrongfully targeted for doing the right thing and reporting a possible securities law violation." Despite this, other than the cease and desist sanction (and possibly the civil penalty), it did not appear that Paradigm was subject to any sanctions directly as a result of its alleged retaliation.

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