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SEC ENFORCEMENT

2015 in Review: Securities Enforcement

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The securities enforcement in 2015 was dominated by the continuing fallout from the Second Circuit's 2014 insider trading decision in *United States v. Newman* and the battle over the Securities and Exchange Commission's efforts to adjudicate more cases in administrative proceedings. Although *Newman* and administrative proceedings grabbed most of the headlines, there were also important developments in the continuing debate about the reach of the Supreme Court's *Janus* decision, the SEC's whistleblower program, and the Department of Justice and SEC's response to the rapidly changing securities markets.

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I. Insider Trading

The fallout from the Second Circuit's insider trading decision in *United States v. Newman* dominated the world of securities enforcement in 2015.[1]

In *Newman*, the Second Circuit reversed the 2013 insider trading convictions of hedge fund managers Todd Newman and Anthony Chiasson and raised the bar for proving insider trading against ''remote tippees.'' *First*, the Court held that the government must prove not only that the tippee knew that the corporate insider disclosed information in breach of a duty of confidentiality, but also that the tippee knew that the corporate insider disclosed the confidential information in exchange for a personal benefit.[2] *Second*, the Court held that in order to establish that the insider disclosed confidential information for a personal benefit, it is not enough for the government to prove ''the mere fact of a friendship, particularly of a casual or social nature'' between the insider and the tippee.[3] Rather, the government is required to show ''proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.''[4]

[1] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).
[2] *Id.* at 448.
[3] *Id.* at 452.
[4] *Id.*

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In July, after the Second Circuit declined to rehear the case, the DOJ petitioned the Supreme Court for a writ of *certiorari* to challenge *Newman's* holding regarding what is required to prove that the tipper received a personal benefit. The DOJ argued that *Newman* (1) departed from the Supreme Court's holding in *Dirks v. SEC* by imposing the requirement of an ''exchange'' between the insider and the tippee[5]; (2) conflicted with decisions of other Circuits, citing in particular the Ninth Circuit's decision in *United States v. Salman*, published less than a month before the government filed its petition[6]; and (3) would harm the fair and efficient operation of the securities markets by making it easier to trade on inside information. To the surprise of many, the Supreme Court denied the government's petition without comment in October.

The impact of the Supreme Court's decision was swift. Within weeks, the government agreed to dismiss insider trading charges in a number of criminal cases, including in cases where defendants had already pleaded guilty.[7] In all, no fewer than 14 criminal convictions and guilty pleas were vacated in 2015 as a result of the *Newman* decision.

The *Newman* decision also impacted the SEC's administrative proceeding against Steven A. Cohen. The SEC originally charged Cohen with failing to supervise two traders at SAC Capital Advisers, Michael Steinberg and Matthew Martoma, both of whom were convicted of insider trading. After *Newman*, however, the SEC's case against Cohen was weakened as the government dropped the charges against Steinberg all together, and the prospect of Martoma succeeding on his appeal appeared to improve substantially. As a result, in January 2016, the SEC reached a settlement with Cohen that does not include a fine or other financial penalty and could allow Cohen to again manage outside money as early as 2017.

Not every defendant who invoked *Newman* was successful, however. In some cases, the courts found that the requirements of *Newman* had been met. The Court upheld the conviction of former Foundry Networks executive David Riley, finding that, even if the jury instructions would have been different post-*Newman*, there was sufficient evidence that Riley received ''concrete personal benefits.''[8]

Other cases noted the limits of *Newman*. In *United States v. Salman*, the Ninth Circuit, in an opinion authored by Judge Jed S. Rakoff of the Southern District of New York sitting by designation, affirmed the conviction of a ''remote tippee'' and rejected the defendant's argument that *Newman* requires, in all cases, that the government show a *quid pro quo* exchange between the tipper and the tippee to establish the requisite personal benefit. The Court held that under the Supreme Court's opinion in *Dirks*, it remains sufficient to show that the tipper ''makes a gift of confidential information to a trading relative or friend'' and noted that *Newman* itself acknowledged that the required personal benefit could include ''the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.''[9]

The effect of the Second Circuit's *Newman* decision will continue to play out in 2016.

Indeed, in January of this year, the Supreme Court agreed to hear the defendant's appeal in *United States v. Salman*. The Court agreed to consider the question whether ''the personal benefit to the insider that is necessary to establish insider trading under *Dirks v. SEC*, 463 U.S. 646 (1983), require[s] proof of 'an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature,' as the Second Circuit held in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), cert. denied, No. 15-137 (U.S. Oct. 5, 2015), or is it enough that the insider and the tippee shared a close family relationship, as the Ninth Circuit held in this case?'' This will be one of the most closely watched cases of the year for securities practitioners.

Another case that practitioners will be watching closely this year is the SEC's civil action arising out of allegations of insider trading ahead of IBM's 2009 acquisition of SPSS Inc. Two defendants who had criminal charges against them dismissed in 2015 are set for trial in February, and the issue of whether the tippers received the requisite personal benefit under *Newman* will be front and center.[10]

Practitioners will also be watching to see if the SEC's Enforcement Division reacts to *Newman* by bringing more of its insider trading cases in administrative proceedings and, if so, how the ALJs apply *Newman*. While the SEC's use of administrative proceedings has been questioned by some as unfair to respondents, it is noteworthy that in September 2015, an ALJ dismissed the SEC charges against a respondent because it failed to meet the requirements of *Newman*.[11]

II. Administrative Proceedings

In 2015, the SEC was battered by criticism over its use of administrative proceedings. Defense practitioners and the media pointed to the SEC's streamlined proceedings and ''in-house'' judges to question whether administrative proceedings are biased, and respondents raised constitutional challenges to the SEC's procedures and the process for appointing ALJs. The SEC defended its use of administrative proceedings but also took steps to modify its procedures. It remains to be seen in 2016 whether the SEC's proposed modifications will mollify its many critics, or whether the courts or Congress will force the SEC to make more drastic changes.

A. Recent Changes in the SEC's Use of Administrative Proceedings

The SEC's use of administrative proceedings has expanded dramatically in the last two years. Before 2010,

[5] *Dirks v. SEC*, 463 U.S. 646 (1983).
[6] *United States v. Salman,* 792 F.3d 1087 (9th Cir. 2015).
[7] *See, e.g., United States v. Conradt*, No. 1:12-cr-00887 (S.D.N.Y.).
[8] *United States v. Riley*, No. 1:13-cr-00339 (S.D.N.Y.).

[9] *Salman*, 792 F.3d at 1093-94. Judge Rakoff sounded a similar theme in his opinion denying the motion of Rajat Gupta to undo his 2012 conviction for tipping Raj Rajaratnam of the Galleon Group. *See United States v. Gupta*, 111 F. Supp. 3d 557, ___ (S.D.N.Y. 2015) (holding that even under *Newman*, ''a tipper's intention to benefit the tippee is sufficient to satisfy the benefit requirement so far as the tipper is concerned and no *quid pro quo* is required.'').
[10] *SEC v. Payton*, No. 1:14-cv-04644 (S.D.N.Y.).
[11] *In the Matter of Gregory T. Bolan, Jr., and Joseph C. Ruggieri*, Exchange Act Release No. 877 (Sept. 14, 2015).

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the SEC could only bring actions in administrative proceedings in a small range of cases, and it could only bring them against SEC-registered individuals or those affiliated with regulated entities. The Dodd-Frank Act, however, greatly expanded the purview of ALJs by enabling the SEC to seek financial penalties from any firm or individual through administrative proceedings.

Armed with its new powers, the SEC announced in June 2014 that it intended to bring more cases in administrative proceedings. The effect of the SEC's new policy was dramatic. While the SEC previously brought half of its cases in administrative proceedings, in the fiscal year ending September 2014, the SEC brought approximately 75% of its cases in-house.[12]

The reaction to the SEC's change in policy was swift and largely critical. In a series of articles published in 2015, for example, the *Wall Street Journal* noted that the SEC had a significantly higher success rate in administrative proceedings than in cases brought in the District Courts. In 2013, for example, the SEC was successful in 90% of ALJ proceedings, versus a 69% success rate in cases brought in District Court. Likewise, the U.S. Chamber of Commerce issued a July 2015 report calling for substantial reform.[13] And Judge Rakoff of the Southern District of New York cautioned that the SEC was ''making a mistake'' by sending important cases to administrative law judges.[14]

B. Common Criticisms

There were four commonly heard criticisms of the SEC's administrative proceedings.

First, SEC proceedings occur at rocket docket speed. Hearings before the ALJ must generally take place four months after the order instituting proceedings; in some cases, that time is shortened to 75 days or one month.[15] Complex cases are typically set on the four-month track, and the SEC has argued that the speed and efficiency of administrative proceedings is one of their central advantages. But that justification has been insufficient for some defense practitioners, who have asserted that the speed of the SEC's administrative proceedings is unfair, particularly in complex cases involving a large number of documents.

Second, proceedings before an SEC ALJ offer vastly different—and some would say insufficient—procedures. As currently structured, for example, the SEC is permitted to take investigative testimony before bringing charges, but respondents are then not permitted to depose witnesses before the hearing unless a witness is unavailable for the hearing.[16] Moreover, because ALJs do not need to follow the Federal Rules of Evidence in adjudicating a case, any evidence that could ''conceivably throw any light upon the controversy at hand should normally be admitted,'' which may include hearsay or other evidence that would not be admitted at trial in a District Court.[17]

Third, all appeals from an ALJ are heard by the Commission, not an Article III court.[18] The Commission retains the right to decline to hear certain appeals, and in litigated appeals, the Commission has found in the SEC's favor in 95% of cases.[19] Only then can a defendant appeal to the Court of Appeals. Though reversals at that stage are not unheard of, the odds are stacked against the respondent: circuit courts must uphold the Commission's findings unless they are arbitrary or capricious, or not supported by a deferential use of the substantial evidence test.

Finally, while no hard evidence of bias has been found, the independence of the SEC's ALJs has been questioned. ALJs are career SEC employees, their salaries are paid by the agency, and their offices sit within the SEC's headquarters.[20]

C. Court Challenges

Meanwhile, respondents have increasingly challenged the constitutionality of the SEC's administrative proceedings, often looking to the District Courts to enjoin the SEC's administrative proceedings.[21] To date, however, the only successful challenges have arisen under the Appointments Clause; respondents have argued that ALJs are inferior officers, and thus they must be appointed either by the President, a court of law, or the head of the agency. Two District Court Judges have enjoined SEC administrative proceedings on this ground, holding that because the ALJs exercise ''significant authority,'' they likely must be appointed by the Commission.[22] These cases are on appeal. In the meantime, the SEC has already begun to address other criticisms of its administrative proceedings.

D. Proposed Changes and the Year Ahead

In May 2015, the SEC identified four factors for determining whether a case should be brought in administrative proceedings or District Court: the availability of legal claims; the respondent's registered status; relative costs and resources; and fairness, consistency, and effectiveness.[23] Then, in September 2015, the SEC proposed a number of changes to its procedures.[24] Those

[12] Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J., May 6, 2015, http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[13] U.S. Chamber of Commerce, Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices (2015), http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/07/021882_SEC_Reform_FIN1.pdf.

[14] Stephen Joyce, *Rakoff, Practitioners Question SEC Practice Of Sending More Enforcement Cases to ALJs*, Mar. 6, 2015, http://www.bna.com/rakoff-practitioners-question-n17179923714/.

[15] 17 C.F.R. § 201.360(a)(2) (2004).

[16] 17 C.F.R. § 201.233(b) (2004).

[17] *In the Matter of Jesse Rosenblum*, Investment Advisers Act Release No. 1644, 30 S.E.C. Docket 692 (May 17, 1984).

[18] 17 C.F.R. § 201.420 (2004).

[19] *See* Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J., May 6, 2015, http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[20] *Id.*

[21] *See, e.g., Chau v. SEC*, 72 F.Supp.3d 417, 433 (S.D.N.Y. 2014); *Bebo v. SEC*, No. 15-cv-00003, 2015 BL 57065 at *1 (E.D. Wis. March 3, 2015).

[22] *Hill v. SEC*, 114 F. Supp. 3d 1297, ___ (N.D. Ga. 2015); *Duka v. SEC*, No. 15-cv-357, 2015 BL 260269, at *3 (S.D.N.Y. Aug. 12, 2015); *Gray Fin. Grp., Inc. v. SEC*, No. 15-cv-492, 2015 U.S. Dist. LEXIS 131792 (N.D. Ga. Aug. 4, 2015); *Ironridge Glob. IV, Ltd., et al. v. SEC*, No. 15-cv-02512-LMM, 2015 BL 382922, at *18 (N.D. Ga. Nov. 17, 2015).

[23] SEC, Approach to Forum Selection in Contested Actions, May 8, 2015, https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf (last visited Jan. 13, 2016).

[24] SEC Press Release 2015-209, ''SEC Proposes to Amend Rules Governing Administrative Proceedings'' (Sept. 24,

changes would allow for three depositions in single respondent cases and five in multiple respondent cases, while extending the time for hearings to up to eight months after service of the order instituting proceedings. Further, the SEC rules would be amended to exclude ''unreliable'' evidence, though it would not prohibit hearsay altogether. Public comment on the SEC's September proposals closed on Dec. 4, 2015, and the final rule has yet to be adopted.

If the SEC's proposals do not assuage the tide of public concerns, it is possible that the SEC will face even greater changes from Congress. In December 2015, for example, the House of Representatives introduced a bill aggressively curtailing administrative proceedings.[25] That bill would allow a respondent to request termination of an administrative proceeding and would elevate the burden of proof to a ''clear and convincing evidence'' standard.

These developments suggest that change to the SEC's administrative proceedings is imminent, though whether they go far enough remains to be seen.

V. Application of 'Janus'

The SEC suffered a significant setback in December of 2015 when the First Circuit reversed the SEC's determination in *In re Flannery* to hold two State Street Bank executives responsible for securities violations and thus nullified the Commission's controversial opinion regarding the scope of the Supreme Court's decision in *Janus*.

In 2011, the Supreme Court ruled in *Janus* that a person is liable under Rule 10b-5(b) for ''making'' a false or misleading statement only if he had ''ultimate authority'' for that statement. The *Janus* ruling marked a shift towards a narrower reading of the antifraud laws, but lower courts have struggled over the meaning of *Janus* and its application to other similar antifraud provisions.

The SEC attempted to answer many of these questions in its December 2014 decision in *In the Matter of John P. Flannery & James D. Hopkins*. The Flannery decision arose from an administrative proceeding in which the ALJ found the two defendants not liable on all claims after an 11-day trial. The SEC petitioned for review by the full Commission, which, in a 3 to 2 decision, reversed the ALJ and found both defendants liable.

The Commission's decision was most notable for its extensive commentary on the proper interpretation of Section 10(b), Rule 10b-5, and Section 17(a) in the wake of *Janus*. The more notable components of the SEC's guidance in *In re Flannery* included:

- The SEC expansively interpreted the scope of ''scheme liability'' under Section 10(b), stating that it extends to cases where the only misconduct alleged is a misstatement and rejecting more narrow approaches adopted by the Second, Eighth, and Ninth Circuits, which have held that subsections (a) and (c) of Rule 10b-5 require some deceptive conduct beyond a misstatement.
- The SEC found that primary liability under Section 17(a) extends to those who do not themselves engage in deceptive or manipulative conduct. It is enough, according to the SEC, that a defendant's conduct ''contributes'' to a fraud.
- The SEC stated that *Janus* does not apply to Section 17(a)(2) violations, i.e., that liability under Section 17(a)(2) is not limited to ''makers'' of misstatements.
- The SEC asserted that the term ''willfully'' means only that ''the person charged with the duty knows what he is doing'' and does not require it to prove that the defendant was aware that he was violating the law.

The First Circuit reversed and vacated the Commission's decision in December.[26] Despite applying the highly deferential ''substantial evidence'' standard of review for agency fact-finding, the Court concluded that the SEC abused its discretion in holding Flannery and Hopkins liable and vacated the Commission's order in its entirety. The First Circuit went through the evidence cited in the Commission's decision in painstaking fashion before exonerating both defendants. With regards to Hopkins, the Court concluded that the SEC's showing on materiality was ''marginal'' and that the SEC had failed to demonstrate *scienter*. As for Flannery, the Court held that one of the two statements cited by the Commission was not misleading, and that even assuming that the other could have been, that single alleged misstatement was insufficient to establish liability under the Commission's interpretation of Section 17(a)(3).

Because the First Circuit's decision focused exclusively on the lack of evidence underlying the SEC's order, it never addressed the merits of the numerous advisory opinions regarding the scope of *Janus* contained in the order. However, given that the SEC's order was vacated in its entirety, it is likely that the SEC's interpretations in *In re Flannery* on the scope of *Janus* and the reach of the securities laws will be entitled to no weight in subsequent litigation.

IV. Whistleblower Protection

The SEC's whistleblower program continued its expansion during 2015. The program, implemented in as part of the Dodd Frank Act, rewards individuals who report violations of the federal securities laws with between 10% and 30% of funds collected in connection with the resolution of the alleged violations. Over the past four years, the number of whistleblower tips received by the SEC has increased steadily from 3,001 in FY 2012 to 3,923 in FY 2015.[27]

While 2015 did not yield anything close to the groundbreaking $30 million award announced late in 2014, there were several developments this past year in the field of whistleblower awards.

A. Awards to Corporate Insiders

In March, the SEC announced a whistleblower award that it estimated would be between $475,000 and

2015), *available at* https://www.sec.gov/news/pressrelease/2015-209.html; Amendments to the Commission's Rules of Practice, 17 CFR Part 201, Release No. 34-75976, *available at* https://www.sec.gov/rules/proposed/2015/34-75976.pdf.

[25] H.R. 3798, 114th Congress (2015-2016) (the Due Process Restoration Act of 2015).

[26] *Flannery v. SEC*, 810 F.3d 1 (1st Cir. 2015).

[27] U.S. Securities and Exchange Commission, 2015 Annual Report to Congress on the Dodd-Frank Whistleblower Program at 21 (Nov. 2015).

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$575,000 to a former company officer who had learned of an alleged fraud through the company's internal reporting processes.[28] This is the first time that a company officer has received a whistleblower award. Corporate officers who receive information second-hand are usually ineligible for such awards, but there is an exception when at least 120 days have passed since the responsible compliance personnel received the information and failed to adequately address the situation. There is some concern among practitioners that this award could incentivize officers to second-guess the decisions of internal compliance officers in the hopes of receiving large whistleblower rewards.

In April, the SEC announced a whistleblower award of approximately $1.5 million for a corporate compliance officer.[29] This was just the second award to an employee with internal audit or compliance responsibilities. Such employees are typically ineligible for awards, but the SEC determined that an award was warranted because there was a ''reasonable basis to believe that disclosure to the SEC was necessary to prevent imminent misconduct from causing substantial financial harm to the company or investors.''[30]

B. Confidentiality Agreements

Also in April, the SEC announced its first enforcement action pursuant to Rule 21F-17, which prohibits companies from taking any actions to impede whistleblowers from communicating with the SEC about potential securities law violations. The SEC alleged that confidentiality agreements that KBR Inc. asked employees to sign during the middle of an internal investigation violated this rule due to the following language in the agreement:

> ''I understand that . . . I am prohibited from discussing any particulars regarding this interview and the subject matter discussed during the interview, without the prior authorization of the Law Department. I understand that the unauthorized disclosure . . . may be grounds for disciplinary action up to and including termination.''

In setting the case for a $130,000 penalty, the SEC conceded that there were no instances in which the agreements had actually been used to prevent potential whistleblowers from coming forward.[31]

C. Circuit Split on ''Reporting Out'' Requirement

The third major development in the realm of whistleblower awards occurred in September when the Second Circuit held that a plaintiff need not bring his or her concerns to the SEC to be considered a whistleblower for purposes of anti-retaliation protection under Dodd-Frank.[32] The SEC has interpreted its own rules not to require ''reporting out'' to the agency, and the Second Circuit found that the relevant provisions ''create sufficient ambiguity to warrant our deference to the SEC's interpretive rule.'' In holding that ''reporting out'' is not required to trigger anti-retaliation protection, the Second Circuit created a split with the Fifth Circuit, which reached the opposite conclusion.[33]

V. New Enforcement Priorities

2015 also saw the SEC and the DOJ expand their securities enforcement priorities in an effort to adapt to rapid technological innovation in the securities markets. One area of focus is so-called ''market structure'' enforcement, an issue that garnered increased attention following the publication of Michael Lewis's book *Flash Boys*. Among the market structure issues identified by the SEC as presenting the potential for securities law violations are (1) alternative trading systems such as dark pools; (2) the improper use of confidential customer information; (3) increasingly automated trading; and (4) high-frequency and high-volume trading.[34]

One market structure case that garnered a lot of attention in 2015 was the DOJ's conviction in *United States v. Coscia* of a high-speed trader for ''spoofing,'' the practice of placing and then quickly canceling orders for commodities futures in an effort to manipulate prices.[35] Spoofing was specifically outlawed under the Commodities Exchange Act by the Dodd-Frank Act, but the government's victory in *Coscia* was the first conviction of its type. With the *Coscia* conviction under its belt, look for prosecutors and regulators to bring more actions against high-frequency traders.

[28] SEC Press Release No. 2015-45 (March 2, 2015).
[29] SEC Press Release No. 2015-73 (April 22, 2015).
[30] SEC Press Release No. 2015-73 (April 22, 2015); Whistleblower Award Proc. File No. 2015-2 at 1 n.1 (Release No. 74781, April 22, 2015).
[31] SEC Press Release No. 2015-54 (April 1, 2015).
[32] *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145 (2d Cir. 2015).
[33] *Asadi v. G.E. Energy (USA) LLC*, 720 F.3d 620 (5th Cir. 2013).
[34] Andrew Ceresney, ''Market Structure Enforcement: Looking back and Forward,'' (Nov. 2, 2015), *available at* http://www.sec.gov/news/speech/ceresney-speech-sifma-ny-regional-seminar.html (last visited Jan. 13, 2016).
[35] *United States v. Coscia*, No. 14-CR-00551 (N.D. Ill).