Securities Regulation Daily

Wolters Kluwer

January 14, 2016

Top 10 SEC Enforcement Highlights of 2015

By Marc D. Powers, Andrew W. Reich and David M. McMillan[*]

It has been almost three years since Mary Jo White was confirmed as Chair of the Securities and Exchange Commission ("SEC"), becoming the first criminal prosecutor to serve in that role.

For the fiscal year ("FY") ending in September 2015, the SEC filed 807 enforcement actions and obtained orders totaling approximately $4.2 billion, a slight uptick from the $4.16 billion obtained in previous year.[1] And the SEC brought a record 507 independent enforcement actions for violations of the federal securities laws. In its announcement of 2015's enforcement results, Chair White touted the SEC's "vigorous and comprehensive enforcement" through "innovative" actions seeking to "hold[] executives and companies accountable for their wrongdoing [and] send[]clear warnings to would-be violators."

What follows is our list, for the third year of the Top 10 Enforcement Highlights for the past year, beginning with a series of actions that highlight the growing debate over whether SEC administrative proceedings are unconstitutional. As you go through our Top 10, you will see that many of these topics reflect the SEC's enforcement concerns of the digital age: ensuring investment advisers and broker-dealers shore up their cybersecurity safeguards; leveling the playing field for investors in dark pools; and policing manipulative high frequency trading. The SEC has also been forced to adapt to recent setbacks in the courts, starting with the Second Circuit's seminal *Newman* decision of December 2014 overturning insider trading convictions, and continuing through the First Circuit's recent *Flannery* decision vacating the enforcement divisions' factual findings for lack of "substantial evidence." As we move into 2016, we expect the SEC to continue its aggressive and innovative approach to enforcement.

1. SEC Administrative Proceedings Challenged as to Constitutionality

The SEC's administrative enforcement process faced a significant challenge in 2015 as several respondents filed federal court injunctives challenging the constitutionality of the SEC forum as violative of the Appointments Clause in Article II of the U.S. Constitution. To date, the respondents have had varying degrees of success. These challenges bear watching as they work their way through the federal courts.

---

* Marc D. Powers is the national leader of the Securities Litigation & Regulatory Enforcement and Hedge Fund Industry practices at Baker Hostetler. He is also a member of the CCH Securities Regulation Advisory Board. Andrew W. Reich is Counsel at Baker Hostetler and specializes in its broker-dealer practice. David M. McMillan is an associate. All are residents in the firm's New York office.

1 Press Release, SEC, SEC Announces Enforcement Results for FY 2015, Release No. 2015-245 *available at* https://www.sec.gov/news/pressrelease/2015-245.html; Press Release, SEC, SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases, Release No. 2014-230 (Oct. 16, 2014), *available at* https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660.

© 2016 CCH Incorporated and its affiliates. All Rights Reserved. Reprinted with permission from Securities Regulation Daily.

The Appointments Clause provides, in part, "the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments." A number of respondents have contended that SEC administrative law judges are "inferior officers" and that, since ALJs are not appointed by the SEC Commissioners (or by the President or a court), their appointments and their presiding over SEC administrative proceedings are unconstitutional. Respondents also point to the fact that federal law provides that ALJs cannot be removed except for "good cause" and that SEC Commissioners cannot be removed except for "inefficiency, neglect of duty, or malfeasance in office." Respondents contend that this arrangement runs afoul of U.S. Supreme Court precedent[2] providing that, under Article II, an "inferior officer" may not be insulated from Presidential removal by more than one layer of tenure protection.

A number of federal district courts have declined to reach the merits of these constitutional arguments, and have instead relied on jurisdictional grounds in dismissing complaints seeking to enjoin SEC administrative proceedings. These courts have concluded that respondents may challenge the constitutionality of the SEC administrative forum only as provided by statute, i.e., initially before the ALJ, with subsequent review by the SEC and the federal circuit court of appeals.[3]

Other district courts have concluded that they had subject matter jurisdiction to hear the respondents' constitutional claims, and have found potential merit in such claims. For example, in *Hill v. SEC,*[4] the district court found that an individual, charged by the SEC in an administrative proceeding with insider trading, had established a likelihood of success on the merits of his constitutional claims. The court granted an order preliminarily enjoining the SEC from conducting its administrative proceeding, and the SEC has appealed to the Eleventh Circuit. The district court in *Duka v. SEC*[5] likewise granted an order preliminarily enjoining an SEC administrative proceeding. In *Tilton v. SEC,*[6] after the district court had dismissed an individual's injunction petition for lack of subject matter jurisdiction, the Second Circuit on appeal ordered the SEC's administrative proceeding stayed "pending further order."

Resolution of these constitutional issues awaits further decisions by the circuit courts of appeals and could have significant ramifications on the SEC's enforcement program in 2016 and beyond.

2. SEC Claims Against Compliance Officers

The SEC grabbed headlines in 2015 by bringing a number of enforcement actions against Chief Compliance Officers ("CCOs") for violations of Rule 206(4)-7 under the Investment Advisers Act of 1940, which requires investment advisers to designate a CCO and adopt written policies and procedures reasonably designed to ensure compliance with the securities laws.[7] On August 6, 2015, the SEC entered an order

2 *See Free Enterprise Fund v. Public Company Accounting Board,* 561 U.S. 477 (2010).

3 *See*, e.g., *Jarkesy v. SEC*, No. 14-5196 (D.C. Cir. Sept. 29, 2015), affirming dismissal by the district court; *Bebo v. SEC*, No. 15-1511, 2015 WL 4998489 (7th Cir. Aug. 24, 2015); *Tilton v. SEC*, No. 15-CV-2472, 2015 WL 4006165 (S.D.N.Y. June 30, 2015)..

4 No. 1:15-CV-1801-LMM, 2015 WL 4307088 (N.D. Ga. June 8., 2015).

5 No. 15 Civ. 357, 2015 WL 4940083 (S.D.N.Y. Aug. 12, 2015).

6 No. 15-2103 (2d Cir. Sept. 17, 2015).

7 *See* U.S. Secs. & Exch. Comm'n, *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204, Investment Company Act Release No. 26299, 68 Fed. Reg. 74714 (Dec. 24, 2003), *available at* https://www.sec.gov/rules/final/ia-2204.pdf.

 © 2016 CCH Incorporated and its affiliates. All Rights Reserved. Reprinted with permission from Securities Regulation Daily.

imposing sanctions against Texas-based investment adviser Parallax Investment, LLC, its president and CCO for various compliance failures, including one instance where the CCO altered documents to deceive the staff about whether the firm had conducted the required annual compliance review.[8] On April 20, 2015, the SEC announced charges against Blackrock Advisers LLC and its CCO over, among other things, the CCO's failure to develop and implement any written policies or procedures to monitor the outside business activities of its employees.[9] And on June 15, 2015, the SEC charged the CCO of Washington-based investment firm SFX Financial Advisory Management Enterprises with wholesale failure to implement the firm's policy requiring an annual review of "cash flows in client accounts," a lapse that enabled an employee to misappropriate client assets for more than five years.[10]

At a November 4, 2015 keynote address before the National Society of Compliance Professionals, the SEC's Enforcement Division Director Andrew Ceresney tried to allay concerns within the compliance community,[11] saying these actions reflected "rare instances" in which the CCO "crossed a clear line by engaging in affirmative misconduct or obstructing regulators, or who wore multiple hats."[12] He said that, when viewed in their context, the cases "do not represent a deviation from the Commission's historical approach to CCO liability but instead a reaffirmation of our traditional views."[13] It remains to be seen.

3. Policing Manipulative High-Frequency Trading

The SEC brought a number of enforcement actions in the high frequency trading arena, furthering its effort to ensure that exchanges, traders and other market participants operate fairly. In June 2015, the SEC brought a settled administrative proceeding against Goldman, Sachs & Co. over violations of the market access rule (Rule 15c3-5 under the Securities Exchange Act of 1934) in connection with a trading incident that resulted in erroneous executions of options contracts.[14] The market access rule requires broker-dealers to implement risk management controls and procedures to limit the broker-dealer's financial exposure and ensure compliance with all applicable regulations.[15] The SEC found that Goldman Sachs violated the market access rule even by accidentally sending approximately 16,000 mispriced options orders to various options exchanges in less than an hour on August 20, 2013 due to a glitch in its new electronic trading functionality, resulting in a loss of approximately $38 million.[16]

---

8 *In the Matter of Parallax Investments, LLC, John P. Bott, II, and F. Robert Falkenberg*, No. 3-15626 (Aug. 6, 2015), *available at* https://www.sec.gov/litigation/admin/2015/34-75625.pdf.

9 Press Release, Secs. & Exch. Comm'n, SEC Charges BlackRock Advisors With Failing to Disclose Conflict of Interest to Clients and Fund Boards (Apr. 20, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-71.html.

10 Press Release, Secs. & Exch. Comm'n, Investment Advisory Firm's Former President Charged With Stealing Client Funds (June 15, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-120.html.

11 Dipietro, B., *SEC Actions Stir Concerns Over Compliance Officer Liability,* Wall Street Journal (June 24, 2015), *available at* http://blogs.wsj.com/riskandcompliance/2015/06/24/sec-actions-stir-concerns-over-compliance-officer-liability/.

12 Speech, SEC, Andrew Ceresney, Director, Division of Enforcement, 2015 National Society of Compliance Professionals, National Conference: Keynote Address (Nov. 4, 2015).

13 Speech, SEC, Andrew Ceresney, Director, Division of Enforcement, 2015 National Society of Compliance Professionals, National Conference: Keynote Address (Nov. 4, 2015).

14 Press Release, SEC, SEC Charges Goldman Sachs With Violating Market Access Rule, Release No. 2015-133 (June 30, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-133.html.

15 Risk Mgmt. Controls for Brokers or Dealers with Mkt. Access, S.E.C. Release No. 34-63241, 99 S.E.C. Docket 2490, 2010 WL 4356454 (Nov. 3, 2010).

16 *In the Matter of Goldman, Sachs & Co.*, No. 3-16665 (June 30, 2015), *available at* https://www.sec.gov/litigation/admin/2015/34-75331.pdf.

 © 2016 CCH Incorporated and its affiliates. All Rights Reserved. Reprinted with permission from Securities Regulation Daily.

The SEC also assessed large penalties against operators of alternative trading venues, or dark pools. On January 15, 2015, the SEC brought at settled administrative order against UBS Securities LLC for violations of Section 17(a)(2) of the Securities Act of 1933, various provisions of Regulation ATS and Rule 612 of Regulation NMS (which prohibits bids or offers in increments smaller than $0.01). UBS marketed an order type called PrimaryPegPlus ("PPP") that enabled the purchase and sale of securities in increments of less than one cent, but Regulation NMS prohibited UBS from accepting orders at those prices, meaning users of the PPP order type (mostly high-frequency traders) could jump ahead of other orders placed at whole-penny prices. The SEC alleged this setup gave UBS's dark pool an unfair competitive advantage over other trading venues that did not offer PPP. [17] The settlement included a $12 million penalty that, at the time, was the SEC's largest against a dark pool operator.[18]

The SEC upped the ante a few months later, assessing an $18 million penalty against ITG Inc. and its affiliate AlterNet Securities for operating a "secret" proprietary trading desk in which traders exploited confidential information of its dark pool subscribers in order to implement high-frequency algorithmic trading strategies, including trades against ITG's own subscribers.[19] According to the SEC's order instituting a settled administrative proceeding,[20] ITG accessed real-time information concerning orders that its sell-side subscribers sent to ITG's algorithms for handling. With that information, ITG employed a high frequency trading strategy that sought to capture the full "bid-ask spread" in a manner that was detrimental to its sell-side subscribers. The SEC found this comprised a fraudulent course of conduct that violated Sections 17(a)(2)-(3) of the Securities Act.

4. First SEC Action to Enforce Cybersecurity Policies

Since the SEC launched its cybersecurity initiative in early 2014, it has announced two rounds of sweeps examinations and issued guidance to help broker-dealers and investment advisers shore up their cybersecurity safeguards.[21] On September 22, 2015, the SEC brought its agenda to the enforcement arena with an order instituting a settled administrative proceeding against St. Louis-based investment adviser R.T. Jones Capital Equities Management. The SEC found R.T. Jones failed to

17 *In the Matter of UBS Securities LLC*, No. 3-16338 (Jan. 15, 2015), *available at* https://www.sec.gov/litigation/admin/2015/33-9697.pdf.

18 Press Release, SEC, SEC Charges UBS Subsidiary With Disclosure Violations and Other Regulatory Failures in Operating Dark Pool, Release No. 2015-7 (Jan. 15, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-7.html.

19 Press Release, SEC, SEC Charges ITG With Operating Secret Trading Desk and Misusing Dark Pool Subscriber Trading Information, Release No. 2015-164 (Aug. 12, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-164.html.

20 *In the Matter of ITG Inc. and Alternet Securities Inc.*, No. 3-16742 (Aug. 12, 2015), *available at* https://www.sec.gov/litigation/admin/2015/33-9887.pdf.

21 *See* OCIE Cybersecurity Initiative, OCIE, National Exam Program Risk Alert, Vol. IV, Issue 2 (Apr. 15, 2014), *available at* https://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf; OCIE Cybersecurity Examination Sweep Summary, OCIE, National Exam Program Risk Alert, Vol. IV, Issue 4 (Feb. 3, 2015), *available at* http://www.sec.gov/ about/offices/ocie/cybersecurity-examination-sweep-summary.pdf; SEC Guidance Update No. 2015-02 (Apr. 2015), *available at* https://www.sec.gov/investment/im-guidance-2015-02.pdf; OCIE's 2015 Cybersecurity Initiative, OCIE, National Exam Program Risk Alert, Vol. IV, Issue 8 (Sept. 15, 2015), *available at* https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf.

 © 2016 CCH Incorporated and its affiliates. All Rights Reserved. Reprinted with permission from Securities Regulation Daily.

establish adequate cybersecurity policies and procedures, leading to a breach of sensitive information of approximately 100,000 individuals.[22] The SEC thus found that R.T. Jones violated the SEC's so-called "safeguards rule," Rule 30(a) of Regulation S-P under Section 504 of the Gramm-Leach-Bliley Act,[23] which requires registered investment advisers to adopt written policies and procedures reasonably designed to protect customer records and information.

5. SEC Presses Insider Trading Actions With Mixed Success In Post-*Newman* Era

The SEC has continued to press insider trading actions in the wake of the United States Court of Appeals for the Second Circuit's pivotal decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), with mixed success. In *Newman*, the Second Circuit reversed criminal insider trading convictions, finding that the government failed to prove that the remote tippees were aware the tippers "received any personal benefit" from the tip. The Court held that the government failed to adduce sufficient proof of a "meaningfully close personal relationship" that could signify "at least a potential gain of a pecuniary or similarly valuable nature."

Although *Newman* appeared to place limits on the SEC's enforcement capabilities in the insider trading arena, the Commission has maintained that the decision will not alter its approach to similar cases because the SEC faces a lower burden of proof than criminal prosecutors and may bring insider trading cases in its own administrative courts.[24] The SEC has, however, had only mixed success in the post-*Newman* era. In *SEC v. Payton*,[25] a civil insider trading action against two former brokers, the Court denied insider trading defendants' motion to dismiss and allowed the case to proceed—even though the defendants' guilty pleas had been vacated in light of *Newman*.[22] The SEC, however, faced more resistance in the administrative proceeding *In the Matter of Gregory T. Bolan, Jr. and Joseph C. Ruggieri*, where an administrative law judge in September 2015 dismissed an insider trading case altogether..[26] The judge, who had previously deferred ruling on motions for summary disposition in April 2015, found that although the Enforcement Division established that the defendant traded on inside information in four of six alleged instances, it did not satisfy its burden to establish that the tipper tipped the defendant for a personal benefit under the meaning set forth in *Newman*.

6. SEC Charges Private Equity Giant With Misallocating Broken Deal Expenses

On June 29, 2015, the SEC charged Kohlberg Kravis Roberts & Co., a private equity firm specializing in buyouts, with breaching its fiduciary duty by misallocating broken deal expenses. The SEC found that KKR violated Section 206(2) of the Advisers Act, which prohibits investment advisers from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." This case followed other recent SEC enforcement actions

22 *In the Matter of R.T. Jones Capital Equities Management, Inc.*, No. 3-16827 (Sep. 22, 2015), *available at* http://www.sec.gov/litigation/admin/2015/ia-4204.pdf.

23 17 C.F.R. § 248.30 (2015).

24 *See* Stephanie Russell-Kraft, *SEC's Ceresney Isn't Sweating 2nd Circ.'s Newman Ruling*, Law360 (Feb. 10, 2015).

25 *SEC v. Payton*, No. 14-CV-04644-JSR, at *9-10 (S.D.N.Y. Apr. 6, 2015).

26 *In the Matter of Bolan Jr. and Ruggieri*, No. 3-16178 (Sept. 14, 2015), *available at* https://www.sec.gov/alj/aljdec/2015/id877jsp.pdf.

 © 2016 CCH Incorporated and its affiliates. All Rights Reserved. Reprinted with permission from Securities Regulation Daily.

against smaller private equity firms regarding improper expense allocation,[27] and was the first SEC case specifically involving misallocated broken deal expenses

The SEC found that, from 2006 to 2011, KKR managed flagship private equity funds that invested tens of billions of dollars in buyouts and other transactions. KKR also managed other investment vehicles, including vehicles for its own executives, which co-invested with the flagship funds in various transactions. In the same period, KKR incurred $338 million in diligence expenses such as research costs, travel costs and professional fees, in connection with unsuccessful buyout opportunities. Undisclosed to the investors in the flagship funds, while the flagship funds bore a large portion of these "broken deal expenses," none of these expenses were allocated to the co-investment vehicles.

The SEC also found that KKR failed to adopt and implement a written compliance policy or procedure governing its broken deal expense allocation practices until 2011, and thus violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. KKR was required under the settlement to pay over $18 million consisting of disgorgement, interest and civil monetary penalty.

The SEC noted in both the press release and the administrative order itself that this case arose from the SEC staff's continued scrutiny of private equity funds' allocations of fees and expenses. Private equity firms should expect this scrutiny to continue.

7. SEC Brings Enforcement Actions Over "Spoofing"

The SEC brought enforcement actions against traders over the practice of "spoofing"—placing sham orders to artificially inflate or depress the price of a security, and then making bona fide trades on the opposite side of the sham order to take advantage of the manipulated price. On October 8, 2015, the SEC brought a settled administrative proceeding against Briargate Trading, LLC[28] and its co-founder Erich Oscher for violations of Sections 9(a)(2) and 10(b) of the Exchange Act, stemming from an alleged scheme to use spoofs to drum up interest in stocks and manipulate their prices.[29] Briargate agreed to pay more than $1 million to settle the charges.

The SEC also brought an enforcement action against three Chicago-based traders over an alleged spoofing scheme in December 2015.[30] According to the SEC's order instituting administrative and

---

27 *See In re Lincolnshire Management, Inc.,* No. 3-16139 (Sept. 22, 2014), *available at* https://www.sec.gov/litigation/admin/2014/ia-3927.pdf; *In re Clean Energy Capital LLC,* No. 3-15766 (Oct. 17, 2014), *available at* https://www.sec.gov/litigation/admin/2014/33-9667.pdf; *In re Alpha Titans, LLC,* No. 3-16520 (Apr. 29, 2015), *available at* https://www.sec.gov/litigation/admin/2015/34-74828.pdf.

28 *In the Matter of Briargate Trading, LLC,* No 3-16889 (Oct. 8, 2015), *available at* http://www.sec.gov/litigation/admin/2015/33-9959.pdf.

29 15 U.S.C.A. § 78i.

30 Press Release, SEC, SEC Announces Charges for Spoofing and Order Mismarking, Release No. 2015-273 (Dec. 3, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-273.html.

 © 2016 CCH Incorporated and its affiliates. All Rights Reserved. Reprinted with permission from Securities Regulation Daily.

cease-and-desist proceedings,[31] the traders violated various securities laws including Section 9(a)(2) of the Exchange Act by placing spoof orders in order take advantage of trading rebate rules known as "maker taker," a scheme that netted the trio approximately $525,000 in profits.

The SEC's spoofing enforcement actions compliment efforts by the Commodities Futures Trading Commission ("CFTC") to police the manipulative practice. In October 2015, the CFTC charged Chicago-based proprietary trading firm 3Red Trading over an alleged spoofing scheme involving repeated spoofing of five futures markets. The case is currently pending in the United States District Court for the Northern District of Illinois.[32]

8. CFTC Brings Action against "Flash Crash" Trader

While this case is not an SEC case, it is nonetheless noteworthy. In a case brought by the CFTC with implications for high-frequency stock market trading, the regulator in April 2015 charged so-called "flash crash" trader Navinder Singh Sarao with price manipulation and spoofing in connection with the May 6, 2010, incident in which U.S. equity markets rapidly declined and recovered in a matter of minutes.

On April 21, 2015, the CFTC announced the unsealing of a civil enforcement action in the U.S. District Court for the Southern District of Illinois, which charged Sarao with unlawfully manipulating, attempting to manipulate, and spoofing with regard to the E-mini S&P 500 near month futures contract (E-mini S&P).[33] The E-mini S&P is a stock market index futures contract based on the Standard & Poor's 500 Index and is one of the most popular equity index futures contracts in the world.

The CFTC's complaint comes several years after the SEC and CFTC issued a joint report detailing the market conditions that led to the flash crash.[34] The CFTC alleges that Sarao engaged in a variety of manipulative algorithmic trading strategies including "layering"—simultaneously placing four to six exceptionally large sell orders with little chance of resulting in a consummated trade, which put extreme downward pressure the E-mini S&P price.[35] According to the CFTC, Sarao used the layering algorithm repeatedly on the morning of May 6, 2010, causing market conditions that led to the Flash Crash.

---

31 *In the Matter of Afshar, et al.*, No. 3-16978 (Dec. 3, 2015), *available at* http://www.sec.gov/litigation/admin/2015/33-9983.pdf.

32 *CFTC v. Oystacher et al.,* 1:15-cv-09196 (N.D. Ill. 2015).

33 Press Release, CFTC, CFTC Charges U.K. Resident Navinder Singh Sarao and His Company Nav Sarao Futures Limited PLC with Price Manipulation and Spoofing, Release No. PR7156-15 (Apr. 21, 2015), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7156-15.

34 Findings Regarding the Market Events of May 6, 2010, Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues (Sept. 30, 2010), *available at* https://www.sec.gov/news/studies/2010/marketevents-report.pdf.

35 Complaint, *U.S. Commodity Futures Trading Commission v. Nav Sarao Futures Limited PLC, et al.,* No. 15-cv-03398 (JAW) (Apr. 17, 2015), *available at* http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfsaraocomplaint041715.pdf.

 © 2016 CCH Incorporated and its affiliates. All Rights Reserved. Reprinted with permission from Securities Regulation Daily.

The unsealing accompanies the arrest of Sarao by British authorities acting at the request of the U.S. Department of Justice (DOJ). After the arrest, the DOJ unsealed its own criminal complaint charging Sarao with substantively the same misconduct. Mr. Sarao is currently fighting extradition in the United Kingdom, and an extradition hearing is set for February 2016.[36]

9. SEC Actions Protecting Whistleblowers

The SEC has advanced its enforcement agenda in the whistleblower arena. In a first-of-its-kind action, the SEC charged a company for using improperly restrictive language in confidentiality agreements with the potential to stifle the whistleblowing process.[37] The SEC on April 1, 2015, instituted a settled administrative proceeding against KBR Inc. over violations of Section 21F of the Securities Exchange Act and Rule 21F-17 promulgated thereunder, which prohibit any action that impedes an individual from communicating possible securities law violations to the SEC.[38] KBR required its employees, before internally reporting a complaint of potential illegal or unethical conduct, to sign a confidentiality agreement that warned employees of possible discipline if they discussed the potential illegalities with outside parties without the approval of KBR's law department.[39] In an undertaking as part of the settlement, KBR agreed to add language to the agreements to clarify that employees are free to report possible violations to the SEC and other federal agencies without KBR approval or fear of retaliation. The SEC also assessed a civil penalty of $130,000.

In April 2015, the SEC announced a whistleblower award of between $1.4 and $1.6 million[40] to a compliance officer who provided information that assisted the SEC in bringing an enforcement action against the officer's own company.[41] That was the second time the SEC granted a whistleblower award to an employee with compliance or internal audit responsibilities. In August 2014, the SEC awarded $300,000 to an employee who performed audit and compliance functions and reported wrongdoing about his own company after the company failed to take action when he reported it internally.[42] These actions serve as reminders that whistleblowers can come from within the company itself, including employees with compliance or audit functions.

10. First Circuit Court of Appeals Vacates SEC Order Not Based on "Substantial Evidence"

In an important case that highlights a court's power to review SEC orders to ensure the SEC's factual

---

36 Boyle, C., *'Flash Crash Trader' Extradition Hearing Put Back to 2016* (Sept. 25, 2015), http://www.cnbc.com/2015/09/24/flash-crash-trader-faces-extradition-to-us.html.

37 *In the Matter of KBR, Inc.,* No. 3-16466 (Apr. 1, 2015), *available at* http://www.sec.gov/litigation/admin/2015/34-74619.pdf.

38 17 C.F.R. §240.21F-17 (2015).

39 Press Release, SEC, SEC: Companies Cannot Stifle Whistleblowers In Confidentiality Agreements, Release No. 2015-54 (Apr. 1, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-54.html.

40 *In the Matter of the Claim for Award in connection with [Redacted]*, Whistleblower Award Proceeding, File No. 2015-2 (Apr. 2015), *available at* http://www.sec.gov/rules/other/2015/34-74781.pdf.

41 Press Release, SEC, SEC Announces Million-Dollar Whistleblower Award to Compliance Officer, Release No. 2015-73 (Apr. 22, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-73.html.

42 Press Release, SEC, SEC Announces $300 Whistleblower Award to Audit and Compliance Professional Who Reported Company's Wrongdoing, Release No. 2014-180 (Aug. 29, 2014), *available at* https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542799812.

 © 2016 CCH Incorporated and its affiliates. All Rights Reserved. Reprinted with permission from Securities Regulation Daily.

findings are supported by "substantial evidence," the First Circuit Court of Appeals in December 2015 vacated an SEC order finding two State Street Bank executives liable for violating Section 17(a)(3) of the Securities Act, as well as Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. *Flannery v. S.E.C.*, No. 15-1080, 2015 WL 8121647 (1st Cir. Dec. 8, 2015).

The SEC instituted proceedings in 2010 against two former State Street Bank employees, James Hopkins, and John Flannery, alleging Hopkins and Flannery misled investors about two fixed-income funds that were heavily invested in residential mortgage-backed securities. The administrative law judge originally dismissed the proceeding, but the SEC's Enforcement Division appealed the ruling and won, with the SEC finding that certain statements contained in materials that Hopkins and Flannery sent to investors were materially misleading. The First Circuit Court of Appeals, however, reversed and held that the SEC's conclusions that the documents were materially misleading were not based on "substantial evidence"—the standard under which courts review the SEC's factual findings.

The First Circuit held that the SEC's evidence that Hopkins' presentation was material to investors was only "marginal" because it was based on the testimony of a single witness, and that testimony could not, by itself, support the conclusion that Hopkins' actions were intentional. The Court also held that the statements contained in the letters from Flannery were not misleading when examined in context.

For 2016, you can expect conflicts of interest, expense allocation, insider trading, microcap fraud, whistleblower sanctions and enforcement of cybersecurity protocols and policies to continue as priorities by the SEC Division of Enforcement.

Follow Us

Jim Hamilton's World of Securities Regulation Blog
Dodd-Frank News Center | Twitter

Get Our Apps

iPad & iPhone | BlackBerry | Android

Related Products & Services
IntelliConnect Research Platform