

Each quarter, Sidley’s Securities & Derivatives Enforcement and Regulatory Practice publishes this review of recent developments in SEC enforcement and regulatory matters.

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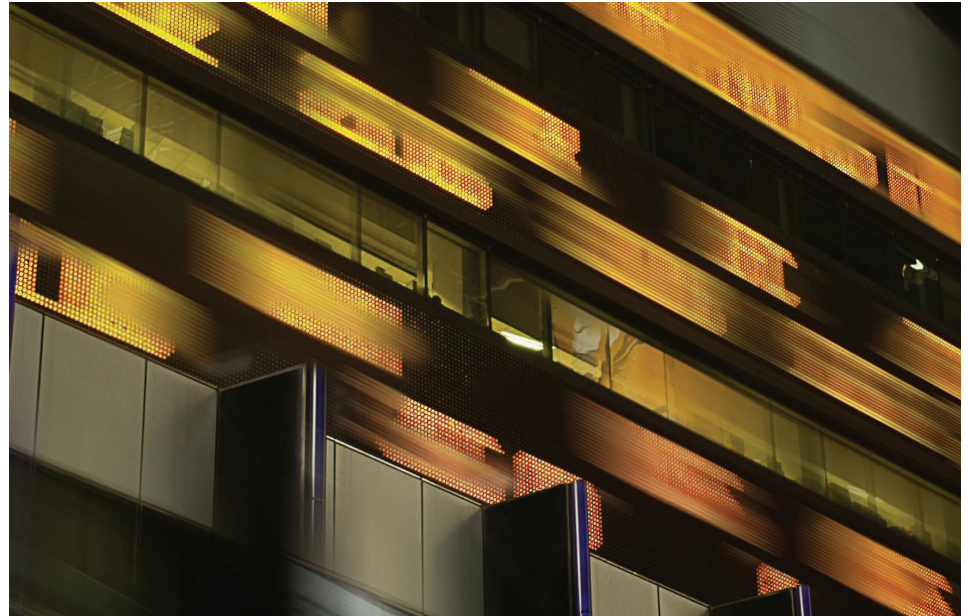
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CHAIR WHITE ARTICULATES THE SEC’S NEW SETTLEMENT POLICY

On September 26, 2013, in a speech to the Council of Institutional Investors, SEC Chair Mary Jo White offered new details regarding the agency’s policy of requiring admissions of wrongdoing in certain enforcement cases. Historically, the SEC’s Division of Enforcement routinely settled cases on a “neither-admit-nor-deny” basis. But as we reported in the previous [edition](#), in June of this year, Chair White announced that the SEC is now more likely to seek admissions of wrongdoing as a condition of settling certain cases.

In the September 26 speech, Chair White said that, while “neither-admit-nor-deny” settlements would continue to play a role in enforcement policy, “certain other cases” would merit admissions of wrongdoing. She explained that “[a] principle of an effective enforcement program is the recognition that there are some cases where monetary penalties and compliance enhancements are not enough. An added measure of public accountability is necessary, and in those cases we should demand it.” Chair White laid out four types of cases in which the agency would potentially require an admission of wrongdoing:

- “Cases where a large number of investors have been harmed or the conduct was otherwise egregious”;
- “Cases where the conduct posed a significant risk to the market or investors”;
- “Cases where admissions would aid investors [in] deciding whether to deal with a particular party in the future”;
- “Cases where reciting unambiguous facts would send an important message to the market about a particular case.”

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CHAIR WHITE ARTICULATES THE SEC'S NEW SETTLEMENT POLICY CONTINUED FROM COVER PAGE

It is not surprising that the SEC's new hard-line settlement approach applies to those cases where investors were gravely harmed or put at serious risk, given the Commission's longstanding central mission of investor protection. But Chair White focused on another reason for the new policy—deterrence. Chair White intimated in her speech that admissions in these cases “would send an important message to the market.” Chair White's focus on the “deterrence-first” school of thought likely reflects her background as a seasoned federal prosecutor.

In the speech, Chair White also discussed the criteria the SEC uses for determining remedies in enforcement cases: the remedies must “sufficiently redress the wrongdoing and cause would-be future offenders to think twice.” Chair White cited the SEC's 2006 policy on financial penalties, which identifies two overarching principles for determining whether to impose financial penalties on a corporation: (i) whether there was a direct benefit to the corporation as a result of the violation; and (ii) the degree to which the penalty will recompense or further harm injured shareholders. The SEC's 2006 policy also identifies seven other factors the SEC considers in assessing financial penalties on corporations. Chair White—although noting that the 2006 policy was “not a binding policy” and implemented by five Commissioners, none of whom are still on the Commission—appeared to endorse the 2006 policy. She said that the policy “in my view sets forth a useful, non-exclusive list of factors that may guide a Commissioner's consideration of corporate penalties” and that “enforcement staff still references these factors as well as other inputs when analyzing and proposing their own recommendations to the Commission.”


Chair White's speech came against the backdrop of two high-profile enforcement actions in which the SEC required admissions of wrongdoing. On September 19, 2013, JPMorgan Chase & Co. admitted wrongdoing as part of a settlement stemming from trading losses that cost the bank over \$6 billion. JPMorgan admitted to violating various provisions of the Exchange Act relating to misstated financial results, deficient internal controls and overvalued investments, and it paid a \$200 million penalty.

On August 19, 2013, hedge fund advisor Philip A. Falcone and his advisory firm, Harbinger Capital Partners, admitted wrongdoing in a high-profile settlement of charges brought by the SEC in federal district court. In June 2012, the SEC

filed fraud charges against Falcone and Harbinger Capital, alleging that they violated the anti-fraud provisions of the federal securities law by Falcone's borrowing \$113 million in fund assets to pay personal tax obligations without disclosing the loan, favoring certain clients to the detriment of others, and improperly manipulating bond prices through a “short squeeze.” In May 2013, Harbinger disclosed that it had reached an agreement in principle with the SEC staff under which Falcone and Harbinger Capital would neither admit nor deny the SEC's allegations. But on July 19, the SEC announced that the Commission rejected the contemplated settlement. Although the announcement did not explain why the SEC rejected the deal, it appears that the SEC's policy shift on settlements was a driving factor.

“[A] principle of an effective enforcement program is the recognition that there are some cases where monetary penalties and compliance enhancements are not enough. An added measure of public accountability is necessary, and in those cases we should demand it.”

These cases are consistent with Chair White's factors. JPMorgan's trading activities caused over \$6 billion in losses and were likely interpreted by the SEC to have placed the bank's investors at significant risk. Mr. Falcone's actions directly affected customer funds, and the SEC's penalties will surely inform future customers in deciding whether to do business with Harbinger Capital Partners. Both cases illustrate the sort of fact pattern that the Commission will likely view as requiring admissions of wrongdoing.

The SEC's new policy should alert industry participants to the possibility of more difficult settlement negotiations and increased litigation activity in the enforcement context. Indeed, Chair White recognized that “we may see more financial firms that say: ‘We'll see you in court.’ But that will not deter us.” Although the Commission's new philosophy is clear, its long-term impact on enforcement trends remains to be seen. 

UNCHARTED TERRITORY: INSIDER TRADING THEORIES AND MUTUAL FUND REDEMPTIONS

Does a mutual fund insider violate federal securities laws against insider trading when she relies on inside information to redeem her personal shares of the fund? A recent decision by the United States Court of Appeals for the Seventh Circuit explores this apparently “uncharted territory.” *SEC v. Bauer*, 723 F.3d 758, slip op. at 25 (7th Cir. 2013). “No federal court has directly opined on this question,” wrote the *Bauer* court, “because the SEC has never brought a[n] [insider trading] claim in the mutual fund context.” *Id.* at 19. In part because of the novelty of the claim, the court remanded the case to the district court to evaluate an alternative theory of insider trading liability—the so-called “misappropriation theory”—that the SEC had not raised in the district court.

In its complaint, the SEC alleged that Jilaine Bauer, the former general counsel of mutual fund manager Heartland Advisors, Inc., was aware that the fund faced a liquidity crunch that would soon require it to sell portfolio securities and that doing so would result in significant markdowns and a concomitant reduction in the fund’s net asset value. Armed with that insider information, Bauer redeemed her personal holdings in the fund, allegedly avoiding a loss of \$20,000. The SEC brought a civil enforcement action for insider trading, and the district court granted summary judgment to the SEC.

The “threshold issue” on appeal was “whether, and to what extent, the insider trading theories apply to mutual fund redemptions.” *Id.* The district court had granted summary judgment to the SEC under the “traditional” or “classical theory” of insider trading, under which a corporate insider violates § 10(b) of the Securities Exchange Act of 1934 by “trad[ing] in the securities of his corporation on the basis of material, nonpublic information.” *United States v. O’Hagan*, 521 U.S. 642, 651–52 (1997). Under that theory, the insider has “an affirmative duty” either to disclose the insider information “to the trading counterparty,” or to abstain from trading altogether. *Bauer*, 723 F.3d 758, slip op. at 18.

But on appeal, the SEC abandoned the argument that the classical theory applied to *Bauer*. That perhaps was wise litigation strategy. As *Bauer* argued on appeal, “mutual fund redemptions cannot entail the type of deception targeted by the classical theory because the counterparty to the transaction, the mutual fund itself, is always fully informed and cannot be duped through nondisclosure.” *Id.* at 23. As a result of the SEC’s abandonment of the classical theory, the court determined that the argument had been forfeited, though it did not necessarily foreclose its applicability in the mutual fund context. *Id.* at 24.

Instead, the SEC argued on appeal that summary judgment should be affirmed under the “misappropriation theory” of insider trading. That alternative theory of liability arises under § 10(b) when an individual “misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.” *O’Hagan*, 521 U.S. at 652. In the SEC’s view, *Bauer* had an “affirmative duty to disclose” to Heartland “her intentions to trade based on confidential information with which she had been entrusted.” *Bauer*, 723 F.3d 758, slip op. at 20. Her failure to do so, the SEC argued, defrauded the mutual fund. *Id.*

The SEC’s alternative argument had a major flaw, however: the SEC “never presented the misappropriation theory to the district court,” *id.*, and the district court accordingly “did not weigh the novelty of the SEC’s claims in the mutual fund context,” *id.* at 22. As a result, the *Bauer* court declined to rule on the applicability of the misappropriation theory and instead remanded to the district court to evaluate that question first.

In doing so, the court explicitly did not “rule out the applicability of § 10(b) to the mutual fund industry,” but it placed the onus on the SEC on remand “to develop a sound application of the misappropriation theory to the facts of this case.” *Id.* at 25. It thus remains to be seen whether this case will represent the expansion of insider trading law to mutual funds. **S**

LIVING ON THE EDGE: COMPLIANCE LESSONS FROM SAC CAPITAL

For the past seven years, the SEC and U.S. Attorney's office have together targeted SAC Capital ("SAC") in an insider trading probe. On November 4th, SAC entered into a plea agreement with the Department of Justice that requires SAC to close its investment advisory businesses and pay \$1.8 billion in penalties—the largest insider trading fine in history. SAC will be able to deduct the \$616 million it agreed to pay the SEC in April 2013 to settle related civil charges, for a total out-of-pocket settlement of \$1.2 billion (*See SEC Enforcement Quarterly 1Q 2013, "SEC Announces Record Insider Trading Settlement of \$600 Million"*).

SAC, headed by its founder Steven A. Cohen, was formed in 1992 and currently manages roughly \$14 billion in assets. Mr. Cohen is widely regarded as one of the most successful hedge fund managers of his generation—especially in the field of high-tech—and SAC generated returns of up to 70% as it successfully navigated the high-tech wave of the late 1990s. Mr. Cohen's reach in the securities industry extends beyond the walls of SAC's headquarters in Stamford, Connecticut—according to *Vanity Fair*, former SAC employees have started at least 31 other funds.

It is his prestigious status and wide-reaching influence that have made Mr. Cohen—and by extension SAC Capital—a prized target for government regulators. On the heels of multiple criminal indictments of SAC employees, and despite a \$616 million settlement in March of this year—at the time, the largest-ever settlement for an insider trading action—the SEC brought a civil administrative action against Mr. Cohen this past July for failing to reasonably supervise two SAC employees who engaged in insider trading.

Less than a week later, the Department of Justice filed a criminal indictment against SAC itself, alleging that SAC engaged in "unlawful conduct by individual employees and an institutional indifference to that unlawful conduct [that] resulted in insider trading that was substantial, pervasive and on a scale without known precedent in the hedge fund industry." On November 4th, SAC agreed to plead guilty to every count in the indictment. The SEC's action against Mr. Cohen is still pending.

SAC was one of the first hedge funds to establish a separate compliance department, and increased its compliance staff from 3 in 2005 to 36 in 2013. However, according to the SEC and DOJ, that compliance department was simply incapable of effectively policing the fund. An analysis of the SEC and DOJ's respective allegations illustrates how SAC's specific

business model and office culture allegedly promoted criminal insider trading behavior *despite* the existence of a seemingly robust compliance department.

First, SAC's business model was predicated on a sense of open competition for Mr. Cohen's approval. While Mr. Cohen managed a small portion of SAC's funds, reportedly \$2 billion, the rest was overseen by roughly a hundred portfolio managers, who each led a small team or "pod." Each portfolio manager, or "PM", had substantial discretion to make investment decisions and was compensated principally based on the performance of his or her portfolio. Further, PMs were expected to share their best—or "high conviction"—investment ideas with Mr. Cohen himself. Two of the trades at issue in the SEC's administrative action, involving Elan and Wyeth, were "high conviction" ideas that Mr. Cohen invested in and closely monitored.

Second, the DOJ indictment detailed how SAC "routinely sought to hire" PM's with "networks of contacts likely to have access to Inside Information." According to the DOJ, SAC would undertake extensive due diligence of potential candidates, in part to "identify the strength of the candidate's industry contact networks." This focus was allegedly "not balanced by any corresponding effort to ensure that prospective SAC PM's... did not use these contacts to obtain illegal Inside Information." Indeed, the indictment cites one instance where SAC hired a candidate "despite a recognized reputation for insider trading."

Third, and perhaps most importantly, both the SEC and DOJ alleged that the office culture encouraged PM's to seek an "edge" over other investors using inside information. The SEC administrative action alleges that Mr. Cohen received such "edge" information regarding Elan and Wyeth. More generally, the DOJ indictment explains how "the relentless pursuit of an information 'edge' fostered a business culture within SAC in which there was no meaningful commitment to ensure that such 'edge' came from legitimate research and not inside information." According to the DOJ indictment, there was no built-in incentive for PMs to question whether information they received was illegal inside information, as their survival at SAC depended on their ability to continually provide Mr. Cohen with "high conviction" ideas. Additionally, compliance personnel were allegedly not sufficiently involved in the process to serve as an effective check. In short, according to the DOJ, SAC's business model and office culture "overwhelmed limited SAC Compliance systems."

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In the end, the SAC Capital story serves as a cautionary tale of how a hedge fund's business model and office culture can overwhelm existing compliance systems. Financial services entities must ensure that the practical need to generate profitable investment ideas is countered by effective compliance measures and a business culture that promotes respect for and adherence to those compliance processes. **S**

SEC'S RULE 105 INQUIRIES QUICKLY YIELD RESULTS

We reported in the last [edition](#) that a number of hedge funds and other buy-side firms received sweep letters from the SEC inquiring about potential violations of Rule 105 of Regulation M. Rule 105 prohibits short selling of equity securities during a restricted period and then purchasing the same securities in subsequent public offerings. On September 17, 2013, the SEC announced its first set of enforcement actions stemming from the sweep. The SEC initiated enforcement actions against 23 firms for alleged Rule 105 violations, with 22 firms settling the SEC's charges. **S**

SEC ANNOUNCES MORE WHISTLEBLOWER AWARDS

It's been a busy few months for the SEC's Office of the Whistleblower. As we reported in the last [edition](#), on June 12, 2013, the SEC announced its second-ever set of whistleblower awards. In the case, the SEC granted three whistleblower claims in connection with its enforcement action against Locust Offshore Management LLC and Locust's CEO Andrey C. Hicks. At the time the SEC announced these awards, the SEC had not collected on its judgments against Locust and Hicks, and therefore, the whistleblower had not received any monetary awards at the time. On August 30, 2013, the SEC announced that the three whistleblowers had been awarded a total of \$25,000 combined and were expected to receive an additional \$100,000 as additional assets are collected from Locust and Hicks.

On September 30, 2013, the Commission granted another whistleblower claim. The whistleblower received a total of \$14 million—by far the largest whistleblower bounty awarded to date—for providing information that led to an SEC enforcement action that recovered substantial investor funds. The SEC did not disclose substantive details about the underlying enforcement action. **S**



RECENT SEC STAFF CHANGES

- On **July 23, 2013**, the SEC announced that Donald M. Hoerl, director of the Denver Regional Office, is leaving the agency. Julie Lutz and Kevin Goodman were named as acting co-regional directors of the Denver office.
- On **August 20, 2013**, the SEC announced that Jane E. Jarcho has been named as the National Associate Director of the Investment Adviser/Investment Company examination program in the Office of Compliance Inspections and Examinations. She had served as acting director since March 2013.
- On **September 4, 2013**, the SEC announced that Paula Dubberly, Deputy Director of the Division of Corporation Finance, is retiring from the agency.
- On **September 11, 2013**, the SEC announced the appointment of Jina L. Choi as director of the San Francisco Regional Office.
- On **September 12, 2013**, the SEC announced that Paul Levenson has been named director of the Boston Regional Office. Levenson joined the SEC from the U.S. Attorney's Office for the District of Massachusetts.
- On **September 27, 2013**, the SEC announced that Matthew T. Martens, the Chief Litigation Counsel for the Division of Enforcement, will leave the agency. The same day, the SEC announced that Matthew C. Solomon will be promoted to the position of Chief Litigation Counsel, upon Martens' departure. **S**

FCPA FOCUS

The Foreign Corrupt Practices Act continues to be a high enforcement priority of the SEC. Here are some highlights of FCPA enforcement from the past quarter. For more information on the FCPA, please see [Sidley's Anti-Corruption Quarterly](#).

6/27/2013: Minnesota-based Medtronic, Inc. announced that it obtained declinations from both the SEC and the DOJ. Medtronic had been under investigation by both agencies for the past five years for potential FCPA violations in connection with its sales of medical devices abroad.

7/2/2013: Subramanian Krishnan, former CFO of Digi International, Inc., settled FCPA charges with the SEC. The SEC filed a civil complaint against Krishnan in September of 2012 alleging that Krishnan had engaged in conduct that resulted in Digi filing inaccurate quarterly reports and corporate funds being used to pay for unauthorized travel and entertainment expenses. Under the terms of the settlement, the District Court entered a judgment prohibiting Krishnan from acting as an officer or director of a public company for five years and ordering him to pay a \$60,000 civil penalty.

7/26/2013: Judge Richard Leon of the U.S. District Court for the District of Columbia approved the SEC's settlement with IBM regarding alleged violations of the FCPA accounting provisions. The SEC alleged that subsidiaries of IBM bribed South Korean and Chinese officials. The SEC filed the settled civil action with the court in March 2011. Judge Leon, however, refused to approve the settlement agreement until IBM agreed

to immediately report future potential violations of the FCPA to the Court and regulators (See *SEC Enforcement Quarterly 1Q 2013, "Another Judge Questions SEC Settlement Practices"*). Accordingly, the terms of the \$10 million dollar settlement agreement, which was finally approved after 28 months of review by Judge Leon, require IBM to file annual reports to the SEC and the court detailing its compliance program used to prevent bribery and to report "reasonably likely" violations of the anti-bribery or books and records provisions of the FCPA within 60 days of gaining knowledge of such potential violations.

7/29/2013: Frederic Pierucci, an executive at Alstom, a French company that provides equipment and services for high-speed rail transport and power generation, pleaded guilty to conspiracy and substantive FCPA offenses for bribing members of the Indonesian Parliament and officials at the state-owned electric company in order to win an \$118 million contract. Pierucci was the vice-president for global sales for a Connecticut-based subsidiary of Alstom.

8/8/2013: Allied Defense, a munitions maker implicated in the DOJ's "Shot Show" sting operation, was notified by the DOJ that it had been granted a declination. The SEC had previously declined to bring charges against Allied Defense in November of 2012. **S**



SECURITIES & DERIVATIVES ENFORCEMENT AND REGULATORY PRACTICE OF SIDLEY AUSTIN LLP

Sidley’s Securities & Derivatives Enforcement and Regulatory group advises and defends clients in a wide range of securities- and derivatives-related matters. With more than 150 lawyers in 10 offices worldwide, we provide comprehensive regulatory, enforcement, and litigation solutions in matters involving the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), self-regulatory organizations (SROs), state attorneys general, and state securities regulators. Our team is distinctive in that it combines the strength of nationally recognized enforcement lawyers with the skills of equally prominent counseling lawyers. We work collaboratively to provide our clients with informed, efficient, and effective representation.

Our team features many prominent practitioners and former officials from the SEC, FINRA, and CFTC, as well as state regulators. Our lawyers include a former associate director of the SEC’s Division of Enforcement, a former co-head of enforcement and associate regional director of the SEC’s Northeast Regional Office, a former deputy director of the SEC’s Division of Trading and Markets, a former SEC senior trial counsel, the former head of enforcement for FINRA, and the former chief of the Massachusetts Securities Division. We also understand the “inside” perspective. Our team includes former general counsels of Charles Schwab and UBS Financial (Paine Webber), as well as the former global head of compliance at J.P. Morgan.

Our team has earned acknowledgement in numerous industry publications, including being named in the 2011 *U.S. News – Best Lawyers* “Law Firm of the Year” for Securities Regulation. In its 2013 edition, *Chambers USA* ranked us among the best U.S. law firms for Securities. In a recent edition, that publication noted the firm’s “well-regarded enforcement practice with a considerable depth of resources.” Sources told that publication that our practice “is highly thought of for public company representations and advisory work.”

For more information, please contact:

Paul V. Gerlach
 202.736.8582
 pgerlach@sidley.com

Barry W. Rashkover
 212.839.5850
 brashkover@sidley.com

Neal E. Sullivan
 202.736.8471
 nsullivan@sidley.com

www.sidley.com

BEIJING BOSTON BRUSSELS CHICAGO DALLAS FRANKFURT GENEVA HONG KONG HOUSTON LONDON LOS ANGELES NEW YORK
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