

Morgan Lewis Presents 2015: Burning Issues at the SEC

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Jill Fisch: Good afternoon and welcome to Morgan Lewis Presents 2015: Burning Issues at the SEC, broadcast live from the Morgan Lewis & Bockius LLP office in New York City, and online at www.sechistorical.org. I'm Jill Fisch, Perry Golkin Professor of Law and co-director of the Institute for Law and Economics at the University of Pennsylvania Law School, and I'm the moderator for today's program.

Since its debut in 2009, this series has examined current cutting edge issues in financial regulation of interest to the legal profession. The series is made possible through a partnership between Morgan Lewis and the SEC Historical Society. With the leadership of its more than 2,000 legal professionals in 28 offices in North America, Europe, Asia, and the Middle East, Morgan Lewis provides comprehensive litigation, corporate, efinance, restructuring, employment and benefits, and intellectual property services in all major industries.

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The SEC Historical Society is grateful for the generous sponsorship of Morgan Lewis for today's program which will examine burning issues at the SEC. Joining me on this panel are Timothy Burke, co-leader of Morgan Lewis' Securities Enforcement and Litigation Practice, resident in Boston. Tim also serves on the SEC Historical Society's Board of Trustees. Andrew Calamari is Director of the SEC's New York Regional Office. Andrew has been a member of the SEC staff since 2000 and previously served as Senior Associate Director and co-head of Enforcement for the New York Office. Merri Jo Gillette is a co-leader with Tim of Morgan Lewis' Securities Enforcement and Litigation Practice. Merri Jo is resident in both Chicago and Philadelphia.

Welcome all. I've had the privilege of working with the presenters to prepare today's discussion and I want to begin with Andy. Can you start us off by giving us a brief overview of current SEC issues and priorities?

Andrew Calamari: Sure, thank you. We're coming up on the end of the fiscal year. Tomorrow is the last day of the fiscal year and all the statistics and the roundup will be summarized in a press release to be in a couple of weeks to follow that. What I thought I would do tonight is just give you a couple of the highlights from the year, really focusing on what I view as a "year of firsts" in a number of ways. I thought I would just tick off some of the actions that really are new and novel beginning with the BDO case that we filed a few weeks ago which was the first action involving admissions by a major auditing firm, and the first accounting action against a major accounting firm in the last six years.

We also brought the first action charging a private equity advisor with misallocating broken-deal expenses, that was the KKR matter, and the first action for failure to report a material compliance matter to a fund board, which was BlackRock. The municipal continuing disclosure cooperation initiative also saw the first 36 cases against underwriting firms. We had our first action against an underwriter for pricing related fraud in the primary market for municipal securities, which was Edward Jones, and the first action applying Dodd-Frank provisions limiting the sale of security based swaps, which was Sand Hill. We had the first action under the anti-retaliation provisions of the whistleblower statute against KBR, and the first action against a major credit rating agency, S&P/Duka. We had the first FCPA action against a major financial institution, BNY Mellon, and just last week, the first action under the distribution in guise initiative, which was First Eagle.

As I say, these were all really first of a kind cases, but they are part of a much bigger set of cases that really continue in the tradition of what we've always done, including bringing many insider trading cases last year, even after Newman. In the financial fraud space, I think you're starting to see a resurgence in that area. We filed BDO, as I mentioned, Bankrate, MusclePharm, KIT Digital, CSC, ITT, Deutsche Bank, and a number of others. We have also continued our focus on investment advisors, bringing the KKR, BlackRock, and F-Squared cases. FCPA was also a good year from a case generation point of view, a number of cases were brought in that area.

In the market structure area, we've continued to bring actions under the market access rule. We had the largest penalty to date against an ATS, which was the ITG case. And then of course there was the hacking action that was announced just a few weeks ago now, which resulted from collaboration among different components of the Commission, including the Market Abuse Unit and the Complex Financial Instruments Unit.

I mentioned the Complex Financial Instruments Unit, which has had a very busy year. I mentioned the S&P/Duka case; it also had the ITT matter, Lynn Tilton, and then the Morgan RMBS matter. The pipeline for the complex financial instruments unit is very large.

One area that may get undersold sometimes is the work of the Microcap Fraud Task Force, and that group which is really now a nationwide group, has just been doing phenomenal work in really making a dent in what is a scourge on the retail investor population, and that is microcap fraud. They've been routinely now suspending trading in securities on almost a weekly basis in addition to various mass trading exercises, but they've also had quite a number of cases that have really been getting behind the scenes in a lot of these truly criminal type operations. That work should not go unnoticed.

And then of course we've had a pretty good year on the trial front with a lot of good judgments, including the \$55-million judgment in the Kokesh matter, and the \$50 million judgment in the Levin matter. Of course we've had a few losses, too, but for the most part I think we feel it's been a very good and productive year on the trial front.

Kind of in a nutshell, those are the highlights from 2015, and as I say we're going to be issuing our press release in the next couple of weeks, announcing a lot more detail, a good summary of everything that we've accomplished in the past year.

Jill Fisch: That's a pretty amazing two minute summary and a really broad range of actions. Thank you Andy. I want to get back to insider trading a little bit later, but I want to turn now to enforcement priorities.

During last year's program, Andrew Ceresney, SEC Director of Enforcement said "a lot has been made of the broken windows strategy, but I think what we're really trying to do here is focus on areas we see as lacking in compliance that need increased focus in compliance, but it's not going to distract us from our broader mission of protecting investors by punishing misconduct more broadly." Andy, you've given us a pretty clear sense of the broader mission and a lot of the actions outside of compliance. Merri Jo, you've raised some issues about the broken windows policy and the SEC's recent enforcement efforts. What issues do you see the policy raising?

Merri Jo Gillette: I think that the Commission is stuck with the fact that they have pretty flat resources. When Mary Jo White announced the broken windows philosophy, that meant that they were making a commitment to doing types of cases and bringing types of stand-alone violations that historically, more often than not, were only charged and brought if they were part of a larger action that included fraud charges, in most instances.

I think the dilemma for the staff potentially, and I'd be interested to hear Andy's thoughts on this, is that they now have sort of taken on this broken windows approach and yet they don't have additional resources. As a manager you've got to decide. If I deploy resources to a compliance base - pick any one of the ones we've seen, Rule 105 investigation, that by definition means I'm not putting those same resources on some other potentially more egregious or more serious violation.

The thing that we have been seeing in the defense bar and I don't know whether it is an outgrowth of this underlying shift or internal expansion in terms of priorities, is an increasing use of the examination staff to develop evidence of broken windows-type violations. It's almost a compression of the examination and enforcement functions in some instances, and then we've seen enforcement referrals where with very little or no investigation on the part of the enforcement, the staff is coming to firms or individuals and basically giving the equivalent of a Wells notice and making a settlement demand.

This is one concern that I really want to hear whether Andy thinks that there's any merit to that approach. The examination process historically was created by the Commission precisely to allow for a forum outside of enforcement within which firms could get into compliance issues or

resolve compliance deficiencies that weren't necessarily at the level of what was considered at that time to merit a full-blown enforcement action. I am wondering whether we're losing some of that ability to engage in dialogue at the exam level, for firms to use that process to really enhance compliance and strengthen compliance short of an enforcement action. I'll stop there and let you react, Andy.

Andrew Calamari: Merri Jo mentioned this on the prep call the other day, this idea of the exam program becoming somewhat conflated with the enforcement effort. I have to say, and I can only really speak for New York because that's where I'm from, but that is not the way that we do it in New York. For the most part, there are sometimes discussions between exam and enforcement when, for example, we think there's some big fraud going on and maybe it's happening at a broker-dealer, so enforcement suggests that the exam program send a team into look at it. Those kinds of things have been happening since the beginning of time. In terms of a more coordinated effort between exam and enforcement, it hasn't worked out that way for us and, in fact, in my time, I can't really think of an instance when right out of the box from an exam we've Wellsed somebody. That's just not the way we do it. I don't know, maybe you have some specific example that I'm not aware of.

Merri Jo Gillette: I do, but they're not from the New York office.

Andrew Calamari: Okay. I really don't think that's the way we're operating, at least in New York. On the bigger picture point, which is broken windows generally, I think broken windows has gotten a bad rap. I think maybe the moniker isn't all that great, and on some level I have always regarded these kinds of cases as being really infrastructure cases. I see them not as wasting resources but as helping, it's like a force multiplier, which is a phrase or a term Mary Jo has used on a number of occasions. If you're picking the right areas and you can beef up compliance in particular areas, then you're either going to stop problems from developing, or at least you're going to make them easier to detect. People may quibble over what areas we pick to do this in, and anybody can certainly debate those issues, but I think the real point of it is not to simply bring a case because we can, not to find any technicality that comes up in a deficiency letter and turn it into a case. I actually think there's a lot of thought that goes into a lot of the initiatives or so-called broken windows cases in terms of what the message is going to be, what the impact is going to be.

Actually it's very interesting because even before Mary Jo came to the Commission, and back in the days when I was an Associate Director on the enforcement side, we used to have our exam referral meetings, and I would always tell the folks on the exam side, don't shy away from good infrastructure cases because I thought they were important. That doesn't mean bring me all your deficiency letters, it just means that if you have something that you think is a serious compliance problem, you bring that to enforcement because that's worth pursuing for the very same reasons. I think this is really along those same lines. I know people can throw out examples, why did you bring that case and I can't answer all that. Everybody can differ on where we make our choices, but I do think the idea is right-headed. I think it's got a good purpose behind it, and it's not just to generate cases.

Jill Fisch: I guess one of the things that we worry about is if the goal is enhanced compliance - do we pursue that goal effectively by taking an enforcement-oriented approach as opposed to detecting problems through the examination process and otherwise and emphasizing deterrence and rehabilitation? Maybe in that vein, Tim, we've seen a particular focus on chief compliance officers. Can you tell us a little bit about what the trends are there, and the extent to which we see this enforcement versus rehabilitation dichotomy?

Timothy Burke: Thank you Professor. One of the real burning issues that developed over the last year within SEC Enforcement was the cases that they brought against chief compliance officers, and everybody in the room knows the chief compliance officer is the person within an organization responsible for setting policy and making sure the policy is being implemented throughout the firm. The debate is when, if ever, a chief compliance officer should be held responsible for a rule violation of somebody else.

Traditionally the SEC has treaded lightly when it comes to bringing cases against chief compliance officers in enforcement cases, but that changed this year. In April the SEC filed two high profile cases against chief compliance officers. The first one, Andy you alluded to this in your list of first impressions, and that's the BlackRock case. The other case was the SFX Financial Management case, and I'll briefly summarize the facts of both and then hopefully introduce the debate that has arisen.

In the BlackRock case, BlackRock had a portfolio manager who had an outside business activity. It was an interest in an oil and gas venture. According to the SEC's order, BlackRock's legal and compliance department knew about the outside business activity, they reviewed it and they approved it. Again, according to the order, BlackRock's legal and compliance team considered whether or not that outside business activity created a material conflict that required disclosure to the Fund's Board. That part of the case is privileged and the discussions among the lawyers weren't revealed, but the order does say that a decision was made not to advise the Fund's Board about the potential conflict of interest that the portfolio manager had.

In the settlement order, the SEC found that BlackRock failed to implement policies and procedures to assess and monitor the outside business activities of its employees and to disclose material conflicts to the Board. They also went after the chief compliance officer as well and said that the chief compliance officer in the same settlement document failed to make the required annual disclosure of all material compliance matters to the Fund's Board. That was in violation of Rule 38a-1 under the Investment Company Act.

The SEC's press release that came out right after the settlement said that this was the first time the SEC brought a case under Rule 38a-1. The very first instance when this issue had been brought to the enforcement level; they charged an individual, a chief compliance officer, who was personally fined \$60,000.

In the SFX Advisory Case, here we have a very different size investment advisor, a very small investment advisor, maybe you've heard of them. They're well known for representing high-net-worth individuals and celebrities, mainly professional athletes. One of the services that SFX provided was to pay bills for its clients who are wealthy people and celebrities who don't have

the time or inclination to pay their own bills. The problem is the president of SFX decided to use some of his clients' money to pay his own bills, and one of his clients turned out to be Mike Tyson. Think about it, if there's one person who you don't want to steal money from, it is probably Mike Tyson.

The SEC charged SFX with inadequate policies and procedures with respect to monitoring the bill paying services. They also charged the chief compliance officer of SFX for a number of things, but before we get to what he was charged with, the chief compliance officer in the course of these events learned about the potential misappropriation when a client complained about a credit card issue. He immediately suspended the president, his boss, who was ultimately terminated and then reported to the criminal authorities.

From the chief compliance officer's point of view, he's taken pretty extreme measures within a small organization against his own boss, who was the president of the company. Nevertheless, the SEC charged him for failing to reasonably implement the firm's policies and procedures with respect to the bill paying services that the company provided. They also charged him, as well as the company, for making material misrepresentations in the way in which the bill paying services were described on the firm's Form ADV brochure, because the ADV brochure said that the accounts from which the bills would be paid would be reviewed multiple times a week by senior management. That turned out to be technically true but the only senior manager that was doing the reviewing was the president who was stealing the money, so therein lies the problem.

Now this created a tremendous amount of debate within the Commission and the Commissioners themselves. I'm sure everybody in the room knows, an SEC settlement requires the approval of the Commissioners, and there are five of them, two Democrats, two Republicans, and one Presidential Appointment.

SEC Commissioner Dan Gallagher, shortly after he voted against the elements of both of these cases that related to the individual charging of the CCO's, took the rare step of issuing a public statement where, in a rather compelling way, he said that he was concerned about the SEC trending towards a strict liability for CCO's under the Advisors Act. He said he had previously admonished the SEC to tread carefully when bringing enforcement cases against chief compliance officers or other compliance personnel, and that the recent actions that the SEC brought this year flew in the face of those admonitions. He also raised the policy concern that if you're going to charge people for failing to implement policies within their firm, are you creating a structure where you're going to incentivize people to opt for a lesser standard, to implement lower standards that would be easier to enforce than a higher standard, and does that make a lot of sense from a public policy point of view.? As he put it, you want to avoid the incentive to create a lower standard so that you can satisfy it when the government comes along, as he put it, and plays Monday-morning quarterback.

Commissioner Gallagher's public statement was met with an equally forceful response from Commissioner Luis Aguilar. Commissioner Aguilar happens to be a Democrat appointment and I'm not saying this was for political reasons, I don't know how politically motivated it is, but I would note that both of them had previously announced that they were stepping down from the

Commission before they made these kind of public statements, so maybe they were less inhibited.

Commissioner Aguilar's comments in response to what Commissioner Gallagher had said was that he was concerned that there was dissent within the CCO community about the impression that the SEC is taking "too harsh of an enforcement stance against CCO's and that CCO's are needlessly under siege from the SEC."

He then went on to point out all the good work that chief compliance officers do and the very important investor protection role that they play. He noted that in his experience in the years that he's served at the SEC in most cases the SEC was not charging compliance officers for compliance-related failures; instead he pointed out that CCO's were most often charged when they wore multiple hats, in other words, a CCO who is also perhaps a portfolio manager or CEO or owner of the investment advisor. In his view, the SEC was not treading inappropriate grounds; they were acting responsibly and bringing cases that, according to him, the SEC was warranted to bring.

Coming back to Commissioner Gallagher, and Andy this is where I wanted to come back to you. He cautioned in his remarks that the SEC should exercise restraint and discretion even when it's deciding to investigate a chief compliance officer or another compliance official. He went on to emphasize the very real psychological impact when an individual is dragged through a testimony process that can go on for months or even years, a Wells submission process, negotiations with the staff, and ultimately perhaps the scarlet letter stigma of an enforcement action. He suggested that the SEC exercise restraint before setting off on the path for investigating a chief compliance officer.

Andy, I know that at some point in just about every investigation, compliance policies and compliance procedures are going to be subject to scrutiny, but what factors do you and your office take into consideration when deciding whether or not to investigate or even pursue a case against a chief compliance officer or another compliance official?

Andrew Calamari: Let me distinguish "investigate" from "pursue," because the investigation generally speaking, especially when you're dealing with a regulated entity, isn't looking at the compliance officer, it's looking at what's happened. Whenever you're dealing with a compliance-oriented failure you're going to be talking to a compliance officer. I don't know that there's really a practical way to deal with that. Just like anybody else in the firm who's touched the issue, a compliance officer is going to have sit through testimony, and that's just the way it's going to be.

Now, I think the debate on CCO liability has obviously been very, very public. You've had Commissioners Aguilar and Gallagher out there espousing different views, although there's also agreement between them on some of the bigger picture issues, and I think that everybody in the Commission is very sensitive to this issue. Certainly, I think this public debate has made that even more true. I do believe we are true to the public statements out there, which are that we will pursue compliance officers only in three circumstances. One, where the compliance officer is actively involved in the underlying misconduct. Two, where the compliance officer misleads the

Enforcement Division or the Commission, or three, where there's a wholesale abdication, not just a mistake, not just negligence in performing your duties, but a wholesale abdication with respect to creating and implementing a compliance program. Those are the three buckets.

I think as Commissioner Aguilar correctly pointed out, there's been something like eight cases against compliance officers in the compliance function in the last 11 years, or something like that. There aren't that many of these cases, and I do think that we are now more than ever before very keenly tuned into the issue, and I can assure everybody that whenever the question arises whether we should Wells a compliance officer that issue is getting a great deal of thought. None of this is happening in a knee-jerk way. These decisions are being carefully considered. We get the issue, we definitely get the issue.

Merri Jo Gillette: I have a follow up to that. Has there been discussion, and if so, how does the Commission or the staff look at the issue? One of the things you hear from the firms and from the industry is that as there's increasingly potential liability for CCOs and that it makes it more difficult to attract and hire people with the highest credentials in those roles. I would just be interested to hear if there's really been a shift in thinking because I think back to the mid-2000s, when the Commission was having what they called "CCO outreach programs" around the country, very much the theme in those programs was "we, the staff of the SEC, want to partner with you the CCOs to really support you and create a strong compliance environment." I'm wondering whether that's still part of the equation from the staff's standpoint or has that thinking been sort of left behind?

Andrew Calamari: No, that's absolutely right. I do recognize that the cases that you've just talked about have caused quite a stir. I think that one of the points that Commissioner Aguilar correctly made, and I'm not going to get into the particulars of any case here or suggest anything about any case, but I do think that there is a messaging aspect of this on which we have not done a very good job. I do think that since we've stated what the buckets are, we ought to be crystal clear in the orders as to why the particular facts fit the bucket. I think that is an area that maybe we need to improve upon just so that the concerns that you're raising can be looked at in a different way and a different context, where you're seeing the facts in a little bit of a different way. That I think is where we need to improve, but as I say I do think there is a tremendous amount of sensitivity to the issue.

Jill Fisch: I think we're hearing a lot about demands for individual accountability. Greater communication about why this particular individual was and should be held accountable would provide really meaningful guidance to the compliance officers and the people who advise them. I think that's a terrific idea.

Andy, let me shift topics now. I want to ask you a little bit about the broker-dealer task force. The task force was established to develop initiatives in areas like churning, anti-money laundering and other abusive activities by recitative brokerage firms. What's in the impact of the task force and what kind of initiatives is it focusing on?

Andrew Calamari: The task force was created really to serve as a vehicle much like the Asset Management Unit is for the Investment Advisor Exam Program. We have the Investment

Advisor Examination Program and the Broker-Dealer Examination Program. Investment Advisor managers have their counterpart in enforcement, which is the Asset Management Unit. We had nothing in Enforcement that was really comparable for broker-dealers so the task force was created for that reason, and the difference between a task force and the unit is staffing. The unit staff comes up with their plan every year, they investigate their cases, they bring their cases, whereas the task force really is designed to generate referrals that then go out to the regions for either examination or enforcement investigation. So far I'd say we've probably sent out about 60 referrals on various topics in the last year or so. Primarily right now, anyway, the focus is on retail issues. That's not to say that over time that focus won't change, but at least initially we felt the retail population really needed to get the most attention and so that's why, as you mentioned, issues like churning, which is a perennial problem, a big problem for certainly many investors, especially elderly investors, is an area of focus.

Andrew Ceresney and Kevin Goodman, on the exam side, each has given a speech this year on the importance of AML compliance. That is an area where the task force is also focused, and I actually think to some degree some of this actually emanated from the work the task force has been doing, because AML compliance as Andrew has pointed out, is absolutely essential to feeding the Enforcement Division information that is necessary to bring and develop cases that need to be addressed very, very quickly. What our statistical analysis showed was that despite the fact that you have something like 4,700 or 4,800 broker-dealers out there, there's an awful lot of broker-dealers that don't file any SARs, and when you actually drill down a little bit more to see where it might make sense, where you might not expect a broker to file SARs because maybe it's a proprietary shop or something like that, and you eliminate all of that, still there's an awful lot of broker-dealers that should be filing SARs and are not.

The point of the initiative really is to go out there and investigate some of the ones that look like they are the prime suspects, and we've got quite a lot of these referrals out there right now, and see if there are cases that need to be brought. As Kevin Goodman points out, AML compliance means, to begin with, that you actually have a compliance program. That you have a compliance program that is tailored to your business, not an off the shelf program, and that you are actively implementing that program in such a way that you're capturing suspicious activity. To bring these cases we don't need to prove that a fraud occurred, we just need to prove that a lot of suspicious activity was floating past your AML officer and nobody bothered to file a SAR, or that they filed a SAR but it was very perfunctory and uninformative, not developed in a way that would really let any reader understand why the activity is suspicious, or cases where SARs are filed but they're filed just way too late.

That's kind of the universe of things we're looking at there, but we really do want to drive home the point, and this is both on the exam and the enforcement side, that AML compliance is something that we are looking at, and it's something that shops really need to get control of and do a much better job of.

Timothy Burke: I just wanted to follow up on one thing. You had mentioned retail investor issues and ticked off churning as one of the retail investor concerns that you have seen referred out. Are there specific products that you've seen come again and again as part of these referrals that people ought to be aware that there's an interest at the SEC?

Andrew Calamari: You mean products that we've got an initiative focused on?

Timothy Burke: Yes.

Andrew Calamari: The initiative involves the retail sales of alternative products, which can mean a lot of things, but including private placements, those kinds of products. There is going to be an initiative that is going to be rolled out very, very shortly, which should include quite a number of referrals internally, to either exam or enforcement, to take a look at some of these shops that are selling these alternative products. Obviously there's a lot of issues, one being suitability, but you're also looking at compliance in those circumstances as well.

Merri Jo Gillette: I was going to ask you a question about where the matters come from that the task force looks at and specifically are they coming from work that's being done by DERA? Are they analyzing for example patterns and outliers to identify firms where you think there may be issues?

Andrew Calamari: In Enforcement we have the Office of Market Intelligence, and within the Office of Market Intelligence we have a Bank Secrecy Act review group. Most of the work, most of the analytics has been done by that BSA review group, so they've taken the universe of broker-dealers and analyzed pretty much all the SAR filings and the patterns of SAR filings. They've looked at the different demographics, like who are your customers, how many customers do you have, are you a penny stock shop. Those kinds of issues and they've distilled it all down to a manageable universe of first wave referrals for exam and enforcement. Those are moving along and there may be more to come on that.

Jill Fisch: Tim, let me turn to you now. Andy in his opening remarks talked about the SEC's litigation successes but they haven't all been successes, have they? The SEC has made increasing use of in-house judges to decide cases through administrative proceedings rather than bringing enforcement actions that are litigated in federal court. This practice has received extensive criticism. Some judges have questioned the legality of the current system, and some commentators have said that the SEC is making use of the administrative proceeding in order to gain a home court advantage and to shield some of its actions from more rigorous judicial oversight. Do you think those concerns are well founded?

Timothy Burke: Professor Fisch you mentioned that the SEC didn't fare well in all of its cases last year, while that may be true, you really kind of have to step back and look where were they playing: were they playing home or away? There's really no place like home for the SEC in terms of how well they do in front of their administrative proceeding officers. That's really one of the most dramatic changes that came out of the Dodd-Frank Act, because the Dodd-Frank Act opened up the administrative proceedings process to allow the SEC to bring civil monetary penalty cases against individuals who are not regulated persons or entities. Now they can essentially bring any case in either federal district court, or in administrative law judge proceeding. It's within their discretion and their purview to make that decision.

In 2014, just to give you some sense of how the stats broke down. The SEC was undefeated at home, they went 6 and 0 in administrative law judge cases, whereas when they tried litigating cases to conclusion in the federal district courts, they only won 11 out of 18. As Andy said the stats for this year are going to be coming out later this month, the official fiscal year for the SEC ends on Wednesday, and they didn't do as well either in the administrative proceeding or the federal court proceeding this year versus last year. But there are some distinct advantages I believe to the SEC when they bring a case in an administrative proceeding. I'll just go through a couple of them and maybe talk about some of the issues of concern that have arisen both with the federal judges and others who have questioned the fairness of the SEC bringing these cases in front of administrative law judges.

First of all in terms of advantages to the SEC, there is a very short time clock in an administrative proceeding. Under the current rule, the SEC rules say that from the moment in time when a respondent is sued until the moment in time when there's a decision by an administrative law judge will be 300 days. For those of you who have litigated cases, particularly complex cases, that is extremely fast in terms of a timeline. The other advantage is that the current rules don't allow a respondent to take depositions except in the rare case where you have to preserve testimony from a witness that won't be available. In the ordinary case, the SEC can investigate for months and months, frankly for years. The SEC has the unfettered ability to take as much deposition testimony as it wants before it brings the case. The SEC can subpoena documents and emails and gather trading records from essentially anywhere in the country. They also have a Wells process where they invite the potential defendant to basically share all of your defenses, lay out how you would defend this case, before the SEC then makes the decision to whether or not they want to go ahead. And then when they finally do decide to go ahead they get to dictate when the clock starts.

There were some changes just last week with respect to some proposed rules that I believe were in part to respond to some of the criticism about the potential unfairness of the administrative law judge process. Among the proposed changes, and none of these have gone into effect yet, they are only in the proposal stage and even if they were to be proposed now they wouldn't be effective for another couple of months. The current rule proposed change is to allow the defendant or the respondent as it's referred to an administrative case, to take up to three depositions. The SEC also gets to take three more depositions on top of all the ones they took before they filed the case. In cases where there are multiple respondents the maximum number of depositions goes all the way up to five. It's among the respondents to decide who's going to take the depositions and what witnesses will be imposed. You can imagine that kind of scenario where you may have two respondents who by the time they're both sued by the SEC may not exactly be playing on the same team and yet they're going to be limited to a cap of five depositions total between all of the respondents. There's also a time limit of 6 hours per witness for these depositions, and there is the concept, although it's not very clear in the proposed rule that for a complex case that you could get an additional four to eight months in time beyond the 300 days. So you get slightly more time to deal with the really complicated cases.

I would suggest that all of these proposed changes are a modest tweak to the home court advantage that the SEC gets when it tries a case in front of its own administrative law judge. You then compound those procedural advantages with the fact that the judge who's presiding over the

case is employed by the same employer as the prosecutor. They both work for the SEC. If you lose in front of the ALJ your first right of appeal is to go back to the Commission, the five Commissioners who approved the institution of the case in the first place. So your first right of appeal is to again the same agency that prosecuted you and decided that you were originally guilty.

Jill Fisch: It sounds a little like Deflate-gate.

Timothy Burke: You had to mention that because I'm from New England, right? Then finally when you do get to a constitutionally-appointed judge which would be the federal circuit level on your second appeal there's an incredible amount of deference's given to the SEC's agency decision.

For all of these reasons there has been a number of challenges to the fairness of the SEC's ALJ process. They fall into a couple of categories of challenges. There are challenges that have been made on the grounds that it's a denial of due process or equal protection rights under the law. As a general matter those cases have not fared well, including here in the Southern District. Courts have somewhat reluctantly said that while the process may not be entirely fair, it's not unconstitutional and agency proceedings are well established not just within the securities industry but across the large body of administrative agency law. Those kind of challenges have not fared that well.

There have been a couple of cases that have successfully, at least at an interim stage, challenged the SEC's process because of the manner in which the ALJ's are appointed. There are two cases in the district court in Georgia, both of them now are up on appeal to the 11th Circuit, but in both of those cases the ALJ's were challenged because they were not appointed by the Commissioners themselves; they were appointed by the Office of ALJ's and I think it's the Office of Personnel Management was also involved. There are some defects in the way in which ALJ's are allegedly appointed.

I think it's a pretty easy defect to fix because the Commissioners could simply hire the ALJ's, and perhaps even do that retroactively, but at least as an interim matter those cases have been stayed. The proceedings are not going forward until the 11th Circuit decides whether or not the umpire who's been appointed to call the balls and strikes is a legitimate umpire or not. All of these factors have led to a very public debate about whether or not people are getting a fair shake when the SEC decides to pursue a case against them in an administrative proceeding. I think Director Ceresney has made it very clear that in his view that the use of the administrative forum is entirely proper, entirely appropriate, and eminently fair to respondents. Karen Brockmeyer, who is the head of the Foreign Corrupt Practices Unit within the SEC, has also said publically that in her view it's "fair to say that bringing cases as administrative proceedings is the new normal."

Andy, with all of that background let me ask you, are we ever going to see another case filed in federal court or is the trend of filing cases in administrative proceeding the new normal?

Andrew Calamari: If you look at 2014, I think the numbers were 57% filed in federal court and 43% in administrative proceedings. At least earlier this year when I looked at the numbers, I don't know the up to date numbers but it was something like 60% federal court, 40% APs, and I also think for a large percentage, and don't hold me to this because I don't have the numbers, but there's a good percentage of APs that are against regulated persons which is as it's always been. That's always been the case.

We're continuing to file cases in federal district court and by no means are we shying away from it. I do think it's interesting when you look at the court challenges that have actually gotten traction. The debate from the defense side seems to be that all these cases are challenging the fairness of the administrative proceedings, the administrative process, and yet those are precisely the arguments that have gotten absolutely no traction whatsoever. The arguments that are left now are primarily separation of powers arguments. There's a disconnect between the arguments being advocated in court by those who are trying to strike down, I guess the AP process, and the public debate, which is that everything is unfair. That is not the point that's being advocated in the federal courts as reasons to invalidate these procedures.

I also think in large measure it's just very interesting when you cited in 2014 we won 100% of APs and lost a number of litigated cases in federal court. I could pick a slice in time where it's exactly the opposite, and I know this year we've lost, we just lost the Ruggeri case in front of an ALJ, which was an insider trading case.

I would also suggest that a lot of the losses that we sustain in the federal courts are also in the insider trading realm, primarily because those are the hardest cases. Most of the time they are circumstantial cases. Every once in a while you've got the smoking gun, you've got the wiretap; those are the cases, they're slam dunks, most people don't litigate those cases; but the ones that are litigated are hard cases and so the very fact that we bring most insider trading cases in federal court probably accounts for a fair amount of the discrepancy between our record in one court or the other.

I also think another big picture point to realize is that whatever forum we're talking about, be it federal court or AP, we win most of the time, the vast majority of the time. I think if you look at statistics, over time we win 80% of the time wherever we are. This notion of unfairness is all based on assertions about the home court advantage. I think it's interesting, it's a bit ironic that on the one hand we're being criticized because the judges are appointed by the Commission and then deciding the Commission's cases. But on the other hand the big challenge in federal court is that the judges aren't actually appointed by the Commission, they are appointed by OPM. Apparently what the challengers are advocating is to have ALJs appointed by the Commission, which I just think is an interesting argument.

The bottom line is there is in every administrative proceeding an extraordinary transparency to how the result was arrived at, unlike a jury trial, where you get a verdict, and unless you're in the courtroom and able to talk to the jurors you don't really have any idea how the jury arrived at its conclusion, what was it that was persuasive or not persuasive. With administrative proceedings, it's all right there and if you look at any, pick a decision, any decision, go to the Secretary's website, these are lengthy, thorough decisions that cite chapter and verse to every piece of

evidence that the judge has considered and either accepted or rejected. The judges generally give their reasons for accepting or rejecting it. I have never seen a study done other than picking a period in time and saying “you won so many there and lost so many there.”

The study that should be done is for somebody to sit down with all those ALJ decisions and read them and then show the travesty of justice. Show me how many cases where you can say the judge was biased or the judge’s decision doesn’t make sense after you read what the judge has to say about the evidence, and add to that, if the judge has made a mistake, show me how many times the Commission hasn’t reversed it. Nobody has done that study, but if you really want to look at the fairness issue, let’s see what folks think when they’re analyzing the actual decisions. I think you’re going to get a very, very different picture.

I don’t want to take too much time on this but I do want to say, there’s a big difference when litigating a civil case outside of the government context. When you’re a defense lawyer you get hit with a complaint, maybe the first time you’ve ever even heard of the client, now you’ve got to scramble to figure out what’s my defense, what are we going to do. When you’re in an SEC investigation most of the time you, the defense lawyers, have been in that investigation since day one. You’ve been at every testimony, you’ve seen every exhibit; now when it comes to the Wells process, we don’t just ask you for your defenses. We sit down with you and we show you, what we do in New York, we show you our evidence and we say this is the evidence against your client. A lot of time we do it by reverse proffer. Nice PowerPoints lay it all out, excepting testimony, telling you exactly what the case is and then telling you, now come back and tell us why we’re wrong. Very, very transparent process, and you know, it’s not out of the blue that someday we just file an AP. You know whether we’re going to file that case or not, and when we do you’re very, very well armed. You’ve already got your documents all organized, you know exactly what’s coming, and on day seven, whatever you don’t have, we produce to you. We produce the entire record to you. It’s not at all like an ordinary civil litigation where on day one you kind of don’t know what end is up. You are in the thick of it on day one when the administrative proceeding is filed, and I think that explains why these trials can go forward on the timelines that have been set forth, because most of the time everybody is armed and ready for it. That’s my defense of the AP.

Jill Fisch: We’re running a little bit short on time. Andy, I want to pick up on what you said about the insider trading cases being the hard cases and ask you to spend just a minute talking about one recent hard case, last year’s ruling by the 2nd Circuit in the United States v. Newman, which made it more difficult to bring insider trading cases against tippees. A lot of people have said that the Newman approach gives hedge funds license to make improper use of inside information, but Newman is a criminal case. Can you tell us a little bit about the impact of Newman, particularly with respect to your ability to bring civil enforcement actions for insider trading?

Andrew Calamari: Again, in the prep session, one of the questions Merri Jo asked me was “how is it different now, what do you do differently?” My answer is we haven’t changed a thing. You get the case, you get it in the same way and you start investigating it in the same way, and the main difference is that now we’ve got another element that’s kind of fuzzy right now, we’re not exactly sure what it means but it’s this benefit concept that Newman has kind of defined in a

bit of a murky way. That becomes an area on which we need to put focus whereas in the past we didn't have to focus on it in that same way. It seems to me in developing these cases that's really the only thing that's changed. We've just got to be aware now that we've got another element we've got to look at.

You point out that a civil case is different from a criminal case. For example Newman says that in a criminal case the tippee needs to know that the information was obtained illegally, but not in our cases. In our cases it's either knew or should have known, so if we can get the inference that, on its face, it looks like information that was probably obtained illegally, that should do it for us. Now the other element of Newman that really doesn't exist in most cases is that, in one stock, we had a 3rd and 4th level tippee and in the other stock we had pure 4th level tippees, so you were very far down the chain there, and obviously the farther down the chain you go the harder it is to prove the case even without the benefit issue, even without the benefit analysis, that's a harder case to prove.

Most of our cases are not like that, that's not to say we're not going to do those cases, but most insider trading cases are not multiple layers removed from the source. A lot of the issues that Newman raises, the complexities that seemingly were raised in Newman, probably are not going to be there. I think in a lot of ways when Newman came down it did cause quite a stir, but as the dust begins to settle, and putting aside whatever the Supreme Court may decide to do, I think the case law is already developing around Newman. It's already telling us what Newman means and you're getting, another ironic point, the only adverse decision we've had under Newman was by one of our ALJ's a couple of weeks ago, who dismissed one of our cases on the benefit element.

Most of the law that's been coming out since Newman has been very favorable to us, in terms of defining the kinds of relationships that are needed. I think, and this is not entirely crystal clear, but as I'm reading it you've kind of got three buckets. One is the traditional friendship. I don't think that's disturbed, and even our ALJ gave us that. I think you've also got this intention to benefit and there's a little bit of a question about exactly what that means, but I think arguably it means that if you can show that the tipper intended that the tippee trade, that will probably suffice, we'll see. And then you've got this other more complex area, which is really what Newman was dealing with, which is the area of the business relationship and exactly how much flesh there needs to be on that in order to satisfy the benefit standard.

We'll see what the cases do there, but I'm kind of optimistic. I think the case law since Newman has been developing, more or less in an appropriate way and in a way that hasn't really inhibited us. I expect that it will continue in that way.

Jill Fisch: Merri Jo, did you have any follow up on that?

Merri Jo Gillette: Just one question. Because a lot of the firms are really faced with trying to insure that they have adequate compliance procedures in place and, just like the SEC staff, they don't know what's going to come out at the end of the day in terms of what the Supreme Court may do around this issue. What is your view about whether Newman means that firms need to be thinking differently or modifying their approach to compliance procedures around trading?

Andrew Calamari: Before I answer that I realize that I forgot to do something more important, which is at the very beginning I should have said that the views I'm expressing today are my views only and don't reflect the views of the Commission or the staff, but I think the answer to the question is you should not change your approach to compliance based on Newman. As I say, we're not really changing our approach to the way we investigate these cases.

Jill Fisch: Thanks Andy, I was going to prompt you when I got to my closing remarks if you hadn't given your disclaimer because I noticed that was missing, too.

We are coming to the end of our discussion and Merri Jo, Andy, and Tim I want to thank you very much for sharing your insights. I hope that the audience, both gathered here in New York and listening online, found this to be an informative discussion. I certainly did. I think we've learned a lot about the current burning issues at the SEC. This program will also add to the valuable body of knowledge in the program series. The audio of this broadcast will be available soon in the virtual museum and archive, and an edited transcript will be added later.

On behalf of the SEC Historical Society, I'd like to thank Morgan Lewis again for their sponsorship and their hospitality in making today's program possible. Thank you all for joining us, and good evening.