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EXPERT ANALYSIS

An Analysis of the SEC's New Whistleblower Interpretive Rule

By H. David Kotz
Berkeley Research Group

In August, the Securities and Exchange Commission issued an interpretive rule attempting to ensure that its whistleblower program provides the proper incentives for employees to file complaints with their employers without fear of retaliation.[1]

The rule clarifies that for purposes of the Dodd-Frank Wall Street Reform and Consumer Protection Act's employment retaliation protections, individuals who have not reported alleged misconduct to the SEC may nevertheless qualify as "whistleblowers."

The SEC announced that employees who report whistleblower-type complaints only to their company will still receive protection from employer retaliation.

The rule is intended to avoid a two-tiered structure of employment retaliation protection that might discourage individuals from first reporting internally in appropriate circumstances — and thus jeopardize the investor-protection and law-enforcement benefits that internal reporting can provide.

The SEC declared that under its interpretation of Dodd-Frank, an individual who reports internally and suffers employment retaliation should receive the same protection as an individual who comes forward to the SEC immediately.

The agency says that providing equivalent employment retaliation protection in both situations removes a potentially serious disincentive to internal reporting.

The SEC indicated that a contrary interpretation would undermine other incentives to encourage internal reporting that were put in place by its whistleblower rules.

While the agency has attempted to clarify its position, it is not so clear that its interpretation will be upheld.

BACKGROUND

It is instructive to consider the background of the regulator's revamped whistleblower program when analyzing these latest developments.

In early 2010, I was serving as the SEC's inspector general. We conducted an audit of the SEC's whistleblower program in place at the time.

Congress was concerned with whistleblower issues and the SEC's management of its whistleblower program. This concern derived primarily from the agency's failure to effectively heed the warnings of Harry Markopolos, who had attempted to blow the whistle on Bernie Madoff's $50 billion Ponzi scheme.

My office found during the audit that although the SEC had a bounty/whistleblower program in place for more than 20 years, very few payments had been made to whistleblowers. In fact, the SEC did not receive many applications from individuals seeking a bounty over this 20-year period.

The audit also found that the whistleblower program was not widely known — either inside or outside the SEC.[2]

We forwarded our audit findings to congressional officials. Congress signed Dodd-Frank into law July 21, 2010, mandating that the SEC revamp its whistleblower program.

The new legislation also expressly pro-hibited retaliation by employers against whistleblowers, and it provided whistle-blowers with a private cause of action in the event that they were discharged or discriminated against by their employers in violation of the statute.

This provision was considered crucial to encourage whistleblowers to come forward more often, both internally and to the SEC, and to remedy the deficiencies of the SEC whistleblower program.

The SEC adopted rules to implement its new whistleblower program May 25, 2011.

Industry representatives recommended that the agency require employees to raise their whistleblower concerns internally before filing with the SEC, while whistle-blower advocates suggested that there be no impediments to filing whistleblower claims.

The SEC announced that employees who report whistleblower-type complaints only to their company will still receive protection from employer retaliation.

Companies argued that it was only fair to allow them to fix problems internally before the government got involved, particularly if they were not aware of the problems before an internal report was filed.

Meanwhile, whistleblowers asserted that requiring employees to report internally would keep complaints from moving forward because of the fear of retaliation.

The SEC adopted a compromise position. While there is no mandatory requirement that whistleblowers report internally, the SEC rules established incentives to encourage whistleblowers to report internally.

For example, a whistleblower could be entitled to an increased award as a direct result of their participation in internal reporting.

If a company failed to perform an investigation and report to the SEC within 120 days — and the whistleblower went to the SEC — the whistleblower could receive retroactive credit back to the original date of internal reporting, resulting in significant monetary value to the whistleblower.

THE SEC'S 2 DEFINITIONS OF 'WHISTLEBLOWER'

Under the compromise position that the SEC adopted, it was critical that whistleblowers were protected from retaliation when they attempted to take advantage of the incentives of reporting internally. However, this protection was placed in doubt almost immediately.

Due to ambiguity in Dodd-Frank's statutory language, the SEC rules set forth two separate definitions of the term "whistleblower": one for the bounty provision and another for the anti-retaliation provision.

The first definition provides that an individual was a whistleblower if, alone or jointly with others, he provided the SEC with information pursuant to the procedures set forth in the rule.[3]

The second definition provides that for purposes of the anti-retaliation protections, an individual was a whistleblower if he or she provided that information in a manner described in the statute.[4]

Under the anti-retaliation provisions and the second definition, the whistleblower is not required to bring his or her complaint to the SEC.

THE COURTS' INTERPRETATIONS

Courts have struggled to interpret these two definitions of "whistleblower" under Dodd-Frank and the SEC rules.

In July 2013 the 5th U.S. Circuit Court of Appeals, in *Asadi v. GE Energy (USA) LLC*, 720 F.3d 620, upheld the first definition of whistleblower as applicable in all circumstances. It also held that Dodd-Frank requires whistleblowers to report an alleged violation to the SEC in order to be covered by Dodd-Frank's anti-retaliation provision.

Khaled Asadi filed a complaint in the U.S. District Court for Southern District of Texas. He alleged that GE Energy violated Dodd-Frank's whistleblower-protection provision by terminating him following his internal reports of a potential Foreign Corrupt Practices Act violation.

GE Energy moved to dismiss Asadi's complaint on the basis that he did not qualify as a "whistleblower" under the whistleblower-protection provision because he only reported internally.

The 5th Circuit affirmed the District Court's dismissal of the action, rejecting the argument that the whistleblower provision should be construed to protect individuals who take actions to inform the company of their claims even if they do not provide information to the SEC.

It also found that Asadi did not meet the second definition set forth in the SEC's 2011 rule, which defines whistleblowers to include those who make internal disclosures — regardless of whether those disclosures are also made to the SEC.

Due to ambiguity in Dodd-Frank's statutory language, the SEC rules set forth two separate definitions of the term "whistleblower": one for the bounty provision and another for the anti-retaliation provision.

Some district courts have followed *Asadi*, while others have not. In *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145 (2015), the 2nd U.S. Circuit Court of Appeals ruled that an employee who reports an alleged securities violation only to his employer is covered by Dodd-Frank's anti-retaliation provisions.

Daniel Berman had alleged in his suit in the U.S. District Court for the Southern District of New York that his employer and its parent company violated the whistleblower provisions of Dodd-Frank. Specifically, he accused the employer and its parent of wrongfully terminating him for raising concerns internally about business practices that he believed constituted accounting fraud.

The companies moved to dismiss the claim, arguing that Berman was not a whistleblower under Dodd-Frank because he did not report the alleged violations to the SEC.

The District Court agreed and granted the motion.[5]

In a 2-1 ruling, the 2nd Circuit reversed the District Court's decision. Citing the two definitions, it found that Dodd-Frank's provisions are ambiguous as to whether an employee who reports an alleged violation only internally qualifies as a whistleblower.

The 2nd Circuit determined that precluding whistleblowers who report violations internally from receiving Dodd-Frank anti-retaliation protection would be bad policy and against the spirit of the law and SEC rules. The panel deferred to the SEC's interpretation of the statute, acknowledging the SEC's August interpretive rule.

THE FUTURE IMPACT OF THE SEC'S RULE

In light of the August SEC interpretive rule and the 2nd Circuit's decision in *Berman*, some may conclude that the matter is now resolved and that the reasoning behind the *Asadi* decision is no longer tenable.

But it remains unclear whether other courts will similarly defer to the SEC's interpretive rule.

In fact, the *Asadi* and *Berman* decisions have created a federal circuit split that could eventually cause the issue to end up before the U.S. Supreme Court.

In the meantime, employers must assume that courts will defer to the SEC's interpretation. They must take steps to ensure that any adverse personnel actions taken against employees who have reported alleged misconduct internally are not considered unlawful retaliation, regardless of whether the employee has also reported the alleged misconduct to the SEC.

Whistleblowers, on the other hand, should feel somewhat confident in light of *Berman* and the SEC's interpretive guidance that they are protected from retaliation even if they have only reported their claims internally.

In an abundance of caution, however, employee whistleblowers may wish to consider reporting their allegations of misconduct to the SEC or exercise their rights under the anti-retaliation provisions of other statutes, such as the Sarbanes-Oxley Act of 2002.

Despite the SEC's efforts to protect whistleblowers who file only internal reports, their protection from retaliation is not yet guaranteed. It may take the U.S. Supreme Court to decide the matter for certain.

Courts have struggled to interpret these two definitions of "whistleblower" under Dodd-Frank and the SEC rules.

NOTES

1 *See* 17 C.F.R. § 241.

2 *See* Sec. & Exch. Comm'n, Office of Inspector Gen., Report No. 474, Assessment of the SEC's Bounty Program (2010), http://www.sec.gov/about/offices/oig/reports/audits/2010/474.pdf.

3 *See* 17 C.F.R. § 240.21F-2.

4 *See* 17 C.F.R. § 240.21F-2(b)(1).

5 *Berman v. Neo@Ogilvy LLC*, 72 F. Supp. 3d 404 (S.D.N.Y. 2015).

H. David Kotz is a managing director at **Berkeley Research Group**, a leading global expert services and consulting firm, where he focuses on internal investigations and serves as an expert witness in securities and fraud-related litigation. Kotz recently completed "Financial Regulation and Compliance: How to Manage Competing and Overlapping Regulatory Oversight," published by John Wiley & Sons in July. The book provides "one-stop shopping" for compliance professionals to manage the regulatory process. It includes specific hands-on advice from Kotz and expert industry leaders on regulatory and compliance-related topics, such as how to manage whistleblower complaints.

Behind the SEC's Recent Crackdown on Compliance Officials

What Does It Mean, and Who Else Should Be Worried?

Recent comments by Securities and Exchange Commission (SEC) Commissioner Daniel Gallagher were noteworthy for both their candor and the subject he raised. On June 18, 2015, Gallagher wrote in a statement placed on the SEC website (http://tinyurl.com/nnatjpw) that the SEC was sending a "troubling message": Chief compliance officers (CCOs) should not take ownership of their firm's compliance policies and procedures, lest they be held accountable for conduct that is not really their responsibility. He explained his dissents in two recent Enforcement actions brought by the SEC against CCOs and derided as not a "model of clarity" an SEC rule that requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of laws and regulations. He also expressed concern that the SEC's current approach would actually disincentivize a vigorous compliance function at investment advisers.

The Two Recent SEC Cases Referenced by Gallagher

The two recent Enforcement actions referenced by Commissioner Gallagher, who is leaving the SEC soon, are worth exploring. The first case cited involved BlackRock Advisers, a registered investment advisory firm with approximately $452 billion assets under management. According to the SEC, BlackRock first knew of and approved an investment of $50 million into the company made by Daniel Rice III, who was the general partner of Rice Energy, a family owned-and-operated oil and natural gas company; and second, a joint venture that Rice Energy later formed with a publicly traded coal company. It eventually became the largest holding (almost 10%) in the $1.7 billion BlackRock Energy & Resources Portfolio, the largest Rice-managed fund.

The SEC claims that BlackRock—and specifically its CCO, Bartholomew Battista—failed to disclose this conflict of interest to either the boards of the BlackRock registered funds or its advisory clients. Most noteworthy, in addition to blaming BlackRock for these alleged lapses, the SEC specifically cited Battista for failing to put into place policies and procedures to assess and monitor outside business activities like Rice's, even though he regularly approved them. In the end, the parties agreed to a settlement with the SEC wherein BlackRock agreed to pay a $12 million fine and Battista agreed to pay $60,000. As noted by the SEC in its April 2015 press release announcing the settlement, this was the first SEC case to charge violations of an Investment Company Act requirement that funds must report material conflicts of interest to their boards of directors (see http://tinyurl.com/p68zjv3).

The second case cited by Commissioner Gallagher concerned former professional boxer Mike Tyson's adviser, SFX Financial Advisory Management Enterprises, which provides advisory and financial management services to current and former professional athletes. In addition to alleging that former SFX Financial President Brian Ourand misused his authority over several accounts to steal approximately $670,000 from clients, the SEC separately charged SFX for failing to supervise Ourand, violating the custody rule, and making a false statement in a Form ADV filing. The SEC also charged SFX CCO Eugene Mason with causing SFX's compliance problems by negligently failing to conduct reviews of cash flows in client accounts, which was required by the firm's compliance policies, and by not performing an annual compliance review. Additionally, the SEC specifically cited Mason as being responsible for a misstatement in SFX's Form ADV that client accounts were reviewed several times each week. The SEC eventually agreed to a settlement with SFX and Mason wherein SFX agreed to pay a penalty of $150,000 and Mason agreed to a $25,000 fine.

FinCEN Case against CCO

The SEC is not the only organization to recently target CCOs for alleged failures to ensure that companies abide by compliance policies and procedures. In December 2014, the Financial Crimes Enforcement Network (FinCEN) issued a $1 million civil penalty against Thomas Haider, former CCO of MoneyGram International, Inc. (MoneyGram). FinCEN claimed that during his oversight of compliance for MoneyGram, Haider failed to adequately respond to thousands of customer complaints regarding schemes that utilized MoneyGram to defraud consumers.

According to FinCEN, Haider was the CCO from 2003 to 2008 and became aware of complaints received by the company's fraud department regarding numerous alleged fraud schemes. FinCEN charged Haider with being personally responsible for MoneyGram's failure to meet its legal obligations under the Bank Secrecy Act, as well as for its failures to implement and maintain an effective anti-money laundering (AML) compliance program, and to timely file Suspicious Activity Reports.

Difficulty in Determining if CCOs Have Legal Exposure

As noted by Commissioner Gallagher, perhaps the most disturbing aspect of this recent trend is that the SEC policy regarding what constitutes wrongdoing on the part of CCOs is now primarily being determined by Enforcement actions rather than through SEC rules. As Commissioner Gallagher pointed out, the SEC rule (Rule 206(4)-7 of the Investment Advisers Act of 1940) intended to delineate the responsibility of CCOs merely states that registered investment advisers are required to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation[s]" of the statute, but offers no guidance as to the distinction between the role of CCOs and management in carrying out the compliance function. Also, in the 11 years since the rule was adopted, the SEC has not issued any guidance on how to comply with it.

Without further elucidation of this rule, CCOs are forced to attempt to "read the tea leaves" of Enforcement actions to determine where and when they may have exposure. From BlackRock, they may understand that exposure may occur if they fail to take action in a case of what the SEC deems an obvious conflict of interest. From SFX Financial, one could expect the SEC to take action if a CCO made a misstatement on an ADV or similar document, and/or failed to perform annual compliance reviews. But it is difficult, if not impossible, to know which future factual circumstance the SEC will determine is a basis for liability on the part of an individual like a CCO.

2104 SEC Speech from the SEC Enforcement Director

If CCOs are forced to learn their regulatory responsibilities and exposure levels from Enforcement cases, it is helpful to attempt to understand the priorities of the Enforcement Division in this area. To that end, it is worth analyzing a May 20, 2014, speech in which SEC Director of Enforcement Andrew Ceresney discussed the circumstances when the SEC would seek sanctions against compliance personnel (http://tinyurl.com/ow23p57).

Director Ceresney's speech contained a short discussion of the SEC's position on the duties of CCOs. He emphasized that the SEC will take action against compliance officers: 1) if they actively participated in the misconduct; 2) if they have helped mislead regulators; or 3) when they have clear responsibility to implement compliance programs or policies and wholly failed to carry out that responsibility.

As an example, Director Ceresney cited a case where the CCO not only knew about the firm's decision to violate the rules, but also participated in the violations by, among other things, failing to implement procedures for which he was responsible that would have brought the firm into compliance, and then concealing those violations from regulators. Director Ceresney also gave an example of a situation where the CCO was considered by the SEC to have wholly failed to carry out his compliance responsibilities by failing to adopt or implement adequate compliance programs after being notified repeatedly of deficiencies by the examination staff.

What Should CCOs Do Going Forward?

Director Ceresney's speech provides some elucidation, but it could be contended that the factual circumstances in the BlackRock and SFX Financial cases, both of which resulted in Enforcement actions that post-dated the speech, reflected less egregious situations than the criteria provided by Director Ceresney as being triggers for Enforcement actions against CCOs. This is the danger discussed above, wherein individuals or firms must rely upon Enforcement cases rather than rules and regulations in determining the extent of their liability. Enforcement cases, by their nature, are fact-specific. It is not easy to determine the appropriate standard of liability from analyzing SEC decisions to bring charges in an Enforcement context.

Therefore, going forward, CCOs should ensure that basic compliance requirements are followed and should understand that as part of their roles, they are personally responsible and potentially liable for these requirements. CCOs must also be wary of imposing too many "paper" rules where they are unsure if the rules can be followed fully every year. In addition, CCOs must carefully document decisions they make so that even if an SEC Enforcement attorney disagrees with the decision, it will be clear that the decision was a reasoned one rather than simple neglect of regulatory responsibilities. Finally, CCOs must have ownership of their compliance programs and demand ownership from their subordinates as well.

Who Else Could Be Targeted?

The SEC's recent crackdown on CCOs is part of a larger focus by regulators on individual liability. Much of this effort comes from the perceived failure by regulatory agencies to prosecute individuals for alleged civil and criminal conduct arising out of the financial crisis. Whether it is the Department of Justice (DOJ), SEC, FinCEN, or entities such as the Commodity Futures Trading Commission (CFTC) or Financial Industry Regulatory Authority (FINRA), there is increased pressure to bring charges against individuals. The often overlapping and confusing jurisdictions of these regulators complicate the matter further.

Depending on their exact role, general counsels may face potential liability for failures to identify or act on supposed “red flags,” failures to respond to numerous complaints alleging the same issue or concern, or where firms fail to correct deficiencies that the regulator believes should have been remedied immediately. Moreover, as at some small firms, the CCO/general counsel position is combined and may face extra scrutiny. In addition, members of an audit committee may face potential exposure for what is deemed to be egregious or even negligent failure to fulfill their duties.

Accordingly, individual officers with legal, compliance, or oversight duties should scrutinize Enforcement actions brought by the myriad regulatory agencies that impact the businesses in which they work. These officers should redouble efforts to ensure not only that their part of the company has the required policies and procedures in place, but also that they can demonstrate that these policies and procedures are being implemented actively and appropriately under their supervision.

H. David Kotz, a member of this newsletter’s Board of Editors, presently serves as a managing director at Berkeley Research Group, a global expert services and consulting firm, where he focuses on internal investigations and serves as an expert witness in securities and fraud-related litigations. Mr. Kotz previously served for over four years as inspector general of the SEC. He recently completed a book, *Financial Regulation and Compliance: How to Manage Competing and Overlapping Regulatory Oversight*, to be published by John Wiley & Sons.

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The Yates Memo – The Background and Its Impact

By: H. David Kotz, Managing Director, Berkeley Research Group

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ISSUANCE OF THE YATES MEMO

On September 9, 2015, United States Deputy Attorney General Sally Q. Yates issued a memorandum (the "Yates memo") directing the Department of Justice ("DOJ") to fully leverage its resources to seek accountability from individuals for corporate misdeeds. Although the Yates memo identified the "many substantial challenges" unique to pursuing individuals, it set forth the following six key steps that the DOJ plans to take to strengthen its ability to seek individual culpability:
(1) in order to qualify for any cooperation credit, corporations must provide to the DOJ all relevant facts relating to the individuals responsible for the misconduct; (2) criminal and civil corporate investigations should focus on individuals from the inception of the investigation; (3) criminal and civil attorneys handling corporate investigations should be in routine communication with one another; (4) absent extraordinary circumstances or approved departmental policy, the DOJ will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation; (5) DOJ attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases, and should memorialize any declinations as to individuals in such cases; and (6) civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.[1]

CRITICISM THAT LED TO THE YATES MEMO

This memorandum was issued after years of criticism against both the DOJ and the Securities and Exchange Commission ("SEC") for the lack of criminal and civil cases brought with regard to the financial crisis. For example, as early as 2013, U.S. District Court Judge Jed Rakoff, who oversaw several fraud trials against companies brought by the SEC, criticized the government for failing to hold individuals responsible for massive frauds, stating that this approach "speaks greatly to weaknesses in our prosecutorial system".[2]

BANK OF AMERICA INVESTIGATION

One of the initial cases in which Judge Rakoff expressed concern about the failure to bring actions against individuals occurred is a matter that I investigated while serving as the Inspector General of the SEC, in 2010. In January 2009, the SEC's Enforcement division began an investigation of the circumstances surrounding Bank of America's approximately $50 billion acquisition of Merrill Lynch. The SEC began investigating allegedly false and misleading statements made by Bank of America in a joint proxy statement filed in connection with the merger. In August 2009, the SEC entered into a provisional settlement with Bank of America for a penalty of $33 million subject to court approval.[3] After the SEC filed the proposed settled action with Judge Rakoff, he held a hearing during which the SEC and Bank of America presented arguments supporting the proposed settlement. In September 2009, the Court rejected the SEC's proposed settlement with Bank of America on the grounds that the penalty amount was too low, and no actions were brought against the individuals who allegedly committed the fraud.[4] As Inspector General of the SEC, I was asked to investigate the circumstances surrounding the SEC's decision to proceed with the initial settlement and found that after Judge Rakoff rejected the SEC's first proposed settlement, a second SEC Enforcement team continued litigating the case, conducting extensive discovery and adding a new claim to strengthen its litigation position. In the end, however, they concluded that "there simply wasn't a factual and legal basis to bring a claim against individuals".[5]

REASONS FOR FEW ACTIONS BROUGHT AGAINST INDIVIDUALS

In my experience, one of the primary reasons that the government has not brought many actions against individuals for wrongdoing arising out of the financial crisis is that the government prefers to bring cases that it has a high probability of settling favorably before trial. In cases brought against companies, the government can utilize its leverage to compel defendants to settle cases without having to use resources that are needed for trial. In addition, companies often make the determination that settling a case even with a relatively large penalty can be cost-effective, particularly when they consider the legal fees associated with defending a claim to trial. Settlements also provide finality for the company, which is beneficial for their bottom line. For example, on the day in July 2010 when the SEC announced a settlement with Goldman Sachs ("Goldman") over misleading investors in the subprime mortgage market with a penalty of $550 million, Goldman's stock price surged 4.43 percent on the rumors of the settlement and an additional 5 percent after the settlement

1 September 9, 2015 Memorandum from Deputy Attorney General Sally Q. Yates with Subject: Individual Accountability for Corporate Wrongdoing at **http://justice.gov/dag/file/769036/download**.

2 *See* article in Reuters dated November 12, 2013 entitled, "Judge criticizes lack of prosecution against Wall Street executives for fraud" at **http://reuters.com/article/us-financial-judge-idUSBRE9AC00O20131113**.

3 *See* SEC Litigation Release No. 21164 / August 3, 2009 at **http://sec.gov/litigation/litreleases/2009/lr21164.htm**.

4 *See* Memorandum Order of Judge Rakoff dated September 14, 2009 in SEC v. Bank of America Corporation, at **http://jdsupra.com/legalnews/order-from-judge-rakoff-in-sec-v-bank-o-87769/**.

5 *See* SEC Office of Inspector General Report of Investigation dated September 30, 2010, entitled, "Investigation of the Circumstances Surrounding the SEC's Proposed Settlements with Bank of America, Including a Review of the Court's Rejection of the SEC's First Proposed Settlement and an Analysis of the Impact of Bank of America's Status as a TARP Recipient," at **http://sec.gov/foia/docs/oig-522.pdf**.

was officially announced, which meant a financial windfall for the company even after it would pay its penalty.[6] Individuals, on the other hand, face the prospect of jail time and/or penalties and fines that may not be reimbursed by their companies and accordingly, are less likely to engage in a settlement. From the perspective of the individual DOJ prosecutor or SEC Enforcement attorney, a quick settlement in a particular action is preferable since they are then able to bring more cases and do not run the risk of lengthy litigation, possibly culminating in an unfavorable decision from a jury. Thus, they are unlikely to initiate a case against an individual defendant where the facts are murky, as they are aware that the matter will likely proceed to trial rather than settle.

In addition, in my experience, particularly at the SEC, there are internal influences that may incentivize the bringing of "easier to prove" cases in general. In another investigation I conducted as Inspector General of the SEC, I found that one of the reasons the SEC failed to uncover the $7 billion Ponzi scheme perpetrated by Allen Stanford in a timely manner was the perception by the SEC Enforcement personnel that the Stanford case was difficult, novel and challenging to prove. The former head of the SEC's Fort Worth office indicated in the investigation that SEC regional offices were "heavily judged" by the number of cases they brought and that it was very important for the Fort Worth office to bring a high number of cases. Another senior official who worked on the Stanford matter said that everyone in Fort Worth was mindful of "stats" since they were recorded internally by the SEC in Washington, and there was a lot of pressure to bring a high volume of cases. As a result, the SEC's Forth Worth Enforcement program focused on "easier cases" or "quick hits" and any potential investigation or action that did not appear likely to produce a number (in the form of a successful prosecution or settlement) in a very short period of time was not prioritized.[7] As was seen in the Bank of America context, cases against individual defendants are rarely "quick hits" as there are additional burdens (such as establishing intent or negligence) when attempting to prove liability against individuals, and as noted above, individuals are less likely to agree to a quick settlement or resolution.

UNEXPECTED IMPACT OF THE YATES MEMO

As the Yates memo outlines, one of the new approaches of the government is to tie the receipt by corporations of cooperation credit, which can potentially significantly reduce their penalties, to the companies giving them evidence of individual culpability. In this way, the government can build stronger cases against individuals that are closer to the "quick hits" that they often prefer. This will lead to an interesting dynamic where companies' decisions to cooperate may now involve their willingness to give potentially damning information about individuals who could potentially be senior-level executives in the company. In the past, it seemed that cooperating with the government was the obvious choice to make, since the feeling was often that the government would find out about the wrongdoing anyway, and cooperation would lead to lower fines and more lenient terms for a settlement. However, when companies are asked to give information about individuals in the company, the decision to cooperate may not be so clear cut. Companies may be very reluctant to divulge information about executives' roles in activities especially where they are not entirely convinced that the individual or even the company actually engaged in wrongdoing. Previously, settlement was often viewed as a significant positive for the company's bottom line, but beginning a process that may lead to personal exposure on the part of company officials may not be favored in the same way.

These new considerations about whether to cooperate with the government may also be impacted by the relatively new policy of the SEC regarding obtaining admissions of guilt in settlements. In 2013, SEC Chair Mary Jo White announced that certain enforcement cases would require an admission of guilt or the regulator would be forced to take the defendant to trial. She explained that "Defendants are going to have to own up to their conduct on the public record. This will help with deterrence, and it's a matter of strengthening our hand in terms of enforcement."[8] This announcement represented a significant departure from the previous policy of the SEC, for which the "neither admit nor deny" settlement approach had been a hallmark of its enforcement strategy. Accordingly, the fact that an admission of guilt by an individual can have significantly greater consequences than similar admissions on the part of companies is another reason that settlements may be seen as less than ideal.

6 *See* Huffington Post article dated July 15, 2010, entitled, "Goldman Sachs SEC SETTLEMENT Reached -- And Stock SOARS" at **http://huffingtonpost.com/2010/07/15/goldman-sachs-sec-settlem_n_648045.html**. *See* also SEC Office of Inspector General Report of Investigation dated September 30, 2010 entitled, "Allegations of Improper Coordination Between the SEC and Other Governmental Entities Concerning the SEC's Enforcement Action Against Goldman Sachs & Co." at **http://sec.gov/foia/docs/oig-534.pdf** (analyzing impact of SEC settlement announcement on stock price of Goldman Sachs.)

7 *See* SEC Office of Inspector General Report of Investigation dated March 31, 2010 entitled, "Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme" at **http://sec.gov/news/studies/2010/oig-526.pdf**.

8 *See* article dated June 21, 2013, entitled, "S.E.C. Has a Message for Firms Not Used to Admitting Guilt" at **http://nytimes.com/2013/06/22/business/secs-new-chief-promises-tougher-line-on-cases.html?hp&_r=0**.

In addition, the Yates memo policy regarding cooperation credit requiring information about individuals could cause significant conflicts between the company and the individual executives and even adversely impact the company's ability to conduct an internal investigation. Certainly, an individual defendant who would be a witness in an internal investigation is much more likely to retain separate counsel in light of the approach outlined in the Yates memo by the government. The addition of separate counsel for witnesses will necessarily complicate the efforts of investigators to conduct the internal investigation as well as make the investigations longer and more costly. Moreover, counsel for an individual defendant could justifiably advise his or her client that cooperating with a company's internal investigation would not be prudent where it may lead the investigation to reveal evidence that will be provided to the government in order to obtain cooperation credit for the company.

Finally, the company would face a particularly difficult dilemma if, in their efforts to secure cooperation credit, they seek to obtain evidence against individuals in the internal investigation, but realize during the course of the internal investigation that they will simply be unable to locate such evidence to the satisfaction of the government. At that point, they may consider abandoning any effort to continue to cooperate.

CONCLUSION AND PREDICTING THE FUTURE

It is important to understand what led to the issuance of the Yates memo to determine the actual impact of this new policy on criminal and civil actions brought by the government. While the government will, undoubtedly, make greater efforts to investigate allegations of wrongdoing against individuals that may lead to actions being brought against them, the inherent incentives in place for bringing cases where the evidence is particularly strong will likely not disappear, and it is simply and will remain more difficult to develop and prove a strong case against an individual than a company. While it is unclear whether the end result will be more prosecutions of individuals, it is clear that there will be more pressure placed on corporations to provide damaging information about any wrongdoing on the part of individuals. Much to the government's chagrin, this increased pressure may not always necessarily lead to the increased cooperation that the government is seeking.

ABOUT THE AUTHOR

H. David Kotz

H. David Kotz presently serves as a Managing Director at Berkeley Research Group, a leading global expert services and consulting firm, where he focuses on internal investigations and matters relating to Foreign Corrupt Practices Act and Anti-Money Laundering regulations. He also serves as a compliance monitor for firms that have entered into deferred prosecution agreements and similar arrangements with government agencies, and as an expert witness in securities and fraud-related litigations.

Kotz previously served for over four years as Inspector General of the SEC. During his tenure, he authored the landmark, widely publicized report investigating the SEC's failure to uncover Bernard Madoff's $50-billion Ponzi scheme. Mr. Kotz also authored numerous high-profile reports of investigation while at the SEC concerning, among others, a $7-billion alleged Ponzi scheme perpetrated by Allen Stanford and an SEC settlement of an enforcement action against Bank of America. In addition, he authored a groundbreaking audit report analyzing the SEC's oversight of Bear Stearns and the reasons for its collapse.

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The SEC Crackdown on High-Frequency Trading: How Far Will It Go?

H. David Kotz and Jennifer Hull*

The authors of this article discuss high-frequency trading, Securities and Exchange Commission enforcement actions, and new regulation systems compliance and integrity rules.

There has been a great deal of discussion in recent months about the evils of high-frequency trading. High-frequency trading is an automated trading platform used by large investment banks, hedge funds, and institutional investors to transact a large number of orders at very high speeds. These platforms allow traders to execute millions of orders and scan markets and exchanges in a matter of seconds. The platforms use complex algorithms to analyze the markets and gain favorable returns on trades they make based on these systems and the speed of their transactions.

CONCERNS ABOUT HIGH-FREQUENCY TRADING

Much of the concern expressed by regulators with regard to high-frequency trading originated from the March 2014 publication of Michael Lewis' book *Flash Boys: A Wall Street Revolt*. Lewis tells the story of several insiders at high-frequency trading firms who used speed and automation to gain an advantage over other investors on Wall Street. When he called the U.S. stock market "rigged" on the CBS news program *60 Minutes*, Lewis caused an uproar in the media and in regulatory circles with the notion that high-frequency traders can see a slower trade request coming through the system and are able to sell shares to a fund at a higher price.

In June 2014, Securities and Exchange Commission ("SEC") Chair Mary Jo White gave a speech before exchange executives in which she vowed to increase oversight of computer-driven trading and called for stricter scrutiny of high-frequency traders and private trading venues. Chair White indicated that she directed SEC staff to develop a rule that would prevent rapid-fire traders from engaging in short-term strategies that can disrupt markets and increase volatility. She also described the need to review practices such as the use of complex order types that may provide certain investors with advantages. Among

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* H. David Kotz is the managing director at Berkeley Research Group, where he focuses on internal investigations and matters relating to Foreign Corrupt Practices Act and anti-money laundering regulations. Jennifer Hull is the director at Berkeley Research Group, where she specializes in regulation of and securities trading by brokers-dealers, investment advisers, hedge funds, insurance companies, and banks.

the specific proposals referenced in the speech were requiring high-frequency traders to register as broker-dealers, establishing an "anti-disruptive trading rule" that could restrict high-frequency traders from executing short-term strategies that could disrupt markets, and requiring firms to improve their management of trading algorithms.[1]

SEC ENFORCEMENT ACTIONS

In September 2014, the SEC brought an Enforcement action against a high-frequency trading firm, Latour Trading LLC, charging the New York company with using faulty calculations in complex trading strategies that allowed it to buy and sell stocks without holding enough capital. The firm was subject to excessive risk because of the faulty calculations. This is concerning because the firm at times accounted for 9 percent of all U.S. stock trading, according to the SEC's order. Latour, which did not admit or deny wrongdoing, agreed to pay $16 million to settle the case.

In October 2014, the SEC levied its first high-frequency trading manipulation charge against Athena Capital Research, for placing a large number of aggressive, rapid-fire trades in the final two seconds of trading days during a six-month period to manipulate the closing prices of thousands of NASDAQ-listed stocks. The firm neither admitted nor denied the charges, but agreed to pay a $1 million penalty.

Recent reports are that the SEC is nearing a settlement of about $12 million to $13 million with BATS Global Markets Inc. over how its Direct Edge Holdings LLC exchanges handled customer orders. The exchange was accused of giving an unfair advantage to high-frequency traders. The SEC's Direct Edge investigation has reportedly focused on certain "order types," instructions that exchanges provide to determine how customers' buy and sell orders are handled.

REGULATION SYSTEMS COMPLIANCE AND INTEGRITY

Naturally, technology concerns are an inevitable consequence of stock markets that are increasingly computer driven. A series of technology-related errors, or "glitches" as commonly described by traders, ultimately resulted in new SEC rules for exchanges to require more cybersecurity and backup systems, as well as more reporting to the SEC during market disruptions. The new rules, entitled "Regulation Systems Compliance and Integrity" ("Reg SCI"), were adopted in November 2014 and impose new standards and procedural and

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[1] Mary Jo White, "Enhancing Our Equity Market Structure," speech at Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference, New York, NY (June 5, 2014), accessed at: http://www.sec.gov/News/Speech/Detail/Speech/1370542004312#.VIoMQdhOW70.

reporting requirements on certain securities-related institutions, including national securities exchanges, alternative trading systems ("ATS") that meet certain thresholds, plan processors, and exempt clearing agencies. Reg SCI does not extend to non-ATS broker-dealers.

IMPACT OF REG SCI

Interestingly, a technology-related error at the former high-frequency trading firm Knight Capital Group was one of the "glitches" that led former SEC Chair Schapiro to issue a press release about initiation of the SEC's efforts to draft what became Reg SCI. On August 1, 2012, after installing new trading software, Knight Capital's computers rapidly bought and sold more than 397 million shares in numerous stocks for about 45 minutes. Those trades pushed up prices and caused market disruption. Knight Capital lost approximately $460 million when it had to sell several billion dollars of erroneously acquired shares back into the market.[2] On August 2, 2012, Knight Capital issued a press release about the "technology issue."[3] On August 3, 2012, Chair Schapiro said:[4]

> [E]xisting rules make it clear that when broker-dealers with access to our markets use computers to trade, trade fast, or trade frequently, they must check those systems to ensure they are operating properly . . . . I have asked the staff to accelerate ongoing efforts to propose a rule to require exchanges and other market centers to have specific programs in place to ensure the capacity and integrity of their systems.

Indeed, according to the final rule, Reg SCI is intended to apply to "those entities that play a significant role in the U.S. securities markets and/or have the potential to impact investors, the overall market, or the trading of individual securities."[5]

Advocates of Reg SCI praise it for helping to prevent technology-related errors like those that occurred at NASDAQ during the initial public offering of

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[2] U.S. SEC, "SEC Charges Knight Capital With Violations of Market Access Rule," press release (October 16, 2013), accessed at: http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539879795#.VIiqhk0tBoI.

[3] U.S. SEC, "Knight Capital Group Provides Update Regarding August 1st Disruption to Routing in NYSE-Listed Securities," press release (August 2, 2012), accessed at: http://www.sec.gov/Archives/edgar/data/1060749/000119312512332176/d391111dex991.htm.

[4] U.S. SEC, "Chairman Schapiro Statement on Knight Capital Group Trading Issue," press release (August 3, 2012), accessed at: http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483674#.VIh78U0tBoI.

[5] U.S. SEC, "Regulation Systems Compliance and Integrity," 17 CFR Parts 240, 242, and 249 [Release No. 34-73639; File No. S7-01-13] (effective February 3, 2015), accessed at: http://www.sec.gov/rules/final/2014/34-73639.pdf at page 27.

Facebook in May 2012. But not everyone is entirely happy with the reach of Reg SCI. It has been criticized for not extending to all significant market participants. For instance, SEC Commissioner Stein said that the new rules do not extend far enough and specifically that "the rule also ignores intraday proprietary trading firms that use sophisticated algorithms to interact at high speeds with the market."[6]

In summary, Reg SCI stipulates specific criteria for technology used by certain market participants. It also requires routine testing of systems and notifications of events causing market disruptions. But it is also widely viewed as not contributing enough to the goal of making trading venues more transparent.

PREDICTING WHAT COMES NEXT

However, for Enforcement actions against high-frequency trading firms, the SEC need not necessarily rely on rules such as those prescribed by Reg SCI. Firms with direct market access are subject to Rule 15c3-5 ("Market Access Rule"). The Market Access Rule requires that participants with direct market access to a marketplace have suitable "risk management controls and supervisory procedures that, among other things, are reasonably designed to (1) systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, and (2) ensure compliance with all regulatory requirements that are applicable in connection with market access."[7] Indeed, the August 1, 2010 technology-related error at Knight Capital resulted in the SEC's first Enforcement action under the Market Access Rule. According to the SEC:[8]

> . . . . Knight Capital did not have adequate safeguards in place to limit the risks posed by its access to the markets, and failed as a result to prevent the entry of millions of erroneous orders. Knight Capital also failed to conduct adequate reviews of the effectiveness of its controls.

High-frequency trading firms will continue to be the subject of heavy

[6] U.S. SEC, "Regulation Systems Compliance & Integrity (SCI),"public statement (November 19, 2014), accessed at: http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543493597#.VIjDUk0tBoI.

[7] U.S. SEC, "Risk Management Controls for Brokers or Dealers with Market Access," 17 CFR PART 240 [Release No. 34-63241; File No. S7-03-10] (n.d.), accessed at: http://www.sec.gov/rules/final/2010/34-63241.pdf.

[8] U.S. SEC, "SEC Charges Knight Capital With Violations of Market Access Rule," press release (October 16, 2013), accessed at: http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539879795#.VIm35k0tBMs.

scrutiny from the SEC, and there may be more Enforcement actions under the Market Access Rule. Other high-frequency trading firms also may be charged with violating the net capital rule, as was Latour Trading LLC.

The SEC may also attempt to pursue additional high-frequency trading manipulation cases. Athena Capital Research was the first, but there will be more. In these cases, the primary challenge facing regulators is determining when a trading strategy has crossed the line from acceptable trading strategy to manipulative scheme. It is often difficult to prove market manipulation.

For instance, the SEC accused Athena Capital Research of manipulative trading by developing and using a computer program that was intended to have an artificial impact on stock prices. However, in a statement issued after its settlement with the SEC in October 2014, Athena said that it "believes that its trading helped satisfy market demand for liquidity during a period of unprecedented demand for such liquidity."

Differentiating a manipulative scheme from an acceptable trading strategy appears to a subject of recent internal studies published at the SEC. On December 4, 2014, the SEC revealed that two internal studies reviewed the role that high-frequency trading plays in the marketplace and found that high-frequency trading has benefits.

In addition to future Enforcement actions, the SEC may also issue new regulations that attempt to restrict high-frequency traders from disrupting markets. One thing is clear: concerns about high-frequency trading are not going away anytime soon, and the SEC will no doubt try to increase its profile on this issue to make it known that it is policing this type of trading.