Wall Street LAWYER
Securities in the Electronic Age
December 2018 ▪ Volume 22 ▪ Issue 12

BOARD INVESTIGATIONS OF #METOO ALLEGATIONS: WHAT "WEINSTEIN CLAUSES" MEAN FOR SEXUAL HARASSMENT INVESTIGATIONS

By Lindsey Weiss Harris, Danielle Rose & Hartley West

Lindsey Weiss Harris is a lawyer in the New York office of Kobre & Kim. She represents Fortune 500 corporations, boards of directors, hedge funds and corporate executives in high-profile deal litigation, shareholder disputes, complex civil litigation, and independent investigations. Danielle Rose is also a lawyer in the New York office and regularly serves as lead counsel in representing clients in high-stakes, commercial litigation and arbitration, often involving disputes between major financial institutions and institutional investors related to complex financial products and services. Hartley West is an accomplished trial lawyer in Kobre & Kim's San Francisco office. West has extensive experience in white-collar criminal and asset forfeiture matters. She has handled cross-border cases involving tax fraud, securities fraud, asset forfeiture, bank fraud, money laundering, antitrust, public corruption, health care fraud, national security, and investigations. Contact: lindsey.weissharris@kobrekim.com, danielle.rose@kobrekim.com or hartley.west@kobrekim.com.

With the rise of the "Weinstein clause" in merger agreements, sexual harassment is now an M&A due diligence issue that is increasingly likely to become the subject of litigation. Investigations of sexual harassment allegations should reflect the fast-changing legal landscape.

"Weinstein clauses" typically require sellers to disclose any complaint of sexual harassment or related misconduct against senior executives or directors in the transaction documents or attest that there have been no such allegations. In some cases, a seller's breach of a Weinstein clause representation or warranty can enable the buyer to recover as much as 10% of the deal consideration. Where a complaint has not already been adequately investigated, for various reasons, the potential seller generally has an interest in evaluating and understanding the allegations,

IN THIS ISSUE:

THOMSON REUTERS®
42044094

often in a time-sensitive manner. How investigations of these allegations are conducted can be critical to deal value, as well as to the interests of the deal parties and their respective shareholders.

Given the stakes, boards of directors should carefully consider how investigations of sexual harassment claims against senior leadership are conducted. *First*, an independent, outside investigation often has advantages over in-house investigations:

- **Credibility and Objectivity**—When allegations reach the highest levels of a company and require the board's attention, an independent law firm can help demonstrate to the buyer as well as to company stakeholders that the board is taking the investigation seriously and acting appropriately. Rightly or wrongly, in-house counsel, or even a company's regular outside counsel, may be accused of bias. An independent firm that has experience conducting sensitive investigations—but no relationship with the accused wrongdoer, expectation of future work from the corporation, or stake in whether a strategic transaction proceeds—can assure outsiders that the investigation is bona fide and conducted in good faith.

- **Privilege**—While human resources or other business professionals may be familiar with sexual harassment policies and procedures, the company or the board *cannot* invoke a privilege over their communications, analyses and reports unless conducted at the direction of counsel for the purpose of advising the company or the board.

- **Confidentiality**—In some instances, witnesses may be more forthcoming with independent counsel, as employees sometimes worry that information shared internally will become widely known throughout the organization. Nevertheless, it is important that witnesses understand the extent to which the information they

Wall Street Lawyer
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

One Year Subscription ● 12 Issues ● $ 1,188.00
(ISSN#: 1095-2985)

provide will be kept confidential (for example, who at the company may have access to the information and resulting reports as well as the circumstances in which the information could eventually be disclosed to third parties or become public).

Second, these investigations should be thorough and designed to uncover all facts surrounding the allegations. The person who filed the complaint, the accused, and any other witnesses with relevant knowledge should be interviewed. Any relevant documents should also be carefully collected and reviewed. Generally, independent counsel should report to the board (or a relevant committee thereof), and board members should devote time to digesting and discussing counsel's findings and recommendations. This allows a board to exercise its duty of care and determine if corrective action is appropriate, facilitating proper disclosure in the M&A context and mitigating the risk of shareholder litigation.

Generally, independent counsel should report to the board (or a relevant committee thereof), and board members should devote time to digesting and discussing counsel's findings and recommendations.

Third, where possible, these investigations should be timely and proactive. An investigation prompted by requested transaction-related disclosures is more likely to garner skepticism, decrease deal leverage, and lead to litigation.

Fourth, where the board is leading the investigation, it should consider whether independent counsel should be retained by the full board or a committee thereof. Where directors themselves are witnesses or are otherwise arguably conflicted, designating an independent subcommittee to consider the results of counsel's investigation may be a prudent choice.

In short, the #MeToo movement has made sexual harassment a meaningful M&A issue, which the leadership of companies weighing strategic transactions should consider and appropriately address.

THIRD-PARTY LITIGATION FUNDING: CIVIL JUSTICE AND THE NEED FOR TRANSPARENCY

By David H. Levitt & Francis H. Brown III

David H. Levitt, of Hinshaw & Culbertson, and Francis H. Brown III, of McGinchey Stafford, were members of the DRI Center for Law and Public Policy Third-Party Litigation Funding Working Group which wrote this white paper. For more than 55 years, DRI has been the voice of the defense bar, advocating for 22,000 defense attorneys, commercial trial attorneys, and corporate counsel and working to defend the integrity of the civil judiciary. This article is the Introduction to the paper, which can be found in its entirety on the DRI website. Contact: www.dri.org.

This is about far more than numbers, but the numbers are good place to begin—and indeed they tell an important part of the story. Litigation financing[1] is big business. According to one article at the end of 2017, the litigation finance industry is a $5 billion market in the United States.[2] The article notes that Burford Capital, the publicly traded third party litigation funding (TPLF) company that is the largest player in the U.S. market, had committed $488 million in TPLF markets in 2017 alone, and a $100 million investment in a single law firm's litigation portfolio; another TPLF company has made an eight-figure portfolio deal with a single law firm.[3] Burford itself states on its website that it has "$3.6 billion invested and available to invest in commercial litigation and arbitration," with a variety of different ways to finance, including single-case and portfolio financing.[4] *The Wall Street Journal* reported in July 2018 that litigation finance jobs are the new hot law job, mentioning companies that had made commitments of $136.6 million and $330.3 million (the latter to 38 investments, an average of nearly $8.7 million per investment), while another had raised $250 million in private equity.[5]

As defined by ABA 20/20,[6] ALF (or TPLF as used here) "refers to the funding of litigation activities by entities other than the parties themselves, their counsel, or other entities with a preexisting contractual relationship with one of the parties, such as an indemnitor or a liability insurer."[7] While there a number of limitations on ABA 20/20, self-described in its own text and discussed further below, that definition is as good as any as a starting point.

But it is only a starting point, because emerging evidence suggests that unlike the situation evaluated in ABA 20/20 in 2012, TPLF continues to evolve from its original roots as a transaction between a party to a litigation and a funding entity.[8] Moreover, while the biggest TPLF entities insist that they do not have any control over litigation or settlement of matters that they finance, they zealously guard the confidentiality of their funding agreements so that neither the public nor litigation opponents can confirm that claim, while evidence mounts that at least some participants in the market actively solicit people who may not have otherwise filed lawsuits or maintain at least some control over the lawsuits they file, including participation in the selection of attorneys.

One such company is reported to have advertised offers to anyone with a qualifying "MeToo" sexual harassment claim to receive $100,000 in "angel funding" along with a referral to attorneys.[9] Another is reported to have placed ads on Craigslist trolling for potential plaintiffs, resulting in the eventual dismissal of 99 "boilerplate lawsuits" alleging violations of the Americans with Disabilities Act—defended at considerable expense and risk by the defendants.[10] Both Reuters and the New York Times have reported on TPLF entities urging women to have unneeded surgery to enhance the values of their claims.[11]

Are these extreme cases of unethical entrants into an emerging marketplace? Perhaps. But they reveal that something more than merely "leveling the litigation playing field" or providing equal access to the courthouse is occurring, especially as more and more players enter the market and the financial incentives continue to increase. And even among the more mainstream, more-likely-to-be-playfield-leveling TPLF transactions, numerous ethical and practical considerations abound, especially with the trend for TPLF transactions to be with the attorneys rather than the parties to the litigation, as disclosed by the big TPLF entities themselves. As one TPLF executive stated: "We make it harder and more expensive to settle cases."[12]

Are these extreme cases of unethical entrants into an emerging marketplace? Perhaps. But they reveal that something more than merely "leveling the litigation playing field" or providing equal access to the courthouse is occurring

DRI believes that one of the most important ways to determine whether a given funding transaction is proper or improper—or somewhere in between—is through increased transparency. At a minimum, the existence and terms of any funding agreement ought to be promptly disclosed, in the same way that insurance policies available to defendants must be disclosed. Whether that disclosure will result in any further discovery will depend on the facts of the particular case. In some cases, disclosure will end with production of the funding agreement; in others, other discovery may be appropriate where the circumstances so warrant. That will be decided on a case-by-case basis, but the base line must be disclosure of the agreement itself.

DRI is uniquely placed to provide a dispassionate evaluation. DRI members primarily (but far from exclusively) represent defendants in civil litigation, but unlike all of the other participants in a litigated matter, DRI members do not have a personal financial stake in the outcome. To be sure, DRI members deeply care about the well-being of, and often have close and longstanding relationships with, their clients. But unlike the plaintiff, the plaintiff's attorney retained with a contingency fee, the TPLF company, and yes, the defendant itself, the DRI member is not personally impacted by the litigation result. DRI's perspective is as a protector and detailed observer of the judicial system, buoyed by the vast experience of more than 20,000 members who are active daily in the trenches of state and federal civil courts.

Identifying the Issues

TPLF is not a monolith, given the wide variation in the participants and the types of deals. Nor is the capacity for disputes within or about the industry one-size-fits-all. Beyond the issue of the impact of TPLF on the litigation where the funding occurred, courts have been called upon to grapple with disputes between the TPLF company and the plaintiff or plaintiff's attorney that it funded, as well as between the TPLF company and its own investors.

Beyond the issue of the impact of TPLF on the litigation where the funding occurred, courts have been called upon to grapple with disputes between the TPLF company and the plaintiff or plaintiff's attorney that it funded, as well as between the TPLF company and its own investors.

Indeed, these types of intra-industry disputes can shed even more light on the nature of the industry, because while the law continues to develop (via legislation, case law, and local rules) on the disclosure of TPLF agreements in the funded litigation, those agreements are discussed in some detail in litigation within the industry—because the TPLF agreements are the very subject of the litigation itself.

Examples of intra-industry disputes:

- *Shenaq v. AkinMears*—A Texas case where the chief business development officer of a plaintiff's law firm alleged that he had been fired to avoid paying him more than $4 million in commissions on over 14,000 medical mesh lawsuits he had acquired for the firm, alleging that the firm had secured $93 million in TPLF for its portfolio.[13]

- *Securities and Exchange Commission v. PLCMGMT LLC, dba Prometheus Law, James A. Catipay, and David A. Aldrich*—The SEC charged the TPLF company of raising $11.7 million from 250 investors over three years, promising ROI of between 100% and 300%, but only investing $4.3 million on actual investments.[14]

- *Maslowski v. Prospect Funding Partners LLC*, 890 N.W.2d 756 (Minn. Ct. App. 2017), review denied, (May 16, 2017)—Honor among participants? Funded plaintiff refused to pay the TPLF company the 60% annual interest called for in the TPLF agreement. The court ruled in favor of the underlying plaintiff, finding the TPLF agreement unenforceable as champertous under Minnesota law.[15]

- *Prospect Funding Holdings, LLC v. Saulter*, 2018 IL App (1st) 171277, 422 Ill. Dec. 72, 102 N.E.3d 741 (App. Ct. 1st Dist. 2018), appeal denied, 424 Ill. Dec. 426, 108 N.E.3d 849 (Ill. 2018)—After the funded plaintiff refused to pay under the TPLF agreement, based on Minnesota law rendering TPLF agreements unenforceable as champerty (see, e.g., Maslowski, supra), the TPLF company sued the underlying plaintiff's attorney. In addition to his client executing the TPLF agreement, the attorney had signed an "Attorney Acknowledgment" that he would honor a "letter of direction" signed by the client to hold any settlement funds received in the underlying case in a trust account, to be disbursed as required under the TPLF agreement. The existence of such a letter of direction and Attorney Acknowledgment is itself something worthy of comment—and something that would not have come to the public knowledge but for a lawsuit between the participants like this one. The court held that the attorney was not liable to the TPLF company either: he could raise champerty as a defense as well, and ethical rules for an attorney did not create a separate duty or cause of action in favor of the TPLF company against the attorney. But, the court did direct the appellate clerk to refer the attorney to the Illinois Attorney Registration and Disciplinary Commission for further investigation.

These cases provide examples of the language sometimes used in TPLF agreements. Other cases establish that despite the assertions of TPLF companies that they do not have control over the litigation or its resolution,[16] reported decisions confirm that there are some occasions where the terms of the TPLF agreement did indeed give the TPLF company at least some measure of control.[17] This highlights the multi-variable nature of the TPLF industry. It may well be that many TPLF companies carefully craft their agreements to disclaim any right to control. But there are clearly plenty of occasions where some manner of control or active participation occurs. And there is no way to know whether the funding agreement at issue is one where control exists or does not, whether the TPLF entity has become a participant in the litigation or is just a very interested bystander, unless the parties to the litigation have the opportunity to inspect the funding agreement.

And even these types of revelations from reported decisions where the funding agreement became an issue in the dispute are only the tip of the iceberg from an issue-spotting perspective. Legions of articles have been written over the past decade on various aspects of TPLF.[18] Notorious (and perhaps prurient) cases such as the oft-mentioned funding by billionaire Peter Theil of wrestler Hulk Hogan's lawsuit against Gawker,[19] or *Gbarabe v. Chevron Corp.*, the failed class action attempt arising out of a rig explosion in Nigeria,[20] present examples of possible abuse of the system, but offer the reason why knowledge of such arrangements can make a difference in the real world. TPLF raises issues of fairness to all participants, potentially changes the lawsuit dynamics for both discovery disputes (such as proportionality and cost shifting), and it creates a host of potential attorney-ethics and privilege/work product issues on a number of levels, plus concerns regarding who has standing to assert such issues.

TPLF companies assert that the level of scrutiny that they use before deciding to invest establishes that their activities tend to screen for meritorious rather than frivolous lawsuits,[21] but the evidence of cold contacts to potential claimants, Craigslist ads, and boilerplate lawsuits[22] demonstrates that this is not always the case.

TPLF raises issues of fairness to all participants, potentially changes the lawsuit dynamics for both discovery disputes (such as proportionality and cost shifting), and it creates a host of potential attorney-ethics and privilege/work product issues on a number of levels

ENDNOTES:

[1]Various phrases are used to describe this business. We use the term "Third Party Litigation Funding" (or TPLF) in this DRI white paper. Another example, the oft-cited American Bar Association Commission on Ethics 20/20 Information Report to the House of Delegates, February 2012 (ABA 20/20) uses "Alternative Litigation Finance" or ALF.

[2]Natalie Rodriguez, Going Mainstream: Has Litigation Finance Shed Its Stigma?, Law360, December 12, 2017, *available at* https://www.law360.com/articles/992299. *See also* Roy Strom, In Growth Bid, Leading Litigation Financier Bulks Up Leadership, American Lawyer, May 7, 2018, *available at* https://www.law.com/americanlawyer/2018/05/07/ in-growth-bid-leading-litigation-financier-bulks-up-leadership, noting that Burford had reported making a record $1.34 billion in investment commitments in 2017, and that its stock price had nearly doubled within the past year. This is a growth industry.

[3]*Id.*

[4]*See* http://www.burfordcapital.com/alm.

[5]Sara Rondazzo, *The New Hot Law Job: Litigation Finance*, Wall Street Journal, July 5, 2018, *available at* https://www.wsj.com/articles/ the-new-hot-law-job-litigation-finance-1530783000.

[6]ABA 20/20 is the Informational Report issued by ABA in February 2012. Many articles refer to an earlier *draft* of that Report, referred to as the "White Paper," and issued for comment in 2011.

[7]ABA 20/20, at p. 1.

[8]*Id.*

[9]Rodriguez, *supra* note 2.

[10]Debra Cassens Weiss, *Serial ADA suits operated like 'a carnival shell game,' depriving plaintiff of proceeds, judge says*, ABA Journal, July 13, 2017, *available at* http://www.abajournal.com/ news/article/serial_ada_suits_operated_like_a_carnival_shell_game_depriving_plaintiff_of.

[11]Alison Frankel and Jessica Dye, *Special Report: Investors profit by funding surgery for desperate women patients*, Reuters, August 18, 2015, *available at* https://www.reuters.com/ article/us-usa-litigation-mesh-specialreport/special-report-investors-profit-by-funding-surgery-for-desperate-women-patients-idUSKCN0QN1QT20150818; Matthew Goldstein and Jessica Silver-Greenberg, *How Profiteers Lure Women Into Often-Unneeded Surgery*, New York Times, April 14, 2018, *available at* https://www.nytimes.com/2018/04/14/business/ vaginal-mesh-surgery-lawsuits-financing.html.

[12]Jacob Gershman, *Lawsuit Funding, Long Hidden in the Shadows, Faces Calls for More Sunlight*, Wall Street Journal, March 21, 2018, quoting Allison Chock, chief investment officer of Bentham's U.S. division, *available at* https://www.wsj.com/articles/ lawsuit-funding-long-hidden-in-the-shadows-faces-calls-for-more-sunlight-1521633600.

[13]David Yates, *Tentative settlement reached in highly publicized AkinMears lawsuit*, SE Texas Record, November 11, 2015, *available at* https://setexasrecord.com/ stories/510647677-tentative-settlement-reached-in-highly-publicized-akinmears-lawsuit.

[14]*See* https://www.sec.gov/news/pressrelease/2016-72.html; substantial judgments were eventually entered against the respondents: http://regulatoryresolutions.com/case/ securities-exchange-commission-v-plcmgmt-llc-et-al.

[15]One of the interesting impacts of the development of TPLF is that it has brought back discussion of the hoary concepts of champerty, maintenance, and barratry, along with consideration of the application of usury principles given the often extremely high ROIs found in this area. Results have been mixed, but it has presented a fertile area for further litigation and analysis.

[16]*See, e.g.*, Matthew Harrison and John Harabedian, *Claimants Shouldn't Be Forced To Disclose Litigation Funding*, Law360, June 11, 2018, *available at* https://www.law360.com/ articles/1052279/claimants-shouldn-t-be-forced-to-disclose-litigation-funding ("Unlike an insurance company, a litigation funding company ordinarily does not control the litigation"). The authors are, respectively, an investment manager and legal counsel for Bentham IMF.

[17]*See, e.g.*, *Abu-Ghazaleh v. Chaul*, 36 So. 3d 691 (Fla. 3d DCA 2009) (TPLF funder had control of litigation, including the final say over settlement agreements, and found liable for defendant's attorney fees and costs); *High Voltage Bevs., LLC v. Coca-Cola Co.*, 2010 U.S. Dist. LEXIS 141785, *48-49 (W.D.N.C. 2010), accepted in part as to champerty ruling, 2011 U.S. Dist. LEXIS 21423 (W.D.N.C. 2011) (creation of a new LLC in which the TPLF funder owned a majority interest, constituted control over the claim); *In re DesignLine Corporation*, 565 B.R. 341, 63 Bankr. Ct. Dec. (CRR) 165 (Bankr. W.D. N.C. 2017) (funding agreement provided that funding would not be provided all at once, required the trustee and her attorneys to go back to the funder on a quarterly basis to request additional funding, and required the trustee to consult with the funder on selection of counsel).

[18]*See, e.g.*, ABA 20/20, note 1, *supra* at notes

1-4; Kyle E. Bjornlund and Ryan W. Hanofee, *How Third-Party Litigation Financing May Be Affecting Your Practice*, For The Defense, July 2015 (citing many other earlier articles).

[19]For one example of reporting on this case, see Derek Thompson, *The Most Expensive Comment in Internet History?*, The Atlantic, February 23, 2018, *available at* https://www.theatlantic.com/business/archive/2018/02/hogan-thiel-gawker-trial/554132.

[20]The funding agreement, calling for a ROI of 600%, was found discoverable. *Gbarabe v. Chevron Corp.*, 2016 U.S. Dist. LEXIS 103594 (N.D. Cal. 2016); one of a number of articles discussing the case—with a link to a copy of the funding agreement—can be found here: Ben Hancock, *How Jones Day Unmasked a Litigation Funding Deal and Won*, The American Lawyer, October 29, 2017, *available at* https://www.law.com/americanlawyer/sites/ americanlawyer/2017/10/29/how-jones-day-unmasked-a-litigation-funding-deal-and-won.

[21]*See, e.g.*, Christopher P. Bogart, *Freshfields says that litigation funding improves the quality of litigation*, April 26, 2016, *available at* http://www.burfordcapital.com/blog/ blog-freshfields-says-litigation-funding-improves-quality-litigation.

[22]See *supra* notes 9, 10, and 11.

FRAUD & LAUNDERING IN LAS VEGAS: FORMER US TAX ATTORNEY, NOW DEFENSE LAWYER, JEFF SETNESS LOOKS AT THE TRENDS IN TAX FRAUD CRIMES & ENFORCEMENT

By Gregg Wirth

Gregg Wirth is a financial journalist and the Managing Editor of Thomson Reuters' Wall Street Lawyer. Contact: gregg@gwirth.com.

As an attorney experienced in prosecuting and defending tax fraud cases, Jeff Setness has seen a lot from both sides of the legal table in his 34 years in law—and sometimes it still surprises him.

After stints in both the Judge Advocate Generals Corps of the Navy and in the US Department of Justice (DOJ) as a Tax Division Trial Attorney and Assistant US Attorney, Setness enter private practice in 1993, defending many of the same types of tax cases he once prosecuted.

"I think when someone's a prosecutor they may not see—through no fault of their own—what I call the human element or the motivation of the alleged perpetrator, because as a prosecutor sometimes you look at cases in very stark terms," Setness says. "But as a defense counsel, now you start to see cases in terms of every shade of gray."

Trends in Fraud Enforcement

Today, Setness works in the Las Vegas office of Fabian VanCott, a 70-lawyer firm with offices in Las Vegas and Salt Lake City. And, over the years, he's seen interesting trends develop in enforcement of criminal tax crimes, healthcare fraud, money laundering, and currency transaction fraud.

"After moving to Las Vegas as an Assistant US Attorney, I saw an increase in the prosecution of the structuring of currency transactions, and they still pop up on the radar today," Setness says.

Structuring of currency transactions—which snagged both disgraced US congressman Denny Hastert and several of the defendants in the FIFA scandal that shook the world of organized soccer—is enforced under Title 31 of the U.S. Code § 5324, and it's that regulation by which the Internal Revenue Service investigates these transactions. In fact, *Ratzlaf v. U.S.*,[1] which the Supreme Court decided in 1993, really defined how these cases are adjudicated and enforced.

Ratzlaf v. US—The Case that Defined Illegal Structuring Enforcement Actions

In *Ratzlaf*, defendant Waldemar Ratzlaf ran up a gambling debt of $160,000 to a Las Vegas casino. He tried to pay the casino in cash and added that he did not want any report of the transaction to be made to the Treasury Department. The casino manager initially refused those terms but then offered to send Ratzlaf around (in a casino-supplied limo) to several area banks where he could obtain numerous cashier checks in the amount of $9,900 each, which is below the level of required reporting.

"It's quite a complicated process, but I saw a rise in cases involving structuring of currency transactions and money laundering," says Setness, who argued the *Ratzlaf* case before the US Circuit Court of Appeals for the Ninth Circuit prior to it moving to the Supreme Court. (Ultimately, the Supreme Court ruled that Ratzlaf didn't act with enough "willful" intent in evading the reporting requirements to be found guilty of that crime.)

"And when I moved back to Las Vegas in 2012, I saw a big push in the enforcement of the US Bank Secrecy Act and the reporting of suspicious transactions."

Interestingly, Setness notes, the Bank Secrecy Act evolved over the years to include Las Vegas casinos, which are now considered financial institutions under the Act. And with about $15 million per day being taken in by Las Vegas casinos, according to University of Las Vegas research,[2] the casinos' designation as financial institutions isn't surprising.

Setness has represented casinos as they try to get into compliance with the Bank Secrecy Act and says his first task often is getting the casinos to accept the fact that they are a financial institution for the purpose of the Act, and beholden to all the reporting requirements and paperwork that designation entails. "It's been quite a development of the law and enforcement for the casinos."

"And when I moved back to Las Vegas in 2012, I saw a big push in the enforcement of the US Bank Secrecy Act and the reporting of suspicious transactions."

Beyond Casinos: Tax Crime and Enforcement Trends

Beyond the casinos, Setness says he's seen developing tax crime and enforcement trends in areas such as tax return preparation, employment taxes, and healthcare fraud. "I'm seeing a big emphasis in enforcement on tax return preparers today," Setness explains, adding that tax return preparer criminal prosecutions are clearly a focus for the government, especially since 2016 when the uptick began. "And I think the reasons are obvious," he says. "Because the illicit conduct of a single tax return preparer can impact a huge number of returns. If a tax return preparer prepares 100 returns that contain incorrect information, for example, think about the fiscal impact!"

Enforcement of employment taxes are becoming more a priority for government tax prosecutors as well because employment taxes have to be paid to the IRS by the employer, Setness observes. "So, obviously if they're not doing so, there is harm to the IRS and there is harm to those employees because their taxes are not being paid in."

Healthcare fraud is another area where the IRS is becoming more active, because the dollar volume of the fraud is so large, and these prosecutions can be so complex and paper-intensive. "Healthcare fraud can also impact the health of your average citizen," he says. "So, it's understandable to see IRS criminal investigators now working in that area."

As defense counsel, Setness says he's noticed that sometimes good people commit criminal acts, and while that doesn't mean the case against them should be not be pursued, it's important to realize there's many different circumstances that can lead to the commission of a crime. "As a result, I like to look at all the facts and circumstances and find out how this person got to where they're at."

Healthcare fraud is another area where the IRS is becoming more active, because the dollar volume of the fraud is so large, and these prosecutions can be so complex and paper-intensive.

ENDNOTES:

[1]*Ratzlaf v. U.S.*, Supr. Ct., No. 92-1196; January 11, 1994.

[2]*See* the UNLV Center for Gaming Research reports, *available at* https://gaming.unlv.edu/reports.html.

STATEMENTS FROM THE SEC'S ROUNDTABLE ON PROXY PROCESS: A DISCUSSION OF VOTING MECHANICS, SHAREHOLDER PROPOSALS & PROXY ADVISORS

By SEC Commissioners

On November 15, the Securities and Exchange Commission held a roundtable to discuss the issue of the proxy process on U.S. public companies, specifically around areas of proxy voting mechanics and technology, shareholder proposals, and proxy advisors. The following were comments made by members of the SEC before the beginning of the roundtable event.

From SEC Chairman Jay Clayton

Please remember that our capital market system—a system that is built on a combination of state corporate law and federal securities regulation—is one of America's greatest strengths and its contributions flow far beyond our borders. This is a ubiquitous and unquestionable fact; perhaps that is why we sometimes fail to remember it.[1]

Also, that system has, in large part, effectively addressed the principal-agent problems that are inherent in pooling capital. Moreover, we have done so in a way that fosters broad investor participation and nimble flows of capital and labor, relying on the bedrock principles of transparency, materiality, clarity of law, and efficient decision making.[2] It is these important principal-agent and participation issues that we are discussing today. The question on the table is: can we improve that system?

Finally, a related question, who are we improving it for? I believe the answer is our long-term Main Street investors. I hope you will approach these important issues them in mind—those who have put or are putting $50, $100, $200 a month away for years and years.

From Commissioner Kara M. Stein

As we all know, the Commission's mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[3] Central to this mission are the laws and rules that govern a shareholder's ability to engage with the company that he or she owns.[4] The Commission's proxy rules allow an investor to actively participate in a company's governance structure. They can afford a single investor a powerful voice.[5] The value of this is not abstract.[6] Shareholders often fight for corporate values that empirically have positive, direct, and long-term effects on the corporate bottom line. In this way, the effects of our proxy rules are not confined to just shareholder-company communications. They allow our capital markets to continue to be among the most vibrant and stable in the world.

Unfortunately, our current proxy regime is arcane at best.[7] Some of this is due to the manner in which proxy materials are distributed and votes are processed. In addition, the way in which many investors hold their shares—through broker-dealers or other intermediaries—introduces further complexity into an already opaque system. As a result, the proxy system does not involve just a company and its shareholders. It involves an array of third-parties, such as broker-dealers, banks, custodians, transfer agents, and proxy advisors, to name a few. While this tangled web has helped to create a plethora of cottage industries, it has not necessarily helped to provide transparency to either companies or their investors.

Today's roundtable will focus on three areas within the proxy regime: proxy voting mechanics and technology, shareholder proposals, and proxy advisors. Each of these areas is a spoke in the overall proxy wheel. They form the framework through which shareholders ultimately communicate with the companies they own.

As far as this morning's first panel is concerned, I am interested in hearing how technology can help proxy mechanics. For example, should companies be able to use distributed ledger or blockchain technology to identify and reach their shareholder bases more efficiently?[8] Would standing voting instructions allow companies to hear from their retail investors more effectively?[9]

Should companies be able to use distributed ledger or blockchain technology to identify and reach their shareholder bases more efficiently?

With respect to shareholder proposals, I would like to hear about the broader shareholder proposal process and, in particular, the numerous pieces of guidance the SEC's staff has issued over the years—from no-action letters to staff legal bulletins.[10] Has the staff guidance remained true to the Commission's rules? Or is the guidance having the effect of silencing proposals that could enhance company value?

Finally, with respect to proxy advisors, I'd like to better understand the role of a proxy advisor in the overall proxy architecture.[11] Just yesterday, a bipartisan bill was introduced in the Senate that would require the Commission to regulate proxy advisors under the Investment Advisers Act.[12] As one Senator noted, "Millions of hardworking Americans rely on th[e] guidance [provided by proxy advisors] for safeguarding their retirement savings."[13] Should proxy advisors be regulated and, if so, how? How would this help or harm investors of all sizes?

Hopefully, today's roundtable will be a new start to a longstanding conversation.

From Commissioner Elad L. Roisman

The first panel today will address the proxy voting process and technology. While this topic is very broad and the panel is very large, I hope that you will get the chance to address a few subjects that I think are very important to the proxy voting process.

- The current proxy voting process and system were developed decades ago. If we were to start from scratch, what changes would we make?
- Companies are required to disclose in their proxy statements the treatment and effect of broker non-votes. When brokers hold shares in street name for the benefit of other investors, generally they may not cast votes on non-routine matters (possibly apart from votes that count toward quorum) unless they have received specific instructions from the beneficial owners. This is a construct of stock exchange rules, which the SEC approves, as well as the Dodd-Frank Act.[14] Passive index fund managers, however, may vote shares without having a prior obligation to reach out to individual investors concerning their voting preferences. Does this distinction make sense, especially considering the Commission's proposed Regulation Best Interest?[15] Should asset managers reach out to the underlying holders to understand their voting preferences?
- Critical to the corporate-shareholder ecosystem is confidence that votes are being counted accurately. As this function is often outsourced, who has the responsibility to ensure an accurate vote count? Should companies, voting intermediaries, or participants do more, especially when the outcome appears to be a close call? How do investors know that their votes were actually cast, and are they affected by practices such as securities lending?

The second panel today will focus on shareholder proposals. I want to stress the importance of shareholders being able to engage with management of companies, and not just in the context of annual meetings. Shareholders are the owners of a company and have the right for their voices to be heard. Shareholder proposals are a means for long-term shareholders to engage with both management and other shareholders. Sometimes, this right to vote is not enough for certain shareholders to express their views or displeasure about a topic, such as in instances when the board is unaware of a matter important to shareholders or unwilling to bring that matter to a vote. We have to strike a balance, though, between proponents who seek to increase shareholder value with their proposals and those who exploit the process to further their personal agenda. Proposals brought by the latter can be a waste of shareholders' time and money, as it is the shareholders who ultimately bear the costs companies spend defending these proposals.

One area that I would encourage participants to discuss is the eligibility requirements for shareholder proposal submissions and resubmissions. The Commission last considered the thresholds for shareholder proposal submissions and resubmissions in 1998, and we have no economic analysis to support the current thresholds.[16] A lot has changed in 20 years, and I think it is appropriate for us to consider whether these thresholds are still appropriate and to do so in a reasoned way.

- For shareholder proposals, is the monetary threshold still appropriate in light of inflation or other changes in the marketplace? Is a monetary threshold appropriate at all? What about percentage of shares held? Should that be one-size-fits-all, or tailored to a company's public float or number of outstanding shares? The required holding period should be reconsidered, as well. What period of time is long enough to determine that a shareholder proposal is being proposed by someone who shares the concerns of long-term shareholders?

- I am also interested to hear your perspectives on resubmission thresholds. Are they appropriately set to ensure that the same unpopular proposal (or a slight variation of such a proposal) is not presented to shareholders year after year?

- Additionally, I am interested to hear your thoughts on "proposal by proxy." I am aware that the Division of Corporation Finance stated last year that it is of the view that a shareholder's submission by proxy is consistent with Rule 14a-8.[17] How is it in the long-term interest of shareholders to allow this practice when the person bringing the proposal either is not a shareholder or cannot qualify to bring the proposal on his or her own? How does this practice protect investors?

The last panel will discuss proxy advisory firms, which have increasingly played a central role in advising fund managers on how to vote proxies and thereby influencing outcomes for fund investors. Given this role, I believe the SEC, fiduciaries that use their services, and members of the shareholder-voting ecosystem must assess how these firms operate and manage conflicts of interest.

- Proxy advisors, particularly the largest firms (ISS and Glass Lewis) have notable conflicts of interests that arise from their affiliations, including their ownership and major customers, as well as from their other business activities, such as advising public companies on corporate governance and perhaps even providing services in addition to voting recommendations to activist hedge funds. How are these firms managing such conflicts when formulating voting recommendations? How are these conflicts disclosed to their customers? Does ISS operate under different obligations because it is an SEC-registered investment adviser while other proxy advisors are not?

- Given the large role that they have, are proxy advisory firms becoming de facto standard setters and influencing corporate behavior?
- Accuracy of the facts underlying voting recommendations is another important issue. How are proxy advisors ensuring they produce voting recommendations based on accurate information? What controls do proxy advisors have in place? And, what opportunity exists for public companies to discuss a potential recommendation or correct erroneous information that the proxy advisor has published? While, in some instances, S&P 500 companies are given the opportunity to review ISS' recommendations before publication, smaller companies have no access to ISS.[18] Wouldn't all companies (and their shareholders) benefit from a meaningful rebuttal period?
- Next, how do proxy advisory firms' voting guidelines serve the interests of investors?[19]
- Should regulations address how proxy advisors prioritize the varying interests of investors and otherwise develop and justify their recommendations?

Finally, fund managers have evolved to play an outsized role in voting proxies—particularly managers of diversified passive funds, which hold shares in thousands of public companies on behalf of millions of Main Street investors. These investment advisers have a fiduciary duty to the funds they advise. I hope the panels today, and subsequent comment letters, will discuss how they are, or should be, fulfilling this duty in the context of proxy voting.

- Are fund managers seeking to vote proxies in ways that maximize the value of company stock to their shareholder investors? What data is used to justify their decisions? Are the reasons for fund managers' voting practices adequately explained to fund investors? To what extent are fund voting decisions decoupled from a fund's portfolio management?
- If an adviser manages funds with differing objectives (such as an ESG-focused fund vs. a fund focused on stocks that pay large dividends), does it cast votes on the same proxy proposals differently for the different funds?
- To what extent are advisers relying on proxy advisor recommendations as a means to minimize a fund's costs of analyzing and voting proxies? By focusing on minimizing costs, are advisers utilizing less bespoke recommendations from proxy advisory firms regarding each issuer held by the fund, despite different funds having differing objectives?
- When utilizing services of a proxy advisory firm, how are the fund managers continually conducting due diligence on these

recommendations and holding these firms accountable?

- Do fund managers analyze how past votes have affected shareholder value or otherwise served a fund's objectives, especially with respect to M&A activities?
- Finally, what additional guidance should the SEC provide to assist fund managers in this context?

I look forward to hearing everyone's suggestions for improvement, and I ask that you keep in mind when you ask for change that the SEC must take a balanced approach to rulemaking. Any changes that we make must promote capital formation, promote market integrity, and protect investors.

ENDNOTES:

[1]More than half of the largest public companies (54 of the top 100) are U.S. companies. *See*PwC, Global Top 100 companies by market capitalization (March 31, 2018), *at* https://www.pwc.com/gx/en/audit-services/assets/pdf/global-top-100-companies-2018-report.pdf.

[2]*See* Chairman Jay Clayton, Opening Remarks at SEC-NYU Dialogue on Securities Markets #4: Shareholder Engagement (Jan 19, 2018), *at* https://www.sec.gov/news/speech/clayton-2018-01-19.

[3]*See* https://www.sec.gov/Article/whatwedo.html.

[4]*See* Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 Vand. L. Rev. 1129 (1993).

[5]*See, e.g.*, "Evelyn Y. Davis, shareholder activist and CEO foil, dead at 89," CBS News MoneyWatch (Nov. 5, 2018), *available at* https://www.cbsnews.com/news/evelyn-y-davis-shareholder-activist-and-ceo-foil-dead-at-89/.

[6]*See* Commissioner Kara M. Stein, *Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance*, Remarks at Stanford University (Feb. 13, 2018), *available at* https://www.sec.gov/news/speech/speech-stein-021318.

[7]*See* Proxy Concept Release, *supra* note 2.

[8]*See, e.g.*, Jeff John Roberts, "Companies Can Put Shareholders on a Blockchain Starting Today," Fortune (Aug. 1, 2017), *available at* http://fortune.com/2017/08/01/blockchain-shareholders-law/.

[9]*See* Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 Minn. L. Rev. (2017).

[10]Over the years, the SEC's staff has issued numerous no-action letters that more or less tell companies whether the staff agrees with their determinations to exclude shareholder proposals. *See* https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8.shtml. But these letters do not say much as to *why* the staff agrees. Hence, the staff has also issued a number of staff legal bulletins that describe the staff's thinking. *See* https://www.sec.gov/interps/legal.shtml. Most recently, the staff issued Staff Legal Bulletin No. 14J, *available at* https://www.sec.gov/corpfin/staff-legal-bulletin-14j-shareholder-proposals.

[11]In short, proxy advisors help institutional investors by providing analysis and voting recommendations. These larger investors typically own shares in a large number of companies and have fiduciary obligations to vote these shares on behalf of their stakeholders. In this way, the relationship between a proxy advisor and an investor is important. For example, to the extent conflicts of interest are not sufficiently disclosed and addressed, investors could be harmed. To be sure, some have called for greater oversight of these entities in view of their "substantial influence on proxy voting matters." *See* David A. Katz & Trevor Norwitz, "Congress Increases Pressure on Proxy Advisory Firms," Harvard Law School Forum on Corporate Governance and Financial Regulation (May 23, 2018), *available at* https://corpgov.law.harvard.

edu/2018/05/23/congress-increases-pressure-on-proxy-advisory-firms/. While others for different, but related, reasons believe that appropriate regulation is imperative. *See* Corporate Governance Fairness Act, infra note 12.

[12]*See* "As SEC Evaluates Proxy Process, U.S. Senators Introduce Corporate Governance Fairness Act" (Nov. 14, 2018) ("Corporate Governance Fairness Act"), *available at* https://www.reed.senate.gov/news/releases/as-sec-evaluates-proxy-process-us-senators-introduce-corporate-governance-fairness-act (discussing the introduction of the Corporate Governance Fairness Act, which is designed to "help ensure that investors may confidently rely on the advice of proxy advisory firms by requiring the U.S. Securities and Exchange Commission (SEC) to regulate all major proxy advisory firms under the Investment Advisers Act (IAA)").

[13]*See* Corporate Governance Fairness Act, *supra* note 12.

[14]*See* NYSE Rule 452 and Section 952 of the Dodd-Frank Wall Street Reform Act of 2010.

[15]Regulation Best Interest (Proposed Rule), File No. S7-07-18 (Apr. 18, 2018).

[16]*See* Exchange Act Release No. 34-40018 (May 21, 1998) (adopting), where the Commission increased the dollar value of a company's voting shares that a shareholder must own in order to be eligible to submit a shareholder proposal but decided not to adopt the proposed increase to resubmission thresholds.

[17]Staff Legal Bulletin No. 14I (CF) (Nov. 1, 2017).

[18]According to the ISS website: "For determining which companies are eligible for a draft review, ISS generally uses the S&P 500 constituent list as of January 31st for annual meetings occurring during the following proxy season." *Available at* https://www.issgovernance.com/iss-draft-review-process-u-s-issuers/.

[19]Some guidelines appear arbitrary, or at least untethered to legal requirements or metrics. For example, ISS' guidelines state that it generally favors voting for resolutions that require disclosures on Climate Change/Greenhouse Gas Emissions without mentioning any legal requirements on companies to do so, value justifications, or thresholds of materiality to investors. *See, e.g.*, ISS' United States Proxy Voting Guidelines, at 57 (guidelines generally favor voting for resolutions requiring disclosures on Climate Change/Greenhouse Gas (GHG) Emissions with no mention of whether this information is material to investors). Other guidelines I have seen actually appear to *undermine* legal authority. Glass Lewis' 2019 Proxy Paper Guidelines state that it will make note of instances where a public company has successfully petitioned the SEC to exclude shareholder proposals and potentially recommend against members of the company's governance committee. *See, e.g.*, Glass Lewis' 2019 Proxy Paper Guidelines, at 29 ("Glass Lewis will make note of instances where a company has successfully petitioned the SEC to exclude shareholder proposals. If after review we believe that the exclusion of a shareholder proposal is detrimental to shareholders, we may, in certain very limited circumstances, recommend against members of the governance committee.").

SEC/SRO UPDATE:

OCIE RELEASES EXAMINATION INITIATIVES FOR REGISTERED INVESTMENT COMPANIES; OCIE ISSUES RISK ALERT RELATED TO THE CASH SOLICITATION RULE FOR INVESTMENT ADVISERS; SEC CRACKS DOWN ON UNREGISTERED COIN OFFERINGS

By Peter H. Schwartz & Scott Turbeville

Peter H. Schwartz is a partner and Scott

Turbeville is an associate in the law firm of Davis Graham & Stubbs LLP in Denver, Colo. Contact: peter.schwartz@dgslaw.com or scott.turbeville@dgslaw.com.

OCIE Releases Examination Initiatives for Registered Investment Companies

On November 8, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) released a Risk Alert about a series of examination initiatives focused on mutual funds and exchange-traded funds (ETFs) in order to "assess industry practices and regulatory compliance in certain areas that may have an impact on retail investors."[1]

In the Risk Alert, OCIE identified six focus areas for funds and advisers, including:

- Index funds that track custom-built indexes;
- Smaller ETFs and ETFs with little secondary market trading volume;
- Mutual funds with higher allocations to certain securitized assets;
- Funds with aberrational underperformance relative to their peer groups;
- Advisers relatively new to managing mutual funds; and
- Advisers who provide advice to both mutual funds and private funds that have similar strategies and are managed by the same portfolio managers.

OCIE indicated that although the examination scope and focus area will be tailored to address the business practices, risks, and conflicts applicable to each topic, the staff will generally assess:

- Policies and procedures of the funds and their advisers, to validate that they are designed to address risks and conflicts, including funds' boards oversight of the compliance program;
- Disclosures by funds to investors in their prospectuses and other filings and shareholder communications, and by advisers to the funds' boards, regarding risks and conflicts; and
- Deliberative processes utilized by funds, their advisers, and their boards exercising oversight, particularly when assessing practices and controls related to risks and conflicts, including disclosures, portfolio management compliance, and fund governance.

OCIE also indicated that while these are the primary focus areas for the initiatives, the staff may select additional topics based on operational and other risks identified during the examinations.

OCIE Issues Risk Alert Related to the Cash Solicitation Rule for Investment Advisers

On October 31, OCIE issued a Risk Alert to provide investment advisers, investors, and other market participants with information concerning the most common deficiencies the staff had cited relating to Rule 206(4)-3 (the "Cash Solicitation Rule") under the Investment Advisers Act of 1940.[2]

The Risk Alert included observations by

OCIE staff and was "intended to assist investment advisers in identifying potential issues and adopting and implementing effective compliance programs."

Investment advisers required to be registered under the Advisers Act are generally prohibited from paying a cash fee, directly or indirectly, to any person who solicits clients for the adviser unless the arrangement complies with several conditions. Among other things, the cash fee must be paid pursuant to a written agreement to which the adviser is a party. The solicitor may not be a person subject to certain disqualifications specified in the Cash Solicitation Rule.

There are additional requirements when the solicitor is not a partner, officer, director, or employee of the adviser or of an entity that controls, is controlled by, or is under common control with, the adviser (a "third-party solicitor"), including:

- the solicitation agreement must contain certain specified provisions (*e.g.*, a description of the solicitation activities and compensation to be received);
- the solicitation agreement must require that, at the time of any solicitation activities, the solicitor provide the prospective client with a copy of (*i*) the adviser's brochure pursuant to Advisers Act Rule 204-3; and (*ii*) a separate, written disclosure document containing required information that highlights the solicitor's financial interest in the client's choice of an adviser;
- the adviser must receive from the client, before or at the time of entering into any written or oral agreement with the client, a signed and dated acknowledgment that the client received the adviser brochure and the solicitor disclosure document; and
- the adviser must make a bona fide effort to ascertain whether the solicitor has complied with the solicitation agreement and must have a reasonable basis for believing that the solicitor has so complied.

Some of the most commonly cited deficiencies include:

- *Solicitor disclosure documents*—OCIE staff observed advisers whose third-party solicitors did not provide solicitor disclosure documents to prospective clients or provided solicitor disclosure documents that did not contain all the information required by the Cash Solicitation Rule.
- *Client acknowledgements*—OCIE staff observed advisers that did not receive in a timely manner a signed and dated client acknowledgement of receipt of the adviser brochure and the solicitor disclosure document. Staff also observed advisers that received client acknowledgements, but such client acknowledgements were undated or dated after the clients had entered into an investment advisory contract.
- *Solicitation agreements*—OCIE staff observed advisers that paid cash fees to a solicitor without a solicitation agreement in effect or pursuant to an agreement that did not contain certain specific provisions.
- *Bona fide efforts to ascertain solicitor compliance*—OCIE staff observed advis-

> ers that did not make a bona fide effort to ascertain whether third-party solicitors complied with solicitation agreements and appeared to not have a reasonable basis for believing that the third-party solicitors so complied. For example, staff observed advisers that were unable to describe any efforts they took to confirm compliance with solicitation agreements.

SEC Cracks Down on Unregistered Coin Offerings

On November 16, the SEC announced its first ever civil penalty against issuers for failing to register initial coin offerings (ICOs). This action was part of a larger series of cases in which the agency has cracked down on alleged abuses in the digital currency industry.

According to the SEC's announcement, CarrierEQ Inc., known as Airfox, and Paragon Coin Inc., both cryptocurrency startups, conducted ICOs in 2017 after the SEC warned in its DAO Report of Investigation that ICOs can be viewed as securities offerings.[3] Airfox raised approximately $15 million in its ICO to finance an app for users in emerging markets to earn and exchange tokens. Paragon raised approximately $12 million in its ICO to develop and implement its business plan to add blockchain technology to the cannabis industry. According to the SEC, neither Airfox nor Paragon registered their ICOs pursuant to the federal securities laws, nor did they qualify for an exemption to the registration requirements. According to the SEC, both startups have agreed to compensate allegedly harmed ICO investors, pay penalties, register their tokens as securities pursuant to the Securities Exchange Act of 1934, and file periodic reports with the SEC for at least one year.

The Airfox and Paragon cases follow the SEC's first non-fraud ICO registration case last year against crypto startup, Munchee, Inc. The SEC did not impose a penalty in that case, however, because Munchee stopped its unregistered offering before delivering any tokens and promptly returned the offering proceeds to its investors.

In addition, the announced settlement with Airfox and Paragon came a week after the SEC announced another "first," settling charges that another crypto firm, EtherDelta, was operating as an unregistered national securities exchange.[4] According to the SEC's order, EtherDelta provided a marketplace for bringing together buyers and sellers for digital asset securities through the combined use of an order book, a website that displayed orders, and a "smart contract" run on the Ethereum blockchain. EtherDelta's smart contract was coded to validate the order messages, confirm the terms and conditions of orders, execute paired orders, and direct the distributed ledger to be updated to reflect a trade.

These cases underscore the SEC's insistence that the relatively new digital currency industry needs to follow traditional securities rules. "We have made it clear that companies that issue securities through ICOs are required to comply with existing statutes and rules governing the registration of securities," Stephanie Avakian, the Co-Director of the SEC's Enforcement Division, said in a statement announcing the Airfox and Paragon settlements. "These cases tell those who are considering taking similar actions that we continue to be on the lookout for violations of the federal securities laws with respect to digital assets."

ENDNOTES:

[1]Office of Compliance Inspections and Examinations, Securities and Exchange Commission, "Risk-Based Examination Initiatives Focused on Registered Investment Companies" (Nov. 8, 2018), *available at* https://www.sec.gov/ocie/announcement/ocie-risk-alert-registered-investment-company-initiative.

[2]Office of Compliance Inspections and Examinations, Securities and Exchange Commission, "Risk Alert: Investment Adviser Compliance Issues Related to the Cash Solicitation Rule" (Oct. 30, 2018), *available at* https://www.sec.gov/ocie/announcement/risk-alert-investment-adviser-compliance-issues-related-cash-solicitation-rule.

[3]See SEC Rel. No. 2018-264 (November 16, 2018), *available at* https://www.sec.gov/news/press-release/2018-264; See also SEC, Release No. 81207, Release No. 81207, *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.

[4]See SEC Rel. No. 2018-258 (November 8, 2018), *available at* https://www.sec.gov/news/press-release/2018-258.

FROM THE EDITORS

Regulatory Enforcement Reports Show Success, Just Don't Look at the Numbers

As enforcement cases have fallen over the past two years for the top regulatory bodies for U.S. securities, top federal officials were quick to point out that numbers, in and of themselves, don't tell the real story of their regulatory efforts.

These comments were included in the release in November of the fiscal-2018 annual reports on enforcement efforts of both the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Another major regulatory agency, the Financial Industry Regulatory Authority, Inc., (FINRA) releases monthly totals of its enforcement actions.

In the prologue to its annual report on enforcement accomplishments—just its second such annual report—SEC Enforcement Co-Directors Stephanie Avakian and Steven Peikin spurned raw number comparisons as a true measure of success. "Quantitative metrics—for example, the raw number of cases filed, or the total amounts of fines and penalties assessed during an arbitrary time period such as a single fiscal year—cannot adequately measure the effectiveness of an enforcement program," Avakian and Peikin wrote in the opening to the report.

Instead, the pair explained that a better measure of the effectiveness of the program can be gained by assessing "the nature, quality, and effects of the Commission's enforcement actions." Interestingly, FY 2018 reflected a higher level of enforcement activity, with the SEC bringing 821 actions and obtaining judgments and orders totaling more than $3.9 billion in disgorgement and penalties. "By these raw metrics, our overall results improved compared to FY 2017."

The CFTC annual enforcement report, released less than two weeks after the SEC's, also urged that any discussion of the agency's success not just look at the numbers. "Any end-of-year report discussing metrics of success inevitably places a certain emphasis on numbers—but a strong enforcement program is about much more than that," the CFTC said in a summary of the report. "It's about preserving market integrity, protecting customers, and deterring misconduct from happening in the first place."

If the regulatory agencies sound a bit defensive, it's not without reason. A recent study showed that SEC enforcement cases had dropped to their lowest level in five years, which some viewed as a confirmation of President Donald Trump's promise to ease up on Wall Street regulation and instead focus on retail market abuses, which reduces the likelihood of large-dollar enforcement actions.

In October, the SEC's Peiken and FINRA's CEO Robert Cook both made public speeches in response to the numbers' downturn. Similar to the SEC, FINRA has shown a sharp decline in disciplinary actions, with fines dropping almost 63% compared to the prior year.

At the time, too, Peikin said the SEC's shifting focus has been effective in aligning enforcement with the agency's core mission of providing investor protection. And both regulators said their agencies remain committed to policing Wall Street fraud.

Wall Street Lawyer will be keeping its eyes open to ensure they do.

John Olson & Gregg Wirth

EDITORIAL BOARD

Wall Street LAWYER

West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

FIRST CLASS
MAIL
U.S.POSTAGE
PAID
WEST

Wall Street LAWYER

THOMSON REUTERS

West LegalEdcenter
610 Opperman Drive, Eagan, MN 55123
Phone: 1-800-344-5009 or 1-800-328-4880
Fax: 1-800-340-9378
Web: http://westlegaledcenter.com

YES! Rush me ***Wall Street Lawyer*** and enter my one-year trial subscription (12 issues) at the price of $1,092.00. After 30 days, I will honor your invoice or cancel without obligation.

Name ____________________

Company ____________________

Street Address ____________________

City/State/Zip ____________________

Phone ____________________

Fax ____________________

E-mail ____________________

METHOD OF PAYMENT

❑ BILL ME

❑ VISA ❑ MASTERCARD ❑ AMEX

Account # ____________________

Exp. Date ____________________

Signature ____________________

Postage charged separately. All prices are subject to sales tax where applicable.