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Third Annual Federal Enforcement Forum Agenda
Thursday, December 1, 2016
Washington, DC

12:30 p.m. – 12:35 p.m. **Welcome**

12:35 p.m. – 1:35 p.m.

Panel I: Financial Services Enforcement—the Impact of the CFPB and the PHH Corp. Decision

Prior to the creation of the CFPB, enforcement actions targeting banks and financial services firms were generally limited to cease and desist orders. In the five years since its inception, the CFPB has announced that it has collected over $11 billion in civil money penalties from its enforcement actions. This panel will explore this significant change in approach, including the reaction by the prudential regulators. In addition, the panel will address the recent D.C. Circuit's decision (PHH Corp. et al. v. CFPB) regarding the unconstitutionality of the CFPB ruling and the impact of this ruling on financial services enforcement.

Moderator: **Joseph T. Lynyak III**, Partner, Dorsey & Whitney LLP and
J.H. Jennifer Lee, Partner, Dorsey & Whitney LLP
Dennis Kiefer, Director, Deloitte Financial Advisory Services LLP

1:45 p.m. – 2:45 p.m.

Panel II: CFTC/FERC Enforcement

In 2016, FERC and CFTC expanded their enforcement reach in the market manipulation area and, for the first time, brought an insider trading case. FERC is also imposing significant civil penalties and banning traders from the markets. This panel will analyze these key FERC and CFTC enforcement trends and discuss their limitations, putting you out in front of these key trends.

Moderator: **Joseph Hall**, Partner & Co-Chair of Energy Industry Group, Dorsey & Whitney LLP
Thomas O. Gorman, Partner, Dorsey & Whitney LLP and former SEC Enforcement Official
Shaun D. Ledgerwood, Principal, The Brattle Group

2:55 p.m. – 3:55 p.m.

Panel III: Key Issues in SEC Enforcement

Public companies, private equity, investment advisers, brokers and others who are regulated by, or deal with, the SEC can be impacted by the agency. Understanding key trends regarding the direction of its enforcement program today and, more importantly tomorrow, is critical. This year, the panel will focus on the pending Supreme Court decision on insider trading which has the potential to rewrite insider trading enforcement, recent enforcement actions against private equity firms and investment advisers, and the future direction of the enforcement and inspection programs to ensure that you know today what will be critical for business decisions tomorrow.

Moderator: **Thomas O. Gorman**, Partner, Dorsey & Whitney LLP and former SEC Enforcement Official
Genna Garver, Of Counsel and Chair of Investment Management Group, Dorsey & Whitney LLP
Paul Glenn, Special Counsel, Investment Advisers Association
David Lipton, Professor of Law, Columbus School of Law, Catholic University of America

4:05 p.m. – 5:05 p.m.

Panel IV: Environmental Enforcement

Corporate liability for environmental violations remains a key issue of concern for companies across industry sectors. With a growing focus on holding management responsible for a company's actions, management must take proactive steps to build a compliance structure and be able to respond quickly to accidents, investigations and heightened scrutiny. The panel will carefully analyze these trends to put you ahead of the curve and ahead of agency enforcement.

Moderator: **Jim Rubin**, Partner, Dorsey & Whitney LLP
Doug Parker, President, E&W Strategies Group, formerly Director of EPA's Criminal Investigation Division

Federal Enforcement Forum
Speaker Biographies

Genna Garver
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Genna Garver is Of Counsel in Dorsey's Corporate Group and chairs the Investment Management practice. Ms. Garver takes pride in the close personal attention she provides when advising investment management clients in connection with federal and state securities laws, private fund formation and securities offerings. She has extensive experience representing financial institutions in transactional and regulatory matters. She focuses on representing investment advisers, hedge funds and other private investment funds implementing various investment strategies. Ms. Garver advises clients on: formation and offering matters for both domestic and offshore funds; SEC and state investment adviser, broker-dealer and private fund regulation; Investment Advisers Act compliance programs; and mock audits and regulatory examinations and investigations. She also counsels banking and private fund clients on all aspects of the Volcker Rule and related matters.

Paul D. Glenn
Special Counsel
Investment Adviser Association
Washington, DC

Paul Glenn joined IAA in February 2006. Mr. Glenn grew up in Cleveland, OH, and has spent his professional career in the Washington, DC area. He has worked at the US Securities and Exchange Commission as a trial attorney and special counsel in the Division of Enforcement and the Office of General Counsel, respectively. Mr. Glenn has also worked at the Office of the Comptroller of the Currency (then OTS), US Treasury, as Deputy Chief Counsel and special counsel. He served as Vice President and Director of Compliance for PNC Bank N.A. in Washington, DC, (formerly Riggs) and Washington First Bank N.A. in Reston, VA (formerly Millennium Bank N.A.). Mr. Glenn has his masters of law degree (LLM) from Georgetown University Law Center and his Juris Doctor and Bachelor of Arts (Political Science) from Case Western Reserve University. In 2010, he received an honorary doctor of laws degree from Nyack College, Nyack, NY. Mr. Glenn is a member of the Bar of the Supreme Court of Ohio, the Supreme Court of the United States, and other federal courts.

Thomas O. Gorman
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Tom Gorman is a Partner in Dorsey's Government Enforcement & Corporate Investigation Group. He has defended public companies and individuals in regulatory actions involving insider trading, market manipulation, financial fraud, corporate governance matters, accounting and auditing issues, FCPA issues, and similar matters. He has also defended securities class action and derivative suits and led teams conducting internal investigations focused on financial fraud and other securities law issues. Mr. Gorman regularly speaks on, and publishes articles regarding, securities litigation issues including the FCPA, internal investigations, financial fraud and insider trading. He has been interviewed on these issues by the *New York Times*, *Wall Street Journal*, *Washington Post*, *Financial Times*, and other leading publications in addition to appearing on CNBC, CNN, and other TV networks. Mr. Gorman publishes a widely-read securities blog, http://www.secactions.com/, which analyzes trends in securities enforcement inquiries and litigation, and provides expert commentary for the LEXIS Securities web page. He serves as a member of the editorial board of the Securities Regulation Law Journal. Mr. Gorman's practice regularly includes other complex business litigation matters arising under the securities, commodities, antitrust laws and the federal racketeering statutes. He served for seven years in positions of increasing responsibility on the staff of the Securities and Exchange Commission in Washington, D.C. Those positions included Senior Counsel, Division of Enforcement and Special Trial Counsel, Office of the General Counsel. In those positions, Mr. Gorman was responsible for the investigation and litigation of securities enforcement actions, accounting and auditing cases and defending suits brought against the Commission and its staff.

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Joe Hall is a Partner and Co-Chair of Dorsey's Energy Industry Group and is responsible for, among other things, developing, implementing and managing Dorsey's strategic initiatives in the power, clean tech, oil, and natural gas industries. Mr. Hall's practice focuses on the power industry, with an emphasis on industry participant responses to competition. He has extensive experience representing electric utilities, independent power producers, power marketers, industrial customers, private equity firms, and other entities in regulatory matters concerning, among other things: participation in Energy Markets, including Regional Transmission Organizations; "Open Access" policies; Transmission Planning and Cost Allocation; Mergers and Acquisitions; Market-Based Rate Authority; Standards of Conduct; Affiliate Restrictions; Rate Cases (transmission and wholesale power); Public Utility Regulatory Policies Act ("PURPA") (federal and state); Merchant Generation; Power Purchase Agreements; Renewable Generation and Integration (including distributed generation); FERC Enforcement and Compliance; FERC Litigation; and NERC Reliability.

Dennis Kiefer
Deloitte Financial Advisory Services LLP
Director
Washington, DC

Dennis Kiefer is a Director in Deloitte Financial Advisory Services LLP Washington DC office. Dennis has over 25 years' experience conducting forensic investigations, assisting legal counsel involved in complex commercial litigation as well as providing financial advisory consulting services to financial institutions, particularly in a regulatory context. He specializes in banking, mortgage lending and broker-dealers and investment advisory firms. Dennis has served as expert witness in litigation matters and has prepared damage claims under a wide variety of legal remedies. He also serves as a forensic (anti-fraud) specialist on some of Deloitte & Touche's largest financial services audit clients and provides fraud prevention consulting services to clients.

Shaun D. Ledgerwood
The Brattle Group
Principal
Washington, DC

Shaun Ledgerwood is an economic expert in the analysis of trading and hedging strategies in energy, commodity and financial markets, and in the enforcement and litigation of market manipulation claims. As a former economist and attorney for the Office of Enforcement for the FERC, he evaluated manipulative behavior within and across wholesale energy markets and related futures and derivatives contracts. Dr. Ledgerwood is the author of several published articles and a book on the definition, detection and analysis of manipulative trading behavior. He regularly presents on this topic at conferences and professional meetings.
Dr. Ledgerwood has developed an economic framework for evaluating allegedly

manipulative trading and uses this to assist clients in maintaining compliance, surveillance and for prosecuting or defending against enforcement actions and related lawsuits brought under antitrust principles or the anti-manipulation rules of the CFTC, FERC, SEC, or equivalent provisions in the EU. Dr. Ledgerwood is presently engaged as an expert in several such actions. He has testified as an expert witness before state utility commissions and in federal court on matters involving liability, damages and valuation. He taught graduate level classes in microeconomic theory, regulation, law and economics, antitrust, remedies and public policy for the University of Oklahoma and Georgetown University.

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Jenny Lee is a Partner in Dorsey’s Securities & Financial Services Litigation Group. She is a pragmatic problem solver. Ms. Lee assists clients in responding to Civil Investigative Demands from the CFPB and defends their interests in ongoing enforcement investigations or litigation matters, including drafting NORA response letters, negotiating compliance with CIDs and negotiating consent orders. As a former CFPB Enforcement Attorney, Ms. Lee understands how the CFPB thinks and applies its authorities to enforce consumer protection laws, including UDAAP, EFTA, GLB Act, FDCPA, FCRA, TILA and RESPA. Ms. Lee has extensive experience in consumer financial matters involving the CFPB, state attorneys general or state banking agencies, the Department of Justice and prudential banking regulators or in Congressional investigations. Her philosophy is that a client’s legal strategy should be managed carefully to fit the business’ budget, not the other way around. Ms. Lee assists banks and supervised institutions subject to CFPB supervisory examinations. She identifies multi-faceted issues that accompany a CFPB inquiry and moves decisively to extinguish embers before they catch fire. Based on her substantive expertise, Ms. Lee represents clients in proactive engagement opportunities with the CFPB to submit comments on new or proposed regulations and conducts due diligence for deals involving acquisitions of financial services firms. She helps companies implement or update their compliance programs to decrease risk or litigation exposure in light of new consumer financial protection regulations. Ms. Lee represents large credit card issuers, consumer reporting agencies, data analytics companies, mortgage bankers, student loan companies, short-term and small-dollar lenders, retail-installment lenders and financial technology companies involved with digital wallets, virtual currencies, money transmission and mobile apps.

David A. Lipton
Columbus School of Law,
The Catholic University of America
Professor of Law
Washington, DC

Professor Lipton teaches securities regulation, corporate finance, and corporations. He also is the director of the Law School's Securities Regulation Program. Professor Lipton received his B.A. degree from Cornell University and an M.A. in public law and government from Columbia University. Before going on to Michigan University law school, where he received his J.D., he worked as a public relations specialist for New York City's anti-poverty program. At law school, he was admitted onto the Michigan Law Review. Upon graduation, he went to work with the New York firm of Debevoise & Plimpton where he practiced securities and corporate law. While at Debevoise, Professor Lipton served as a pro bono litigator for the Community Law Offices of East Harlem.

After practicing in New York, Professor Lipton began his teaching career at Case Western Reserve University School of Law where he taught corporations, contracts and agency law. He was accepted as a visiting Attorney Fellow at the Securities and Exchange Commission where he served in the Division of Market Regulation. He has been on the faculty of the law school since 1980. In that time, he has increased the school's securities offerings from one to ten courses. In addition, he has created numerous internships with regulatory agencies, private firms and associations.

Professor Lipton created the Law School's Securities Program which offers a certificate in Securities Regulation. He was also instrumental in forming and maintaining the school's active Securities Alumni Practice Group as well as the Student Securities Law Association and the Securities Regulation Moot Court Competition. Professor Lipton is frequently quoted in newspapers, radio and television in matters relating to securities market regulation, broker-dealer regulation, securities arbitration, insider trading, duties of corporate directors and the impact of technology on securities regulation.

For approximately 25 years, he has chaired arbitration panels for FINRA. He frequently conducts programs at the law school and with the D.C. Bar on matters relating to securities, market regulation, corporate governance, arbitration and securities trading. He also organized a number of symposia to encourage the recruitment of minorities in the securities industry. These programs became models for later efforts by the SEC.

He regularly taught a training program on Broker-Dealer Supervision for the NASD/Wharton School's Institute for Professional Development. For the past several years, Professor Lipton has devoted his scholarly activities to his twice annually updated Treatise on Broker-Dealer Regulation. This treatise is considered the standard reference guide in the securities legal community.

He has been elected to serve as chair, vice chair and member of the Steering Committee of the D.C. Bar's Section on Corporations, Finance and Securities. He has chaired and served as a member of the National Association of Securities Dealer's (now FINRA’s) National Arbitration Committee. Professor Lipton has served two separate terms on the FINRA’s National Market Regulation Committee, in addition to a three year term on its National Adjudicatory Committee. He had served as a director of the Municipal Securities Rulemaking Board where he chaired the Audit Committee.

Professor Lipton served as a member of the Board of Advisors to the SEC Historical Society. He subsequently became a Board of Trustees member and a Vice President of the Museum.

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Joe Lynyak is a Partner in Dorsey’s Finance & Restructuring Group and is a member of the Banking Industry Group. He practices in both the Dorsey’s Washington, D.C. and Southern California offices. Mr. Lynyak possesses a broad knowledge base regarding foreign banks and domestic banks, savings associations, bank holding companies, finance companies, mortgage banking companies and their subsidiaries and affiliates. His practice includes providing financial intermediaries advice in the areas of regulatory and strategic planning, application and licensing, legislative strategy, commercial and consumer lending, examination, supervision and enforcement, and general corporate matters.
Mr. Lynyak’s FDIC-insured financial institution clients benefit from his experience

in the special state and federal statutory and regulatory requirements—including safety and soundness issues—that apply to regulated financial intermediaries. He regularly counsels clients on matters such as retail operations, privacy, identity theft, consumer compliance, application and underwriting, payments systems, Internet, electronic commerce, examination, supervision and enforcement, operational and strategic planning matters. Mr. Lynyak is a frequent lecturer on legal topics involving the operation and regulation of financial service companies. Specific regulatory topics upon which he has advised clients and spoken at conferences include the Dodd-Frank Act, prudential regulation, the Volcker Rule, the Bank Secrecy Act (and other anti-money laundering provisions), mortgage lending and the CFPB.

Doug Parker
E&W Strategies Group
President
Washington, DC

As a former senior EPA enforcement official, Doug has extensive experience and a unique perspective on the enforcement of our nation's environmental laws. He serves clients by providing strategic direction in the areas of corporate and individual risk, crisis mitigation and environmental compliance. His experience as a special agent with EPA's Criminal Investigation Division (CID) for 24 years, including the last four years as CID's Director provides a unique lens and series of insights for companies addressing their internal operations or who may be facing scrutiny from the government, NGOs or the public.

While overseeing criminal cases ranging from the Deepwater Horizon investigation to the recent Volkswagen defeat device case, as well as the agency's enforcement initiatives in the renewable fuels sector, Doug worked extensively with EPA's civil enforcement program and the Department of Justice to set and execute national enforcement policy. He also served as EPA's primary spokesperson on criminal matters with the media and Capitol Hill. This experience allows him to deliver exceptional understanding of the federal government and environmental policy space for companies seeking to navigate this area of public policy or for those seeking subject matter expertise in the environment and natural resource policy area.

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Jim has over 25 years of experience in federal and state environmental and natural resources regulatory and litigation matters. Jim's practice focuses on air pollution; climate change law and policy; natural resource laws; hazardous materials transportation; and federal, state and citizen enforcement matters -- particularly those related to the energy sector. He also provides counsel to businesses on domestic and international compliance matters in the environmental context and on corporate transactions.

Jim previously was counsel in the global energy sector at a private firm. Before going into private practice, Jim served for 15 years in the Environment and Natural Resources Division of the U.S. Department of Justice, where he was an assistant chief in the Law and Policy Section, a trial attorney in the Environmental Defense Section, and an agency representative to the White House Climate Change Task Force. He coordinated the Division's international program and worked on a wide variety of domestic and international environmental policy and litigation matters, as well as trade and investment negotiations and disputes.

Third Annual Federal Enforcement Forum: CFPB AND FINANCIAL SERVICES

Moderator: Joseph T. Lynyak III, Dorsey & Whitney LLP, Partner

Dennis Kiefer, Deloitte Financial Advisory Services LLP, Managing Director

J.H. Jennifer Lee, Dorsey & Whitney LLP, Partner

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Agenda

- Introduction
- Key enforcement trends
- Consumer complaint activity
- Underlying motivations for CFPB approach
- The impact of PHH Corp. et al. v. CFPB
- Emerging trends/new administration and the CFPB

Introduction: Unique CFPB Approach

- Previously, banking enforcement actions were limited to cease and desist orders

- By contrast, the CFPB has been more prolific in monetary terms. From 2011-2016, the following has resulted from CFPB enforcement or supervision matters:
  - $11.7 billion ordered in relief to consumers by CFPB enforcement actions
  - 27 million consumers will receive monetary relief because of CFPB supervisory and enforcement work
  - $440 million ordered to be paid in civil penalties as a result of CFPB enforcement actions

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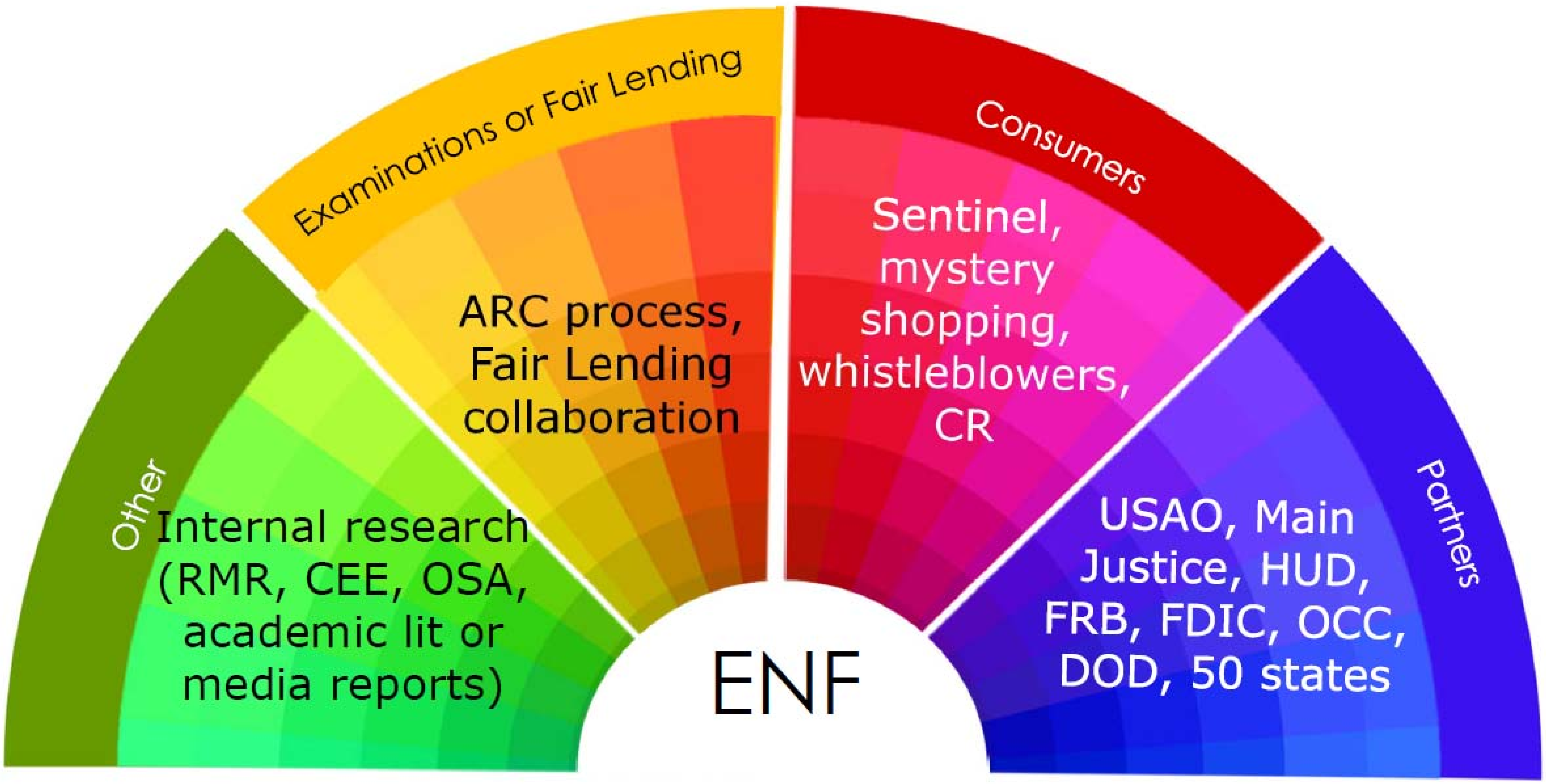
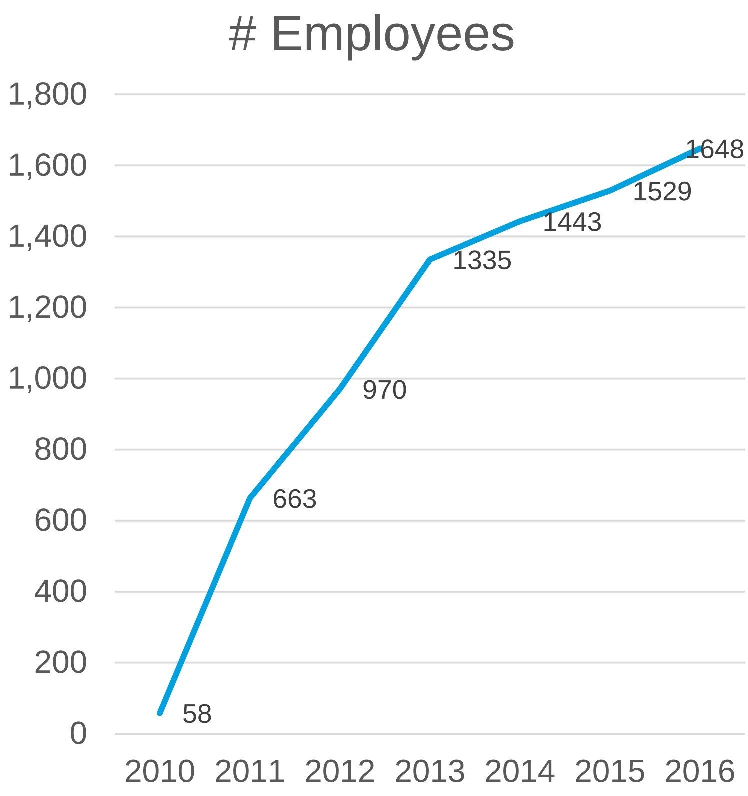
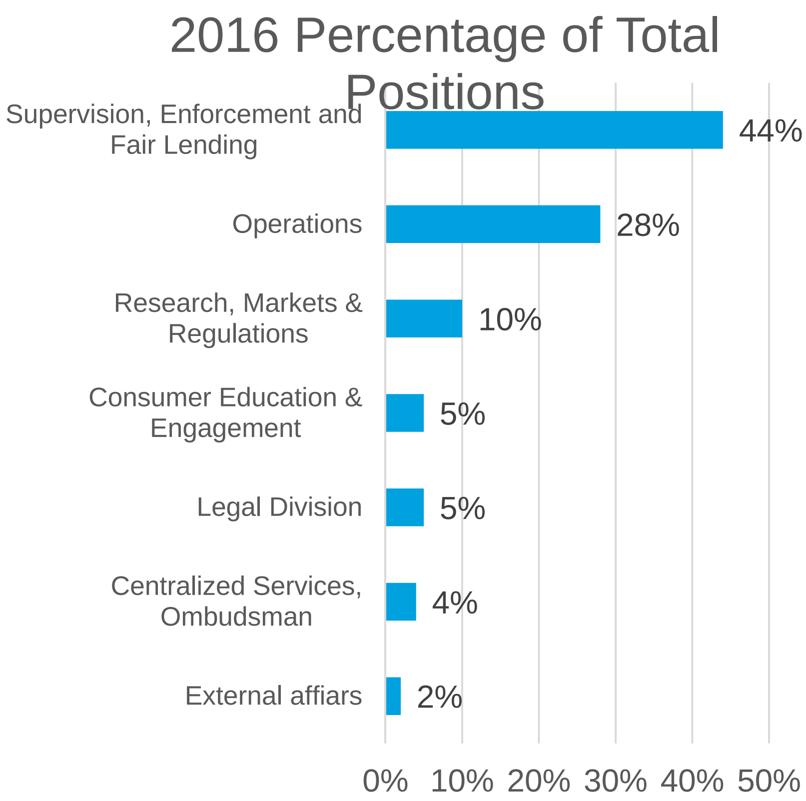
Possible Catalysts for a CFPB Investigation



CFPB: Rapid Growth, Enforcement Focus





Source: Financial Report of the CFPB for 2016, pg. 13

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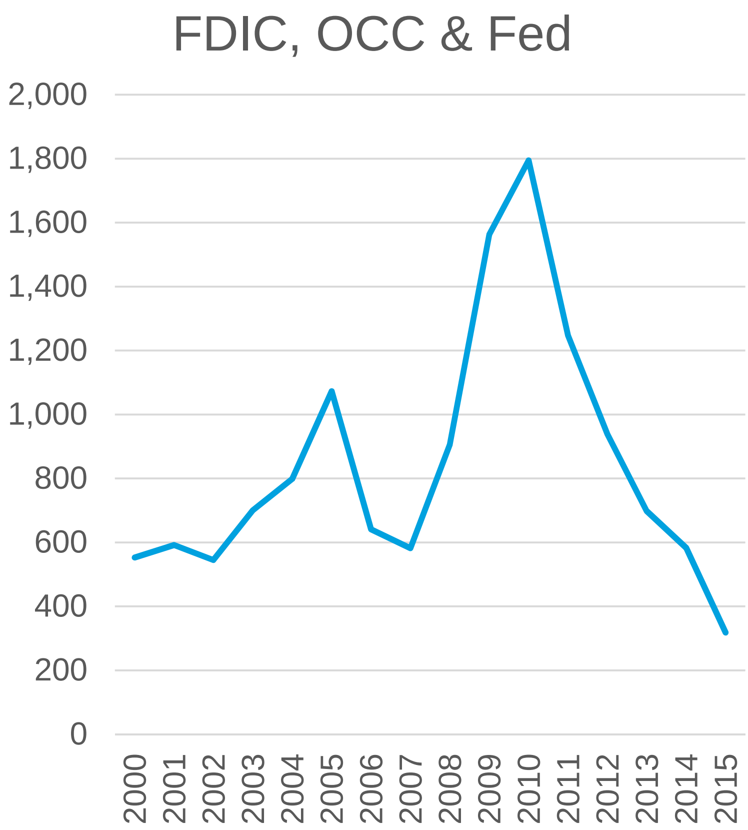
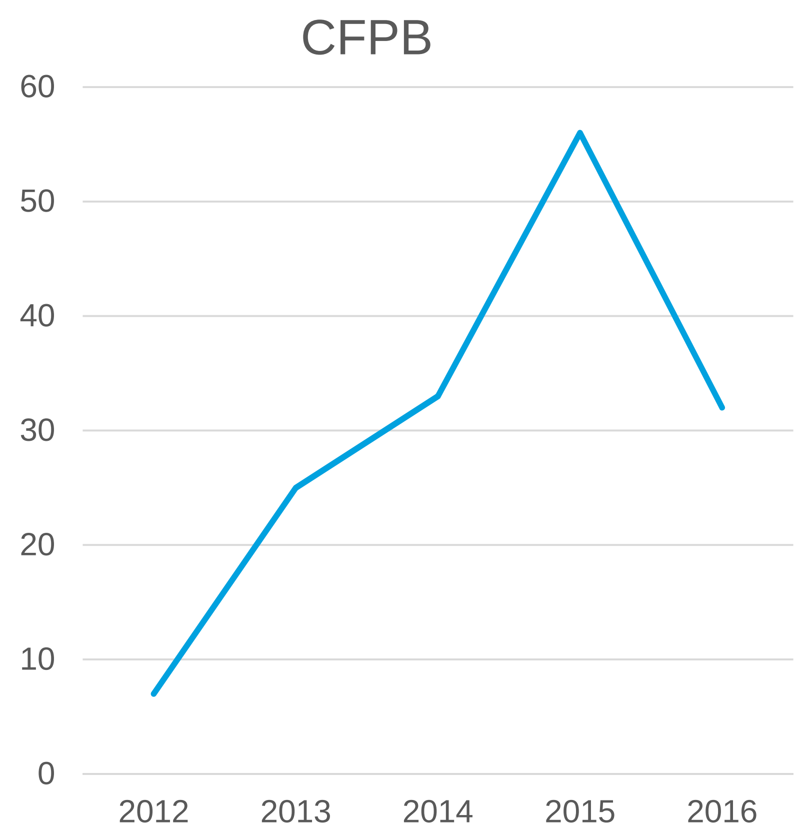
Number of Enforcement Actions





* 2016 through October

Source: SNL Financial; Deloitte Center for Financial Services Analysis; CFPB

Consumer Complaints Activity:

Consumer Response Division: A Statutory Obligation

"The Director shall establish a unit whose functions shall include establishing a single, toll-free telephone number, a website, and a database or utilizing an existing database to facilitate the centralized collection of, monitoring of, and response to consumer complaints regarding consumer financial products or services."

12 USC § 5493(b)(3).

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Consumer Complaints Activity:

Consumer Response Division: A Statutory Obligation

- **The enabling statute also requires coordination**
  - **between the CFPB and the Federal Trade Commission, other federal agencies and the states**
  - **in terms of handling consumer complaints and sharing information about consumer complaints.**

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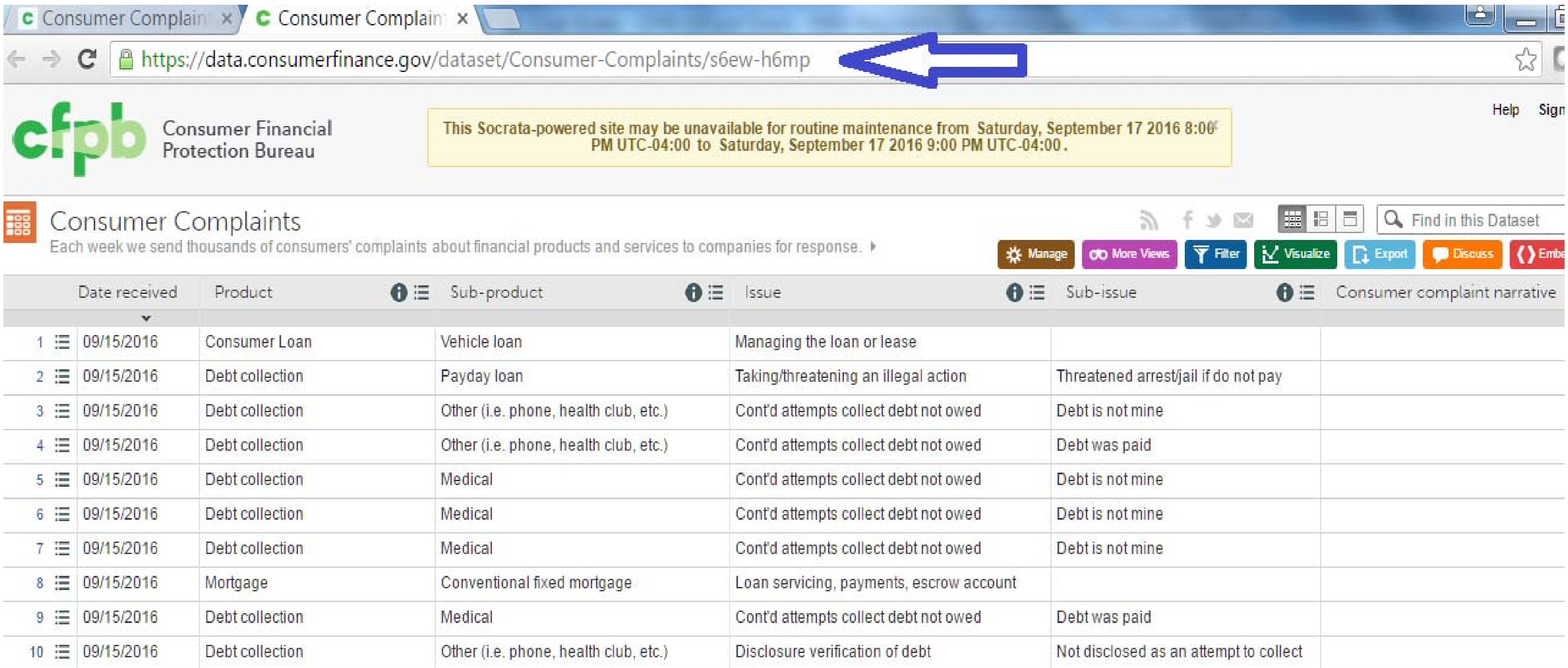
Consumer Complaints Activity:


Consumer Complain ×
Consumer Complain ×
https://data.consumerfinance.gov/dataset/Consumer-Complaints/s6ew-h6mp

Consumer Financial Protection Bureau

This Socrata-powered site may be unavailable for routine maintenance from Saturday, September 17 2016 8:00 PM UTC-04:00 to Saturday, September 17 2016 9:00 PM UTC-04:00.

Help Sign

Consumer Complaints

Each week we send thousands of consumers' complaints about financial products and services to companies for response.

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	Date received	Product	Sub-product	Issue	Sub-issue	Consumer complaint narrative
1	09/15/2016	Consumer Loan	Vehicle loan	Managing the loan or lease		
2	09/15/2016	Debt collection	Payday loan	Taking/threatening an illegal action	Threatened arrest/jail if do not pay	
3	09/15/2016	Debt collection	Other (i.e. phone, health club, etc.)	Cont'd attempts collect debt not owed	Debt is not mine	
4	09/15/2016	Debt collection	Other (i.e. phone, health club, etc.)	Cont'd attempts collect debt not owed	Debt was paid	
5	09/15/2016	Debt collection	Medical	Cont'd attempts collect debt not owed	Debt is not mine	
6	09/15/2016	Debt collection	Medical	Cont'd attempts collect debt not owed	Debt is not mine	
7	09/15/2016	Debt collection	Medical	Cont'd attempts collect debt not owed	Debt is not mine	
8	09/15/2016	Mortgage	Conventional fixed mortgage	Loan servicing, payments, escrow account		
9	09/15/2016	Debt collection	Medical	Cont'd attempts collect debt not owed	Debt was paid	
10	09/15/2016	Debt collection	Other (i.e. phone, health club, etc.)	Disclosure verification of debt	Not disclosed as an attempt to collect	

Consumer Complaints Activity

Product	Monthly Avg. Since Launch	Total through 10/1/16
Debt Collection	6,881	271,379
Credit Reporting	3,503	168,232
Mortgage	4,210	248,485
Bank Acct or Service	1,768	99,955
Credit Card	1,651	104,477
Consumer Loan	785	44,049
Student Loan	563	31,439
Payday Loan	435	15,678
Money Transfer	166	7,097
Other Financial Service	370	10,390
TOTAL	16,007	1,008,463

Source: http://www.consumerfinance.gov/data-research/research-reports/monthly-complaint-report-vol-16

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Complaints Used for Enforcement:

In CFPB Investigations:

- Office of Enforcement reviews consumer complaints received from Consumer Response
- Review of complaints might be first step in any investigation or pre-investigation
- Might drive the scope of a Civil Investigative Demand

In CFPB Litigation

- Consumer complaints driving causes of action
- Consumer complainants as witnesses
- Statements from consumer complainants in court filings

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Underlying Motivations for CFPB Approach:

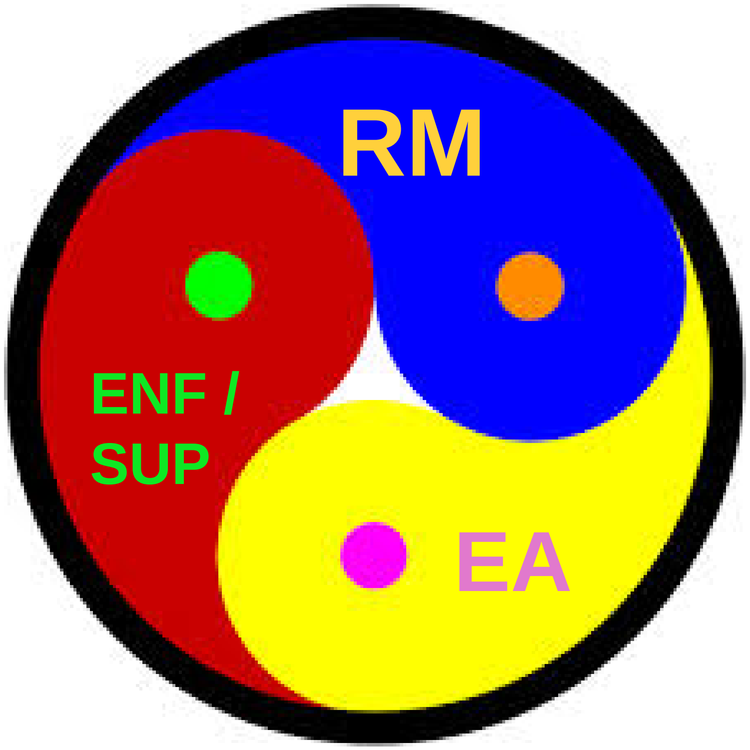
- Architecture of agency as set forth in the Dodd-Frank Act encourages intra-agency debate; policy directs consensus-based decision making
    - The prevailing factor: protect consumers from sources of harm
- Market-driven approach – not some markets, but all
- Multi-faceted “all hands” method
    - Do more, better, faster, and get it done yesterday
- Superiority of enforcement to rulemaking
- Absence of incentives to look for inadvertent consequences such as restricted access to credit

A “New Age” Agency

(1) Enforcement/Supervision

(2) Rulemaking

(3) External Affairs



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This results in the protection of consumers…..?

- Enforcement program manifests behavioral economics school of thought

- Data-based approach begs the question: which data, and how gathered?

  - Arbitration rulemaking – consumer phone surveys
  - Disclosures for overdraft protection – consumer feedback on drafts
  - Enforcement consent order negotiations – loan disclosures used “in the field”
  - Evidence-gathering in enforcement actions – call recordings review

- Protecting consumers from themselves

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PHH Corp. et al. v. CFPB

- October 11, 2016—the Federal Court of Appeals for the District of Columbia Circuit ruled that the CFPB was structured in an unconstitutional manner
  - And then proceeded to fix the infirmity prospectively
  - Specifically refused to discuss what the ruling meant for everything the CFPB has done since it was created
- The CFPB requested an en banc review on November 18th
  - To be determined…
- We will look briefly at—
  - The procedural posture of the PHH decision
  - The arguments made by PHH in the DC Circuit
  - What the DC Circuit ruled

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The Procedural Posture of the PHH Decision

- A short review of administrative law
  - Agencies do not regulate solely by issuing regulations—
    - APA rulemakings
    - Interpretations
    - No-action letters
    - Enforcement actions
    - Litigation
- HUD was no exception—
  - For decades HUD issued letters interpreting RESPA and Regulation X
    - Particularly conduct under Section 8—referrals
      - Marketing service agreements a good example

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The Procedural Posture of the PHH Decision

- **19 years ago—HUD issued what became known as the "Countrywide Letter"**
  - **It authorized mortgage lenders to form reinsurance affiliates and own a piece of mortgage policies—and premiums—related to loans they originated**
  - **To avoid Section 8 referral issues—HUD required that actual credit risk be purchased by the reinsurer and the fees generated directly relate to the risk assumed**
- **Many mortgage lenders followed the Countrywide Letter's requirements—**
  - **Some years reinsurers made money**
  - **Some years reinsurers lost money**
  - **Independent audits verified ownership of real credit risk**

The Procedural Posture of the PHH Decision

- **In 2014 the CFPB claimed that PHH was violating Section 8 of RESPA because it was receiving reinsurance premiums that constituted a kickback scheme in violation of Section 8 of RESPA**
- **The CFPB's actions coincided with an interpretative view of Section 8(c) of RESPA that reversed 3 decades of the industry's understanding of Section 8's requirements**
- **An administrative hearing was held and an administrative law judge issued a ruling that held in favor of the CFPB and recommended a disgorgement order of approximately $6.5 million**
- **PHH disagreed and filed an appeal—but the appeal was Director of the CFPB**
  - **Guess what happened???**

The Procedural Posture of the PHH Decision

- **In the appeal to the Director, PHH made three legal arguments:**
  - **The "novel" interpretation of Section 8 was incorrect as a matter of law**
  - **The CFPB's new view of Section 8 in the minimum required that it announce that new legal position instead of retroactively using it against PHH without notice**
  - **Several of the alleged violations were outside of the applicable statute of limitations for RESPA violations**

The Procedural Posture of the PHH Decision

- **Director Cordray ruled against PHH on all issues**
- **The Director—**
  - **Adopted the new view of Section 8 of RESPA**
  - **Held that a regulated entity could only rely upon agency rules formally adopted in accordance with an APA rulemaking**
  - **Held that the CFPB was not subject to any statute of limitations when taking enforcement actions**
  - **Increased the disgorgement penalty from $6.5 million to $109 million**
  - **In a display of kindness—the Director did not impose any civil money penalties**
- **After 2 years of administrative torture—PHH was finally able to appeal to a federal court for a de novo ruling on the merits**

Constitutional Separation of Powers

- **The three branches of the federal government**
  - **Executive branch**
  - **Legislative branch**
  - **Judicial branch**
- **The Supreme Court's decision on independent agencies**
- **The Humphrey's Executor Decision**
  - **There can exist a form of agency somewhat out of the control of the President—called an independent agency—if—**
    - **The agency has a limited purview**
    - **A commission form of governance is in place**
  - **In that circumstance the President's power to hire and fire can be limited dismissal only "for cause**

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The Arguments Made by PHH in the DC Circuit

- In April 2016 the DC Circuit held oral arguments
- Arguments made by PHH—
  - PHH was constitutionally flawed
  - The CFPB's interpretation of Section 8 of RESPA was clearly wrong and not subject to deference
  - Retroactively applying its new interpretation of RESPA was a violation of PHH's due process rights to fair notice
  - The CFPB is subject to statutes of limitation

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What the DC Circuit Ruled

- The DC Circuit issued its opinion on October 11th—
  - Ruled in favor of PHH on all issues
    - RESPA—the DC Circuit determined that Section 8 of RESPA is clear in that it authorized the creation of reinsurance subsidiaries
      - The only issue was whether reasonable value was being paid for the credit risk assumed
      - The DC Circuit held that the CFPB was not entitle to interpretative deference on this issue—now or in the future
    - Due Process—the DC Circuit utterly dismissed the CFPB's position that it could ignore decades of HUD's interpretative guidance and make up new law on the fly
      - By retroactively applying its new interpretation of RESPA without alerting the public, the CFPB violated PHH's due process rights—thereby voiding the $109 million disgorgement order (with the ability to start all over again)
    - Statute of Limitations—the CFPB is not a dictatorship—it is subject to applicable statutes of limitation
      - In this case the applicable statute was RESPA's 3-year statute
      - The maximum statute is likely the general 5-year statute for federal agencies

The Constitutionality of the CFPB

- **The DC Circuit first ruled that the CFPB was unconstitutionally structured as an independent agency because of the limit on the power of the President to fire the Director**
  - **The DC Circuit struggled with a solution because it recognized it could not by judicial decision create a commission to operate the CFPB**
  - **It determined that existing Supreme Court precedent permitted it to strike the provision in the Dodd-Frank Act limiting the power of the President to fire only for cause and thereby *prospectively* correcting the constitutional infirmity**

The Result—the DC Circuit Ruled in Favor of PHH on all Issues—but Saved the CFPB on a Go-Forward Basis—Specifically Stating that the Ruling Does Not Address the Status of Everything the CFPB has Done Prior to October 11th

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What the PHH Decision May Mean if Ruling Upheld

- **The CFPB—**
  - **Case precedent seem to indicate that the CFPB can reaffirm all existing—**
    - **Regulations**
    - **Corporate actions**
    - **Enforcement decisions and orders**
  - **Open rulemakings may have to start all over**
    - **Arbitration one example because of threat of legal challenges**
- **However—the ability and method of reaffirming prior CFPB actions may be before the Supreme Court**
- **Most recently, the CFPB filed a petition to the D.C. Circuit seeking review *en banc***

What the PHH Decision May Mean

- **Covered Companies—**
  - **RESPA Section 8 interpretations now reinstated**
  - **Prior Consent Orders arguably void or voidable**
  - **Will companies begin to push back against the CFPB?**
- **Other Agencies**
  - **Anecdotal evidence that other federal banking agencies have objected to CFPB's aggressive and punitive enforcement behavior**
  - **PHH decision may encourage other agencies to encourage the CFPB to adopt a safety and soundness approach to bank regulation rather than its current approach that focuses on high-visibility enforcement actions**
- **Waiting in the wings—The Trump Administration…**

Emerging Trends: UDAAP +

1. Fair Debt Collection Practices Act
2. Electronic Funds Transfer Act
3. Fair Credit Reporting Act
4. Truth in Lending Act
5. Real Estate Settlement Procedures Act
6. Other enumerated statutes
7. UDAAP (§§ 1031/1036 of the Dodd-Frank Act)

Consistent trend: alleging violations of enumerated statutes while often also alleging the same underlying conduct constitutes unfair, deceptive and/or abusive acts and practices (“UDAAPs”) in violation of the Dodd-Frank Act

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Emerging Trends: "Payment Processor" Matters

- **Meracord** (2013)/**Global Client Solutions** (2014) – payment providers allegedly provided "substantial assistance" to debt settlement companies and ignored red flags such as high chargeback volumes
- **Universal Debt** (Apr. 2015) – allegedly provided "substantial assistance" to DCs engaged in fraudulent collection practices – failed to appropriately monitor accounts with DCs, ignored red flags such as consumer disputes and communication problems with DCs and in certain cases flagged DCs as prohibited merchants but continued to do business with them anyway
- **Intercept** (June 2016) – allegedly ignored red flags indicating fraud such as high return rates, enforcement actions against clients, repeated consumer complaints and warnings from banks. Cordray: "Companies cannot turn a blind eye to wrongdoing when they process payments from consumer banking accounts on behalf of clients that are breaking the law."

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Emerging Trends: "Fin Tech" and Small-Dollar/Short-Term

Dwolla (March 2016)

- Online payment platform alleged to have deceived consumers about data security practices and the safety of its online payment system

LendUp (Sept. 2016)

- Online lender had marketed lending services as a way for consumers to build credit
- CFPB alleged there were no written policies or procedures related to credit reporting and that LendUp did not properly furnish information to credit reporting companies, thus allegedly denying customers the promised opportunity to improve creditworthiness

T3Leads (Dec 2015/ Nov 2016 – motion to dismiss denied)

- Lead aggregator had purchased consumer loan applications from lead generators containing data (e.g., names, phone numbers, home and email addresses, employer information) and sold "leads" to small-dollar lenders and other companies
- Conduct was allegedly "unfair" and "abusive" where T3 had failed to vet or monitor its lead generators and lead purchasers, "exposing consumers" to the risk of having their information purchased by others who would use it for illegal purposes

Emerging Trends: Challenges to CFPB Investigative Authority

J.G. Wentworth LLC (April 2016 – Cordray decision)

Westgate Resorts Ltd. (March 2016 – Cordray decision)

Accrediting Council for Independent Colleges and Schools (Oct. 2015 – Cordray decision; April 2016 – Judge Leon decision; June 2016 – Appeal to D.C. Circuit)

- Judge Leon reasoned that the CFPB's investigative authority must be tethered to its overall UDAAP authority
- Although the UDAAP power applies to a "covered person" under the Dodd-Frank Act, the power to prevent UDAAP includes the authority to issue CID's to "any person" who has "possession, custody, or control of any documentary material."
- Because the purpose of the CID was to explore areas not within the CFPB's jurisdiction, the CID was impermissible
- "Although it is understandable that new agencies like the CFPB will struggle to establish the exact parameters of their authority, they must be especially prudent before choosing to plow headlong into fields not clearly ceded to them by Congress." – Judge Leon

QUESTIONS?

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FERC and CFTC Enforcement Developments in 2016

December 1, 2016

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Introduction and Agenda

- Statutory and Regulatory Background
- Update on FERC and CFTC Enforcement Programs
- Strategic-level lessons learned from the last year of enforcement activity
- What are the short-term and medium-term outlooks for FERC and CFTC enforcement?

Market Manipulation – Definition

- **Based on open-ended fraud statutes**
- **Agencies will not provide definition/safe harbor**
- **View:**
  - **"I think anybody who reads the Constellation case can get hopefully a very clear signal of what is manipulation…[y]ou can't lose a whole bunch of money in one market, a financial market, to in essence gain substantial amounts of money in a physical market…[s]o if somebody thinks it's not clear, that may be their problem and not ours."**
    - ***Statement of FERC Chairman Jon Wellinghoff following FERC's ruling in Constellation Energy Commodities Group, Inc.***

Market Manipulation – FERC

- **Section 4A of the Natural Gas Act, as amended by Section 315 of the Energy Policy Act of 2005, states:**
  - **"It shall be unlawful for any entity, directly or indirectly, to use or employ, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance … in contravention of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas ratepayers."**
- **Section 222 of Part II of the Federal Power Act, as amended by Section 1283 of the Energy Policy Act of 2005, states:**
  - **"It shall be unlawful for any entity (including an entity described in section 201(f)), directly or indirectly, to use or employ, in connection with the purchase or sale of electric energy or the purchase or sale of transmission services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance … in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of electric ratepayers."**

Market Manipulation – CFTC

- **Anti-Fraud Liability – Section 6(c)(1) of the Commodity Exchange Act, as amended by Section 753 of the Dodd-Frank Act, states:**
  - **"It shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations…"**
  - **Impact on price is not required**
- **Price Manipulation – Section 6(c)(3) of the Commodity Exchange Act, as amended by Section 753 of the Dodd-Frank Act, states:**
  - **"[I]t shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity."**
  - **Requires specific intent – recklessness does not suffice**

Market Manipulation – Statutory Origin

- **FERC and CFTC statutes and rules are based on SEC Exchange Act Section 10b and Rule 10b-5.**
- **SEC Rule 10b-5 prohibits, in connection with the purchase or sale of any security, any person from:**
  - **Directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange;**
  - **Employing any device, scheme, or artifice to defraud;**
  - **Making any untrue statement of a material fact or omit to state a material fact; or**
  - **Engaging in any fraudulent or deceitful act, practice, or course of business.**
- **Rule 10b-5 embodies a "code of ethics" to prevent fraudulent and manipulative behavior.**

Market Manipulation – Statutory Origin

- **Manipulation is a term of art referring to a variety of deceptive practices. *Santa Fe v. Green*, 430 U.S. 462 (1977).**
  - **Applies to practices such as wash sales, matched orders, rigged prices or feigning market activity**
  - **Key – deception in the marketplace "intended to mislead investors by artificially affecting market activity."**
- **Catch-all provision but "what it catches must be fraud." *Chiarella v. United States*, 445 U.S. 222 (1980); *see also FERC Final Rule Prohibiting Market Manipulation*, FERC Order No. 670 (2006) (like the SEC's, FERC's provision applies to "any action, transaction or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market").**
- **Attempt is enough**
  - **For example, in 2012, the CFTC ordered Barclays to pay $200 million in penalties for *attempted* manipulation and false reporting concerning the LIBOR and Euribor benchmark interest rates.**

Market Manipulation – Application

- **Application is keyed to a case-by-case, facts and circumstances approach**
- **Critical element is intent, which is frequently measured by conduct in the marketplace, such as:**
  - **Uneconomic or sham trading or transactions**
  - **Persistence and repetition of conduct**
  - **Misrepresentations about market conduct**
  - **Impact on marketplace**
  - **Business purpose**

Update on FERC Enforcement: Overview of FERC Enforcement Initiatives in 2016

- **Record-breaking number of litigation proceedings - as of November 2016, FERC Enforcement is seeking to recover $567,210,000 in civil penalties and $45,708,118 in unjust profits through seven litigated proceedings.**
- **In FY 2016, FERC Enforcement proposed and assessed civil penalties in two of three investigations for which it had issued Orders to Show Cause in FY 2016. The Commission issued an Order to Show Cause in a third matter, *Total Gas & Power North America, Inc., Total, S.A., Total Gas & Power, Ltd., Aaron Hall, and Therese Tran f/k/a Nguyen*, Docket No. IN12-17-000, which is now pending before the Commission, following an unsuccessful federal district court challenge to FERC's authority to assess penalties for the violations at issue.**

Overview of Recent FERC Enforcement Proceedings

- PJM UTC/MLSA proceedings
  - City Power Marketing, LLC and K. Stephen Tsingas
  - Coaltrain Energy
    - In May 2016, FERC issued an order assessing $38 million in civil penalties for alleged energy market manipulation, plus disgorgement of unjust profits.
  - Houlian Chen, Powhatan Energy Fund, LLC, et al.
- ETRACOM LLC and Michael Rosenberg

What happens if there are no "smoking gun" documents?

- Is it reasonable to review transactions and trading activity with "20-20 hindsight" years after a transaction or trade takes place?
- Can a transaction be less than optimal but nevertheless still implement a legitimate business purpose?
- Was the relevant party working from incorrect facts unknowingly?
- What if the trading platform was experiencing an error?

Is it possible to establish market manipulation based entirely on economic data?

- **How do you establish fraud based entirely on economic data?**
- **How do you satisfy the legal requirement to establish fraud using economic data?**
- **What is the evidentiary hurdle for the regulator?**

What is the proper economic measure of manipulation?

- What part of a company's trading portfolio should be analyzed?
  - What markets relate to each other?
  - What if a company trades products across multiple industries?
- What makes a trade uneconomic?
  - Example: A company enters into a virtual transaction that impacts a physical position and there is a "transaction" cost for the virtual transaction.
  - What is the proper measure of the profit resulting from the physical position?
- What is the proper measure of the economics of two potentially related transactions?
  - Should the regulator subtract the "transaction" cost from the virtual position or the physical trade when establishing the economics of the trade?

Different Characterizations of UTC Trade: FERC's Characterization

	UTC	Costs
Pays:	$P_{DA(A)}$ □ $P_{DA(B)}$	Market Charges ($0.05)
Paid:	$P_{RT(A)}$ □ $P_{RT(B)}$	AS Charges ($0.20)
		Transmission ($0.75)
	Assume Revenue = $0.30	Cost = $1.00

MLSA

Pro Rata Share of MLSA Pool

Revenue = $1.70

UTC Profit of -$0.70 (Uneconomic) + Revenue = $1.70 = $1.00 (Net Profit)

FERC's analysis would group all transaction costs with the UTC. Because transmission costs are included, the UTCs appear uneconomic.

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Different Characterizations of UTC Trade: Alternative Characterization

UTC

Pays: $P_{DA(A)}$ □ $P_{DA(B)}$
Paid: $P_{RT(A)}$ □ $P_{RT(B)}$

Costs

Market Charges ($0.05)
AS Charges ($0.20)

Transmission ($0.75)

MLSA

Pro Rata Share of MLSA Pool

Assume Revenue = $0.30

Cost to UTC = $0.25
Transmission = $0.75

Revenue = $1.70

UTC Profit of $0.05 (Economic) + MLSA Net Profit = $0.95
= $1.00 (Net Profit)

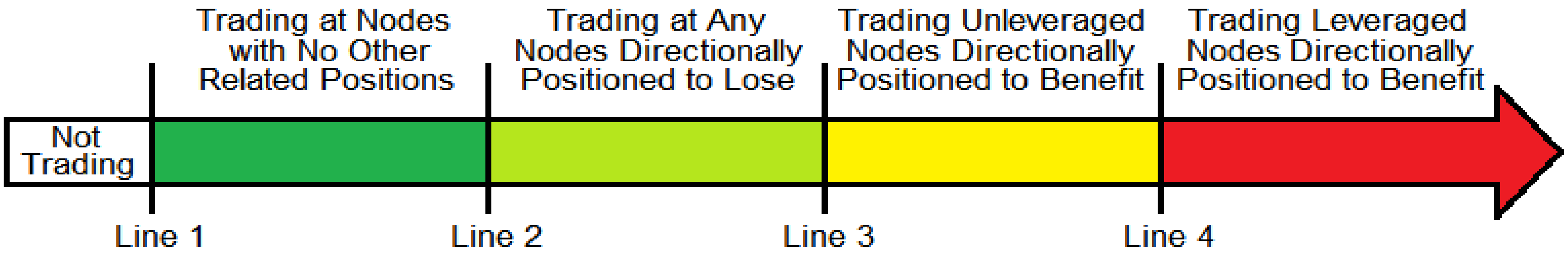
By comparison, the transmission costs could be grouped with the MLSA. Now there is no manipulation because the UTCs are profitable.

What does the last year mean for a trading platform subject to FERC's Enforcement Program?

- **Key concepts for implementing a cross-product trade surveillance system based on recent FERC precedent**
  - **Does the price-making trade directionally improve the value of the price-taking position?**
  - **Is the price-taking position leveraged such that the resulting profits will exceed any losses in the price-making trade?**
  - **Was the price-making trade profitable on a stand-alone basis (i.e., economic versus uneconomic)?**

What does the last year mean for a trading platform subject to FERC's Enforcement Program?

- Current practice in some companies is to abstain completely from price-making trades if price-taking positions exist:
  - No compliance risk, but leaving profits on the table
- Better surveillance could allow for legitimate, profit-seeking trades, with increasing layers of compliance risk:
  - Line 1: Trade where there are no other positions (very slight risk)
  - Line 2: Trade only if the value of swap is injured (slight risk)
  - Line 3: Trade where swap benefits but is unleveraged (some risk)
  - Line 4: Trade where swap benefits and is leveraged (high risk)
- Risk increases if trades are unprofitable or partially clear:
  - May be wrongfully interpreted as uneconomic behavior/leverage



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Comparing the Last Two Years of FERC Enforcement to the CFTC and SEC

- **CFTC**
  - **In FY 2016, the CFTC filed 68 new enforcement actions involving reporting violations, manipulation, attempted manipulation, spoofing and fraud, among others.**
    - **The CFTC has imposed nearly $1.3 billion in total monetary sanctions.**
  - **In August of 2016, the CFTC issued its largest whistleblower award to date ($10 mlllion).**
  - **The CFTC continues to strengthen enforcement activity in the agricultural/commodities markets, and strengthen its extra-territorial jurisdictional reach to enforce market manipulation rules against foreign persons.**
    - **May 2010 Flash Crash**
      - **In November 2016, a federal court in Chicago ordered U.K. resident Navinder Singh Sarao to pay more than $38 million in sanctions for price manipulation and spoofing leading to the Flash Crash of U.S. markets.**
- **SEC**
  - **SEC market manipulation cases are frequently brought in an administrative forum and based on cases developed in that forum.**
  - **District court cases are typically microcap "pump-and dump" cases.**
  - **The SEC typically does not bring open market manipulation cases in federal court.**

Strategic Legal Issues

- **Legitimate business purpose – a defense to an allegation of market manipulation**
- **Benefits of litigating market manipulation in federal court**
  - **Assume full *de novo* review and due process rights**
  - **What are the differences between the federal court process and the administrative process?**
  - **How does this compare to the SEC experience?**

Strategic Legal Issues

- **How does the potential for full litigation subject to *de novo* review at the federal court level impact decisions during FERC informal and/or formal investigation?**
  - **Taking a more aggressive versus less aggressive position during initial stages of investigation**
    - **Forcing the Government to make its case**
    - **Cooperation Credit**
    - **5th Amendments Issues**
      - **Companies versus Individuals**
- **What may FERC do differently?**

How is a legitimate business purpose a defense to an allegation of market manipulation?

- **Legitimate transactions have no deceptive intent.**
- **Is there a "loophole" defense if a transaction has a legitimate business purpose of profitability?**
- **Is the answer to this question the same if a case is litigated in a jury trial?**
- **Is this any different compared to CFTC or SEC?**

Legal Questions that are Subject to Pending FERC Federal District Court Cases

- **Federal Court Review**
  - **Full "de novo" review versus limited review of the FERC record**
  - **Benefit of full discovery in federal court**
- **Individual liability under the Federal Power Act**
- **Statute of Limitations**
  - **Triggers**
  - **Tolling**
- **FERC versus CFTC jurisdiction**

Pending FERC Federal District Court Proceedings

- **City Power Marketing LLC, No. 15-cv-01428 (D.D.C.)**
- **Powhatan Energy Fund LLC, No. 3:15-cv-00452 (E.D. Va.)**
- **Barclays Bank PLC, No. 2:13-cv-2093 (E.D. Cal.)**
- **ETRACOM LLC, No. 2:16-cv-01945 (E.D. Cal.)**
- **Coaltrain Energy L.P., No. 2:16-cv-00732 (S.D. Oh.)**
- **Total Gas & Power North America, Inc., No. 4:16-cv-01250 (S.D. Text)**

FERC Cases Involving *De Novo* Review Claims Before Federal District Courts

- ***FERC v. Maxim Power Corporation et al.*, No. 15-30113-MGM (Mass.)**
  - **Settled by the parties but potentially illustrative of future cases**
  - **On July 21, 2016, a Massachusetts District Court determined that FERC was required to participate in a full trial *de novo*.**
  - **FERC had maintained that the court was required to engage in only a review *de novo* of the relevant facts and issues, rather than a full trial *de novo*.**
  - **The court determined that based on the statutory language, approaches of other courts, due process requirements, among other things, *de novo* review means that Maxim is entitled to "an ordinary civil action governed by the Federal Rules of Civil Procedure that culminates, if necessary, in a jury trial."**
  - **The parties were ordered to establish a discovery plan, under the Federal Rules of Civil Procedure, that promotes an efficient resolution of the case with the goal of avoiding duplicative efforts from the discovery already conducted in FERC's initial investigation.**
  - **With *Maxim*, the tide may be shifting toward defendants despite a series of court orders favorable to FERC enforcement in various manipulation cases.**
- ***City Power Marketing, LLC, and K. Stephen Tsingas*, No. 15-1428 (D.C.)**
  - **On August 10, 2016, the District Court for the District of Columbia followed the same path as the federal court in *Maxim*, ordering full trial *de novo.***

Important FERC Rulemakings and White Papers

- **NOPR on Collection of Connected Entity Data from Regional Transmission Organizations and Independent System Operators**
  - **The data collection requirements would apply to all market-based rate sellers and entities trading virtual products or holding financial transmission rights.**
  - **In July 2016, FERC proposed revised reporting requirements and streamlined data collection processes.**
    - **FERC withdrew its two earlier proposals in Docket Nos. RM15-23-000 and RM16-3-000).**
  - **Proposed Changes Include:**
    - **A reworked and narrowed definition of connected entity.**
    - **Reduce and clarify the scope of ownership information that market-based rate sellers must provide.**
- **Revise the information required in asset appendices and eliminate the requirement from Order No. 816 that market-based rate sellers submit corporate organizational charts.**

Important FERC Rulemakings and White Papers

- **2016 FERC Report on Enforcement**
- **Staff White Paper on Effective Trading Compliance Practices**
- **Staff White Paper on Anti-Market Manipulation Enforcement Efforts Ten Years After EPACT 2005**

FERC Compliance White Paper Do's and Don'ts

- **Do**
  - Employ compliance personnel with different backgrounds and areas of expertise including legal, operations, risk management and trading.
  - Train frequently, and track participation.
  - Use human resources to help with compliance, by, for example, reviewing compliance history when recruiting candidates.
  - Use IT to help with compliance, by, for example, acquiring compliance specific technology resources.
  - Document trading strategies and maintain a list of prohibited ones.
  - Monitor your traders and provide a forum for employees to report potential non-compliance.
- **Don't**
  - Over-rely on long standardized annual trainings or off-the-shelf compliance tools.
  - Set restrictions on trading and then fail to monitor for violations or discipline in meaningful ways.
  - Allow trading staff to overrule compliance staff.
  - Rely too heavily on attorneys for training and fail to involve operations staff.

What can we expect in 2016-2017 from FERC Enforcement?

- **FERC – We expect FERC to become even more aggressive in 2016-2018.**
  - **FERC has had several recent victories in non-market manipulation cases in areas related to FERC jurisdiction.**
  - **FERC has been relatively successful in cases that have been sent to federal district court**
- **New leadership in Trump Administration**

Conclusion

- FERC will most likely continue to be aggressive over the next year but may find itself needing to prove a market manipulation case based on economic data; this could be difficult.
- Federal court review of FERC enforcement cases will continue to shape key issues and should provide greater guidance.
- Maintain a robust compliance program based on FERC guidance; keep ahead of the precedent.

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The Future of Insider Trading
The Supreme Court and *Salman*

Thomas O. Gorman
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www.secactions.com

December 1, 2016

INTRODUCTION

- **The Supreme Court's decision in *Bassam Yacoub Salman v. United States*, No. 15-628 (S. Ct. Jan. 19, 2016) may well be the most significant insider trading case in years**
- **The USAO in Manhattan told the Court that *Salman's* predecessor – *U.S. v. Newman*, 773 F. 3d 838 (2d Cir. 2014) – might constitute the end of insider trading prosecutions**
- **While the two cases are not identical they are similar – both center on the application of the "personal benefit" test articulated in *Dirks v. SEC*, 463 U.S. 646 (1983)**

INTRODUCTION

- **To examine *Salman* and its potential significance, five points will be considered:**
  - **1) The decision in *Dirks***
  - **2) *Newman* and illegal tipping**
  - **3) The impact of *Newman***
  - **4) The decision in *Salman***
  - **5) The application of *Salman***
  - **6) The briefs in *Salman***

DIRKS

- *Dirks* centered on whether a tippee has an obligation to disclose or abstain from trading which hinges on whether the insider's tip is a breach of duty
- The facts: Ray Dirks was an analyst;
  - He discovered what was probably one of the largest frauds at the time in the late 1970s – Equity Funding
  - He learned the information from insider Ronald Secrist
  - While he approached regulatory authorities and news outlets, no action was taken
  - Finally he told his clients who traded
  - The SEC charged him with insider trading and found him liable
  - The D.C. Circuit affirmed

DIRKS

- The Supreme Court reversed
- The Supreme Court began its analysis by noting that not all trading while in possession of insider trading is illegal
  - There is no parity of information requirement in the securities markets
- To that end the Court sought to draw a bright line between that which is legal and that which is not; that question in turn centers on whether the insider will benefit directly or indirectly from the disclosure
- This line is derived from the Section 10(b) element of deception
- Only deception by the insider breaches the statue; that deception arises from a breach of duty for a personal benefit; absent a personal benefit there is no breach of duty
  - In drawing this line, the Court looked to its decision in *Chiarella v. United States*, 445 U.S. 222 (1980).

DIRKS

- The question must be considered based on the objective evidence
- The focus is on whether the insider will obtain a benefit that will translate into future earning
- In this context the relationship between the insider and the tippee may suggest a quid pro quo
- The elements of fiduciary duty and exploitation are also present when a gift is made to a trading relative or friend such that the trade resembles the insider himself profiting
- Here neither Secrist nor Dirks transmitted the information for a personal benefit; thus there was no breach of duty

NEWMAN

- In *Newman* the Second Circuit in 2014 also sought to draw a line
- Facts: The defendants were Todd Newman and Anthony Chiassons, both remote tippees 3 to 4 steps down from the source of the information, a Dell. Inc. employee
- The tips involved concerned Dell, Inc. and NVIDIA
- Each defendant was a portfolio manager at different hedge funds; each obtained the information through others who passed it on from the source

NEWMAN

- **On appeal the Second Circuit noted that there was no criminal insider trading case where third and fourth tier tippees were convicted as in *Newman***
- **The court began its analysis by discussing the classic and misappropriation theories of insider trading**

NEWMAN

- The court cited *Dirks,* stating that there is no breach of fiduciary duty absent a personal benefit to the insider
- Stated differently, simply disclosing the information is not a breach
- Indeed, there is no requirement of parity of information in the securities markets as *Dirks* held

NEWMAN

- **The elements of tippee liability are thus:**
  - **1) the corporate insider has a fiduciary like duty**
  - **2) the insider breached his duty by disclosing the inside information to the tippee**
  - **3) the tippee knew of the breach and that the insider got a personal benefit**
  - **4) the tippee trades**

NEWMAN

- **The jury instructions did not mention the personal benefit test and were thus inadequate**
- **In reviewing the sufficiency of the evidence the court defined the personal benefit test**
  - **It includes pecuniary gain and reputational benefit that can translate into future earnings**
  - **It includes the benefit one would obtain from making a gift to a friend or relative**
  - **While a benefit can be inferred from a personal relationship, that inference in not permitted absent proof of a meaningfully close personal relationship that guarantees an exchange that is objective, consequential and represents at least a potential gain of a pecuniary or similar value or nature – that is, it suggests a *quid pro quo***

IMPACT OF *NEWMAN*

- ***Newman* had an immediate impact on tipping cases**
- **One example stems from two parallel cases: *U.S. v Conradt*, No. 12-cr-00887 (S.D.N.Y.) and *SEC v. Payton*, No. 14-civ-4644 (S.D.N.Y.)**
  - **Both center on the acquisition by IBM of SPSS**
  - **The tip traces to attorney Michael Dallas, an associate at a NYC law firm**
  - **He was friends with Trent Martin; the men had a history of sharing confidential information; Dallas tipped Martin**

IMPACT OF *NEWMAN*

- Martin was roommates with Thomas Conradt an attorney at a brokerage firm; the two had a very close relationship; Martin tipped Conradt
- Conradt worked at the broker with Payton and Durant; Conradt tipped his fellow workers; all traded
- While Conradt asked Martin about the information source, the coworkers did not
- Conradt also tipped David Weishaus and others at the broker; all traded

IMPACT OF *NEWMAN*

- **The criminal case: Conradt, Weishaus, Martin and Payton were all charged and pleaded guilty prior to *Newman***
- **Subsequently, the guilty pleas were vacated based on *Newman***

THE IMPACT OF *NEWMAN*

- **The SEC based its civil enforcement action against the same traders on the same facts**
  - **First a motion to dismiss was brought**
  - **Judge Rakoff denied the motion**
    - **The court began by emphasizing the difference between criminal and civil cases**
    - **Turning to *Newman* the court stated that the first question is to determine if Martin, the tipper obtained a personal benefit; since there was a history of personal favors and their expenses were "intertwined," and the court found that Martin had obtained a personal benefit**
    - **The second question is if the defendant knew of the benefit; here again the allegations were sufficient that since Conradt and Martin were friends and roommates and Conradt had helped his friend with certain matters; this presents a situation suggesting that there were reciprocal befits**
    - **Finally there was evidence the defendants tried to conceal their trading activity**

THE IMPACT OF *NEWMAN*

- **After *Salman* was decided in an opinion written by Judge Rakoff (sitting by designation) *Payton* was tried to a jury**
- **The jury instructions broadly defined personal benefit to include not just a monetary gain but also other things such as "the benefit one would obtain from simply making a gift to a trading friend"**
- **The court accepted the definition suggested by the SEC which permitted the benefit to flow to *either* the insider or the tippee**
- **The jury returned a verdict in favor of the SEC**

SALMAN

- **Facts: This action also centers on a remote tippee**
  - **The action focuses on brothers Michael and Maher Kara and their brother-in-law Bassam Salman**
  - **The insider trading charges stem from trading on 4 transactions**
  - **Brothers Kara had a complex relationship**
  - **Maher worked at Citi Healthcare Group**
  - **Initially he sought help from brother Michael since he had no experience in the area**
  - **Eventually Michael, who traded securities, began asking more pointed questions about stocks and pushing his brother for information**

SALMAN

- **Michael taught brother Salman to trade**
- **He also passed along information he got from Maher**
- **The informational flow can be tracked as follows:**

Tipper →	Direct Tippee →	Remote Tippee →	Remote Tippee
Maher Kara	Michael Kara	Bassam Salman	Salman Family Member

SALMAN

- **Maher and Michael testified at trial for the government**
- **Maher testified that he would reveal information to his brother just to silence him**
- **Michael testified that he obtained the information, traded and passed it to his brother-in-law**
- **The jury found Salman guilty**
- **The Ninth Circuit, in an opinion written by Judge Rakoff, affirmed**

SALMAN

- **Like the Second Circuit in *Newman*, the Ninth Circuit claims to have followed *Dirks***
- **The test under that decision is whether the insider will personally benefit directly or indirectly and if the tippee knows or should have known about the breach**
- **Key is the personal benefit**
  - **It includes a pecuniary gain or reputational benefit that will translate into future earnings**
  - **It also exists where there is a gift to a trading relative or friend**

SALMAN

- **Here the tipper disclosed the information knowing it would be used to trade, making a *Dirks*-type gift**
- **Here this was admitted in the testimony**
- **Defendant argued there is no evidence that Maher received any tangible benefit as described in *Newman***
- **The court held that if *Newman* went that far it would decline to follow**

SUPREME COURT

- **Before the Supreme Court each side continues to claim it is faithfully following *Dirks***
- **Petitioner**
  - **Begins by asking the court to draw a clear line between illegal tipping and legal trading – the same approach as *Dirks* and *Newman***
  - **<u>The issue for decision is</u>: Whether *Dirks* requires proof of an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature or is it enough that the insider and tippee share a close family relationship**

SUPREME COURT

- **Petitioner**
  - **The argument opens with the familiar canon that only Congress can define criminal conduct**
  - **This is a repeated theme of the Court**
  - **Statutory language: Section 10(b) of the Securities Exchange Act does not address insider trading**
    - **This point has been an important limiting principle for the Court**
    - **This is consistent with *Dirks*' conclusion that only some persons under some circumstances will be barred from trading while in possession of inside information**

SUPREME COURT

- **Benefit: The test for assessing the benefit is objection in keeping with the notion of establishing a guiding rule**
- **The focus is on a pecuniary gain or reputational benefit that will translate into future earning**
  - ***Dirks* viewed gain as a benefit, profit**
  - **The quid pro quo of the exploitation is for tangible benefits flowing to the insider**
- **This case does not involve securities fraud; Maher did not trade or get a kickback**
  - **Maher transmitted the information only to get his brother off his back**

SUPREME COURT

- **Petitioner**
  - **Defining personal benefit as pecuniary gain is consistent with the constitutional limits here**
    - **This is a criminal statute that must be strictly construed**
    - **It would be a violation of due process to take someone's liberty based on a vague statute**
  - **The standard used by the Ninth Circuit here undermines *Dirks*' notion of drawing a line**
    - **Any suggestion that the personal benefit can be met with a psychic gain would render the notion impermissibly vague**
    - **Enforcement on this basis is impermissible**

SUPREME COURT

- **Respondent**
  - **The government frames the issue as: Whether under *Dirks* a tipper personally benefits and thereby breaches his fiduciary duty by disclosing confidential information to tippee as a gift for use in securities trading**
  - **The government begins and ends with *Dirks*, barely mentioning *Newman***
  - **Deception: The corporate insider violates the statute and is deceptive by violating the relationship of trust and confidence that exists with the shareholders**
    - **The misappropriation theory is built on a similar notion**

SUPREME COURT

- **_Dirks_ concluded that it was not a violation of the securities laws to trade to expose a fraud – the Court rejected a "broad" theory of liability implicit in the decision finding _Dirks_ liable**
  - **That theory would have required equal access to information**
  - **But the Court found that the corporate insider violates Section 10(b) when information made available for a corporate purpose only is taken advantage of by trading without disclosing**

SUPREME COURT

- **Respondent**
  - **The duty of a tippee is derivative of the that of the insider – the tippee assumed the fiduciary duty of the insider**
  - **The key question then become if the insider will personally benefit**
    - **This question must be considered on the objective facts**
    - **For example what there a quid pro quo**
    - **Or was there a gift**

SUPREME COURT

- **Petitioner**
  - **Based on these principles the personal benefit test is met when the insider discloses the information without a corporate purpose**
  - **Since the insider only has the use of the information for a corporate purpose he breaches Section 10(b) when trading for himself; the same is true when the tippee trades**
  - **Thus if the insider gave a gift of information for trading and a business justification for the gift is absent –Section 10(b) is violated**
  - **Finally the phrase "friend or relative" is only an example in *Dirks* – a gift to anyone for trading violates Section 10(b)**

ANALYSIS

- **Both sides claim to be following *Dirks***
- **Yet their views are radically different: Petitioner has limited the personal benefit to one that is pecuniary; Respondent makes it apply to any gift to anyone who may trade**
- **Petitioner's view is quite limited; the government's argument is virtually open ended**
- **The positions of the parties appear to etch the outer edges of liability**
- **The Court has repeatedly followed precedent suggesting *Dirks* will be affirmed**

TAKEAWAYS

- **Look for the Court to**
  - **Retain the notion of a gift**
  - **Reject the government's open ended theory**
  - **Tie the concept to something real and possibly tangible**
  - **Limit it by the nature of the relationships**

Insider Trading Before the Supreme Court: *Dirks* and *Salman*

By: Thomas O. Gorman [1]

One of the most closely watched cases of the coming Supreme Court term is *Salman v. U.S.,* S. Ct. No. 15-628, the Ninth Circuit's insider trading decision penned by Judge Rakoff of the U.S. District Court for the Southern District of New York. The issue for decision is the meaning of the "personal benefit" test established by the High Court in *Dirks v. SEC*, 463 U.S. 646 (1983). While the case is important because of its potential impact on the liability of remote tippees, it takes on added significance in view of the Second Circuit's pre-*Salman* decision in *U.S. v. Newman,* 773 F. 3d 438 (2d Cir. 2014), *cert. denied.,* No. 15-137 (U.S. Oct. 5, 2015). There the court used *Dirks* to draw a line in the sand as to remote tippee liability which the Manhattan U.S. Attorney's Office and the SEC have decided as significantly undermining insider trading enforcement.

This article examines the arguments presented by the parties and the argument before the High Court. It concludes with an analysis of those arguments.

I. *Factual background*

The case centers on three relatives: Brothers Michael and Maher Kara and their brother-in-law Bassam Salman. Maher secured a position with Citigroup's healthcare group as a vice president. He advised biotechnology and pharmaceutical companies on mergers, acquisitions and financing strategies. He rose to the position of director and was based largely in New York. Michael operated a hazardous waste business in California, home turf for the family. Mr. Salman worked as a grocery wholesaler in Chicago throughout the relevant period. He engaged in securities as did Michael.

The insider trading charges center on four transactions: 1) the sale of Bone Care International, Inc. to Genzyme Corporation in the spring of 2005; 2) the acquisition of Andrex Corporation in early 2006; 3) the acquisition of United Surgical Partners International, Inc. by a private equity firm in mid-2006; and 4) the purchase of Biosite Incorporated in early 2007.

The two brothers had a complex relationship. When Maher first joined the Citi healthcare group he had no experience in the sector. He periodically sought Michael's advice because of his college science background. As his career progressed Maher continued to discuss business with his brother, using him as a sounding board. Maher repeatedly gave his brother clear instructions that the information they discussed was confidential.

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Over time Michael began asking more pointed questions. In 2005 and 2006 he pestered his brother about healthcare companies. At times Maher avoided the phone calls. At times his nagging was so persistent that Maher disclose information to him to "get him off my back." Periodically Maher would remind his brother that the information was confidential. Michael never disclosed that he was trading on the information.

Michael and his brother-in-law began discussing stocks in late 2004. Michael furnished Mr. Salman with recommendations based on his own research as well as information from his brother. Mr. Salman's trading essentially paralleled that of Michael.

Maher and Michael testified at the trial of Mr. Salman on behalf of the government. Michael testified that his brother told him Bone Case would be acquired. Maher was working on the deal. Michael traded and advised Mr. Salman to invest. Maher also worked on the Andrex deal. After he was removed from the deal by his supervisor, he told Michael that he was extremely upset. Michael then invested in Andrex, without the knowledge of his brother. He also recommended that his brother-in-law purchase shares. Mr. Salman bought call options. Maher also told Michael about the USPI deal after persistent questioning; Michael traded and told Mr. Salman about it. He also traded. Finally, Maher told Michael about the Biosite deal after being implored to do him a favor. When Maher told his brother not to trade Michael responded "don't worry." He then traded and told Mr. Salman who also traded. There is no evidence that Maher knew the information was shared by Michael with anyone.

At the conclusion of the trial the court instructed the jury that to convict Mr. Salman of insider trading it needed to find that (1) insider Maher personally benefitted from the disclosure of material, nonpublic information and (2) that Mr. Salman knew that the insider had personally benefitted from the disclosure. The term "personal benefit" was defined to include "the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." The court informed the jury that it was not required to find that Mr. Salman knew "the specific benefit given or anticipated by the insider in return for disclosure of inside information; rather, it is sufficient that [Salman] had a general understanding that the insider was improperly disclosing inside information for personal benefit." The jury returned a verdict of guilty on all counts.

The Ninth Circuit affirmed. On appeal Mr. Salman argued that *Newman* required the reversal of his convictions. Specifically, he claimed that under *Dirks* and *Newman* the personal benefit instruction given by the district court was insufficient. Since there was no evidence that Mr. Maher engaged in an exchange with Michael that yielded even a potential pecuniary gain, under *Newman* the verdict should be set aside. The Ninth Circuit rejected this claim, holding that to the extent *Newman* went that far, the circuit declined to follow.

II. *Petitioner's Opening Brief*

The Petitioner asks the Court to draw a clear line demarking illegal tipping, an argument that evokes the underpinnings of *Dirks* and *Newman.* The issue for decision is framed as:

Whether *Dirks* requires "proof of an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature" or "is it enough that the insider and the tippee shared a close family relationship . . ." The approach is backstopped by the rule of lenity, limitations on the power of the federal courts in the area of defining criminal conduct and the constitutional due process notice and separation of powers provisions.

Petitioner begins with the familiar canon that only Congress can define criminal conduct. The Court has repeatedly held that Section 10(b) does not create any general duty to refrain from trading on inside information or entitle investors to a parity of information. Under the Court's approach the "line between lawful trading and criminal activity . . . is determined by whether the insider . . . disclosed the information to obtain some personal benefit. If he did not, there was no Section 10(b) violation, and the 'tippee" was free to trade." In drawing this line the focus was on the "improper exploitation of a fiduciary relationship for personal profit."

Section 10(b) does not specifically address the question of insider trading. This has been an important limiting principle since the Court first addressed the question of Section 10(b) and insider trading in *Chiarella v U.S.,* 445 U.S. 222 (1980). There, in drawing a line between the legal and the prohibited, the Court eschewed a parity of information theory, recognizing that "'not every instance of financial unfairness constitutes fraudulent activity under Section 10(b).'" The Court then concluded that the judicially implied insider trading offense "applies only where the person who trades has a fiduciary relationship with the issuer of the securities."

Dirks built on that determination three years later, emphasizing that "'only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information.'" The Court went on to hold that since a tippee generally owes no duty to the company, trading only violates the statute if the insider breached his fiduciary duty and the tippee knew it. But not every breach of fiduciary duty violates the statute. Rather, the *Dirks* Court concluded, there is a violation only when the breach was for personal benefit or gain. This rule provides a "guiding principle" for market participants.

The test for assessing the benefit is an objective one in keeping with the notion of establishing a guiding principle. The focus is on pecuniary gain or a reputational benefit that will translate into future earnings. As examples the Court cited "'cash, reciprocal information, or other things of value.'" In citing these examples, Petitioner argued that *Dirks* viewed the term "gain" as synonymous with "benefit," focusing on the idea that the insider is exploiting corporate information for "profit." Thus the "quid pro quo" of the exploitation is for tangible benefits potentially flowing to the insider, not those which are intangible. The fraud thus turns on the insider's pecuniary motive. This approach is consistent with the Court's later Section 10(b) jurisprudence as well as cases under provisions like the honest services fraud statute. *See, e.g. McNally v. U.S.,* 483 U.S. 350 (1987).

Salman does not involve securities fraud, according to Petitioner: "Maher did not trade on the information, and he did not provide it to get a kickback. On the contrary, Maher gained nothing of value from his disclosures, and had no financial motive. His motive was to get a bullying brother 'off his back.'" Indeed, the government has conceded that Maher's "'breaches of fiduciary duty were in large part the result of Michael Kara's persistence in seeking inside information.'" While their relationship was one of love and trust, Michael also manipulated and deceived his brother.

Defining personal benefit as pecuniary gain is consistent with the Court's earlier decisions as well as constitutional limitations, according to Petitioner. First, it has long been held that criminal statutes must be construed strictly under the due process clause as well as the rule of lenity. Second, it would be a violation of due process to take someone's life, liberty or property using a criminal standard that is vague and fails to give ordinary people fair notice. Third, to the extent the personal benefit concept incorporates intangibles, it is ambiguous and thus must be resolved in favor of Petitioner. This is consistent with the Court's jurisprudence limiting the scope of the implied right of action under Rule 10(b)-5 which is grounded in constitutional separation of powers principles. *See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164 (1994); *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. 148 (2008).

Finally, the standard used by the Ninth Circuit in *Salman* undermines *Dirks'* limiting principle: "Any suggestion that the personal benefit requirement could be established by psychic gratification, such as the satisfaction derived from giving a gift, would render the requirement impermissibly vague." In this case "[a]ny benefit Maher might have received is purely emotional, and it is unclear what that benefit could have been." Indeed, using the gift concept as a proxy for the personal benefit element fails to give law enforcement a minimal guideline. This is evident from the over three decades of cases following *Dirks* in which the DOJ and the SEC "effectively nullified the personal benefit requirement by invoking the 'gift' talisman whenever there is no tangible economic benefit to the tipper." Enforcement on this basis results in the kind of arbitrary and discriminatory actions the due process clause was designed to prevent. "In sum, a pecuniary benefit is the paradigmatic benefit described not only in *Dirks* but also in this Court's other insider trading cases . . ." The decision of the Ninth Circuit should be reversed.

III. *Respondent's Brief*

The Solicitor General and the SEC present the issue for decision this way: "Whether, under *Dirks v. SEC,* 463 U.S. 646 (1983) a tipper personally benefits, and thereby breaches his fiduciary duty, by disclosing confidential information to a tippee as a gift for use in securities trading." In analyzing this issue the SEC contends that the "essential quality of a gift of confidential corporate information – and the reason why a gift of such information for trading breaches the insider's fiduciary duty – is that it serves personal, not corporate, purposes. Thus, when the objective facts show that information was provided as a gift for securities trading, and no corporate purpose exists for the disclosure, the personal-benefit is satisfied."

The government's brief begins and ends with *Dirks.* There is little mention of the Second Circuit's decision in *Newman.* A corporate insider violates Section 10(b) of the Exchange Act, according to the government, by trading in the securities of his corporation on the basis of material, non-public information. Under the classic theory of insider trading those securities transactions are a deceptive device within the meaning of the statute because it "violates the relationship of trust and confidence that exists between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." (internal citations omitted). The misappropriation theory is also built on deception, but tied to an outsider feigning loyalty to the duty owed to the source of the information.

Following these principles, the *Dirks* Court concluded that analyst Ray Dirks did not violate the securities laws by disclosing material non-public information as he did not trade and sought only to expose a fraud. The Court disapproved of the "broad theory" which it viewed as implicit in the SEC's censure of Dirks. That theory would have required equal access to information by all traders. "Nevertheless, the Court confirmed, a corporate insider violates Rule 10b-5 when he possesses information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and takes advantage of that information by trading without disclosure." (internal quotations omitted). That action is contrary to the duty of the insider to the shareholders.

The duty of a tippee is derivative of the insider, *Dirks* explained. The tippee who received inside information assumes the fiduciary duty of the insider. The critical question becomes whether the insider will personally benefit from the disclosure. That question must be resolved by considering the objective facts. For example, there may be a relationship where the exchange is a *quid pro quo.* Likewise, when an insider makes a gift of inside information to a "trading relative or friend," a situation in which "'[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient'" may exist (quoting *Dirks,* 463 U.S. at 664).

Based on these principles, the *Dirks* personal benefit test is met when the insider discloses corporate information without a corporate purpose, according to the SEC. The personal benefit requirement is a means of determining if the insider has breached his or her fiduciary duty. The insider has access to inside information only for a corporate purpose – access is not provided for personal use. Thus, an "insider who trades for himself on material, non-public information inherently acts contrary to a corporate purpose, to the detriment of shareholders. That trading is a breach of his fiduciary duty. The same is true when an insider, while not trading himself, provides the information to a tippee for that person to trade." Under *Dirks* the insider may not furnish the information to the tippee to do what he cannot – trade. Thus the "existence of 'personal benefit' is simply the flip side of the absence of a corporate purpose . . . and so a personal benefit exists when a corporate purpose does not," according to the SEC.

Dirks also says that "a personal benefit 'exist[s] when an insider makes a gift of confidential information to a trading relative or friend,'" (quoting *Dirks* at 664). In that circumstance, as well, the insider acts for a personal purpose and – given that the tip is a 'gift' precisely because the tipper understands that the tippee intends to trade on the information and make money from it – sets a third party against the shareholders' interest." The critical point is that the insider breaches his fiduciary duty by disclosing the inside information to a "favored person, and does so knowing or expecting that the information will be used for securities trading."

Under *Dirks* "a gift of information for trading intrinsically involves a personal gift." *Dirks* emphasized that a gift of information with the expectation that the recipient will convert it into cash is the functional equivalent of the insider trading himself. Thus, in order "for a gift of information to trigger liability, the government need not show that the insider personally profited (or expected to) in a financial sense. The point of a gift is to transfer something of value without a *quid pro quo* . . . Thus, if the evidence establishes that the insider gave a gift of information for trading and that a business justification for the disclosure is absent, the fact finder need not investigate the exact nature of the personal reasons that drove the tipper to decide to confer such a gift." And, the insider may benefit in intangible ways. The critical question is thus whether the tipper is "serving a corporate purpose, not . . . what the gifting tipper obtains for himself . . ."

Finally, the *Dirks* personal benefit test applies to a gift to any person. The "relative or friend" language in the opinion was not presented as a limiting principle.

The government argues that Petitioner's arguments are not consistent with *Dirks.* First, his claim that insider trading does not involve deception is directly contrary to the Court's earlier decisions. Second, Petitioner's claim that the personal benefit must be for a pecuniary gain misreads *Dirks* which states that "a gift of confidential information is sufficient to establish that the tipper has personally benefited and thereby breached his duty." Third, the *Dirks* standard is not vague. To the contrary, it has been well understood for thirty years until the "erroneous" decision in *Newman.*

III. *Petitioner's Reply Brief*

The opening paragraph of the brief focus on these themes: "The government's brief illustrates the dangers of common-law crimes. A personal benefit test that extends beyond pecuniary gain presents vagueness dangers, so the government asks the Court to refashion the judge-created tipping crime by replacing the personal benefit element with a broader 'lack of corporate' requirement. The government invites the Court to create this new rule long after Petitioner acted, thus ensuring that he had no notice of the proposed retroactive judicial expansion of the crime."

First, the government's position is "squarely at odds with *Dirks,*" according to Petitioner. That decision did not fashion the "corporate purpose" test advanced by the government. Section 10(b) liability for tipping does not hinge on "whether the insider had a corporate purpose for making his disclosure." To the contrary, under *Dirks* the question is whether the "insider personally *will benefit,* directly or indirectly from his disclosure. Absent some *personal gain,* there has been no breach of duty to stockholders," according to Petitioner (emphasis in original). Lack of a corporate purpose is not the question. Only personal gain triggers liability under *Dirks.*

This approach is tied to the Court's *quid pro quo* theory of liability that the insider is in effect selling the information selectively "for cash, reciprocal information, or other things of value for himself" (internal quotes omitted). The personal benefit test hinges on whether the insider receives a benefit from the disclosure such as a pecuniary gain or "a reputational benefit that will translate into future earnings."

The predicate for the *Dirks* approach is the Section 10(b) requirement of deception. As the Court made clear in *Santa Fe v. Green,* 430 U.S. 462 (1977), a breach of fiduciary duty is not sufficient to violate the Section. Rather, there must be manipulation or deception. The tip must thus be "a *fraudulent* breach" that "takes advantage of information intended to be available only for a corporate purpose *and not for the personal benefit of anyone."* Viewed in this context, a disclosure is fraudulent only when the tipper's motive is pecuniary. The government's claim that disclosing the information when the tippee will trade is inconsistent with this notion. Indeed, under this test *Dirks* would have come out the other way because the Court only found that the tipping insider did not receive a personal benefit, not that those receiving the information would not trade.

Second, the government's claim that the pecuniary gain standard is inconsistent with the gift language of *Dirks* is incorrect. In view of the emphasis in *Dirks* on pecuniary gain, the Court "could not have intended to equate 'gift' with situations in which the tipper receives nothing with personal benefit to the tipper." Also incorrect is the government's contention that the phrase "trading relative or friend" which apples to "gift" does not mean what it says and fails to limit the notion of gift. That suggestion leaves the concept open ended, ignoring the fact that *Dirks* established a limiting principle.

Third, the government's position is inconsistent with the text of the statute, its history and constitutional limiting principles. There is nothing in the text of Section 10(b) about insider trading. While the government cites to various amendments to the statute, those provisions do not address the situation here. Likewise, the legislative history to those sections does not support that position.

Finally, the open ended position of the government highlights the need to narrowly construe the personal benefit test. Here the "government seeks unbounded license to prosecute people for trading with an informational advantage . . . [which is] why the Constitution commits the power to define crimes to the legislature, and why it requires Congress to provide clear notice about what conduct is barred . . . The need for a narrow construction is even greater here, because §10(b) does not expressly prohibit *any* insider trading" (emphasis original). Under similar circumstances in other areas such as "honest services fraud" the Court has rejected attempts to utilize broad concepts to impose criminal liability. *See, e.g. McNally v. U.S.*, 483 U.S. 350 (1987). That same approach is required here – the personal benefit test must be cabined to its *Dirks* defined contours, not left as the open ended concept suggested by the government which would impose the long rejected "parity of information" rule.

Under the facts here there is no legal basis for imposing liability using the government's "novel lack-of-corporate-purpose" approach. Indeed, there is "no legal basis to expand the tipping crime to cover 'remote tippees" who have not participated in the tipper's breach of duty. The government does not dispute Salman's lack of involvement in the breach . . ." And, the jury was not instructed on the "lack of corporate purpose" standard. Thus, the conviction must be reversed.

IV. *Oral Argument*

Oral argument in *Salman* highlighted the themes threaded through the briefs of the parties and the Court's 1983 opinion in *Dirks*, centering on the question of gifts of inside information. Petitioner Salman hewed to the notion that the personal benefit and any gift must result in a pecuniary benefit to the insider. Petitioner cautioned that the Court should tread carefully in crafting elements of an insider trading cause of action in a criminal case as it has in construing other federal criminal statutes such as in the honest services fraud area. Respondent, in contrast, argued that transmitting inside information to one who intends to trade is impermissible. Both parties claimed the mantel of *Dirks* while the Court time and again returned to its earlier opinion, gently chiding the advocates they their positions were out of step with that decision.

Petitioner, represented by Alexandra Schapiro, began by citing *McNally* and *Skilling,* two honest services fraud cases, and *McDonald,* the Court's reversal of former Virginia governor Bob McDonald's corruption conviction last term, for the proposition that Congress, not the courts should define vague statues like Exchange Act Section 10(b) which fails to mention insider trading. The Court was not receptive. Justice Ginsburg immediately went to the core of the case: "Suppose in this case the person with the . . . inside information, the brother with the inside information, had himself traded in the securities, and then gave the proceeds to his . . . older brother? Would that have violated 10(b)?" Petitioner responded to the hypothetical, drawn nearly verbatim from *Dirks,* that it would. Justice Kennedy immediately picked up the theme noting that "[t]his is standard accomplice stuff."

Petitioner tried to return to the key theme of her argument: "if the insider – as occurred in this case, and it's undisputed in this case – did not act for any financial gain, did not make any money at all, that's what's not covered" by Section 10(b) and *Dirks.* Justice Sotomayor then turned to the question of what constitutes a gift: "Isn't that always the quid pro quo of a gift, that you believe that if you give someone a gift, it's going to cost you one way or another?" While that may be true Petitioner noted, under that test "virtually anything would – any disclosure would then amount to a gift, and this Court has been crystal clear that – that not any disclosure leads to a violation."

Justice Sotomayor agreed that every communication of inside information is not a violation of the law. Rather, there has to be "a personal benefit, or a personal purpose, that there has to be a reason you're doing it, not accidentally, not – unknowingly, but something you're doing because you want to receive some benefit from it." Justice Breyer picked up this theme, tying the notion of receiving a benefit from a gift to family members, noting that "the statute books [are] filled with instances where the public wants to know . . . how your family might benefit."

Justice Kagan then returned the argument to what became a central theme: "So there's a lot of language in *Dirks* which is very specific about, it's not only when there's a quid pro quo from the tippee to the tipper, but when the tipper makes a gift to the tippee, and in particular a relative or friend." While Petitioner agreed with this point, Ms. Schapiro, tried to turn back to her central theme – there has to be a pecuniary benefit. Justice Kennedy was unconvinced, noting that "*Dirks* says there's a benefit in making a gift . . ." Justice Kagan agreed noting that here "I'm stealing corporate information. It's essentially a kind of embezzlement or conversion. I'm stealing information to give a gift to somebody I know. It might be, as in this case, a family member. It might be a friend. And I benefit from that because . . . I personally benefit. It's the exact opposite of using corporate information for corporate purposes. I'm using it for my own personal benefit."

Petitioner continued to press for a "clear line," a central theme of *Dirks.* Justice Breyer brushed aside the issue of vague statutes such as honest services fraud, citing the antitrust laws as a "very vague statute." The real question here, according to Justice Kennedy, is not whether there is a breach – that is a given – but how "far out does liability extend?" Petitioner's line was financial – the gift must be financial. When pressed further by Justice Stomayor who asked for an alternative, Petitioner admitted there was none. If "*Dirks* is the test" noted Justice Ginsburg, "then this case falls within it because it's a gift, right?" Petitioner disagreed.

Justice Kagan seemed to sum up the Court's view, stating: "Ms. Schapiro, here [it] is not a question of expanding it [*Dirks*] further. You're asking us to cut back significantly from something that we said several decades ago, something that Congress has shown no indication that it's unhappy with . . . And you're asking us essentially to change the rules in a way that threatens that integrity . . ." of the markets.

Picking up on comments from the Justices, the government, represented by Deputy Solicitor General Michael Dreeben, began by claiming that a "pecuniary gain" limitation to the personal benefit test would be harmful to the integrity of the securities markets, permitting an insider to "parcel it [inside information] out to favored friends, family members and acquaintances [who] could all use it in trading . . ."

Exploring the limits of the gift theory, Chief Justice Roberts then noted that "not everything is a gift . . . social acquaintances, you know, that people say we're all going away for the weekend, why don't you join us? I can't, I'm working on this Google things, or something like that, and it means something to the other people. You wouldn't call that a gift. You'd call it a social interchange . . . And it seems to me that, however you read *Dirks* . . . certainly doesn't go beyond gifts." The Government did not disagree. The difference is that there has to be a breach where the information was made available to the insider for a corporate purpose and the insider is providing it to someone for a personal purpose.

Justice Breyer proceeded to examine the limits of the Government's view by asking "If you give it [inside information] to anyone in the world, and – whom you happen to know, and you believe that that person will trade on it, that is for a personal advantage" to which the Government responded "Yes." The breath of this comment lead Justice Alito to state that "[i]t doesn't seem to me that your argument is much more consistent with *Dirks* than Ms. Shapiro's." Mr. Dreeben responded, arguing that disclosing information that was entrusted for a corporate purpose to any person for trading violates the insider trading laws. The limit to this position, the government told the Court, is if "there's no knowledge that the individual to whom you're going to give the information is trading, there's no breach of the *Cady, Roberts* [seminal SEC administrative decision in the area] duty. This is because *Dirks* is bottomed, according to the government, on the traditional corporate duty of loyalty – a point the Government reiterated but which was not picked up by any of the Justices.

When assessing the knowledge of the insider regarding the prospect that the outsider would trade, the government contended that the duty is breached if the "insider anticipated that the person to whom he gave the information would trade." Anticipated is the same as knowledge, the government told Justice Kagan in response to a question. Later the government augmented this point, noting that the doctrine of conscious avoidance could also be used to establish knowledge.

The limits of the government's theory – and the difference between DOJ criminal cases and SEC civil enforcement actions – was explored in an exchange between Justice Sotomayor and the government:

Justice Sotomayor: " I think you're taking this way out of existing law. Are you going to suggest that tippees aren't routinely prosecuted when tippers don't know that they are going to trade? I think they are, and most often it's because you claim that they should have known it was confidential information."

The government: "In a criminal case, we're not claiming that. The SEC in a civil case--"
Justice Sotomayor: "There's plenty – there's a legion of cases I read for this – preparing for this argument where the government has said--"

The government: "I don't think that there are, Justice Sotomayor, because I don't think that that's what we're – we're certainly not making that submission in this case. And I think that the cases that we are trying and the jury instructions that we are obtaining contemplate that the disclosures to a trading relative or friend. And that is the heart of the gift theory. So I don't think that I'm departing from the way that the --"

Justice Sotomayor: "So you're going to let go of the guy that Justice Alito – the guy on the street who looks dejected is not my friend or a close relative, but I give you a tip and say, go trade on this. It will make you a lot of money. That person – that tipper would not be liable."

The government: "He would, Justice Sotomayor, for the very reason you yourself articulated. In that situation, there's a gift of information to someone whith the intent that the person trade."

As the argument drew to a close Justice Kagan asked the government if they could limit the gift issue for now to relatives and friends, leaving the broader question for later. The government agreed.

V. *Analysis*

While each party claimed to have advanced a position which closely followed *Dirks,* the arguments highlighted the fact that neither the position of the Petitioner nor that of the government faithfully applied the Court's seminal decision. To the contrary, as questioning from the Justices made clear, Petitioner is requesting that the scope of *Dirks* be contracted. The government is asking that *Dirks* be expanded and the effect of that decision to establish a clear, bright line be obliterated.

Despite the positions of the parties, during the argument the Justices repeatedly indicated that *Dirks* and its holding regarding gifting inside information to relatives or close friends will stand. While neither the Justices nor the advocates discussed the kind of evidence necessary to establish this point, or the *Dirks* demand for objective criteria, those requirements seem likely to stand as well as the core holding of the decision requiring a personal benefit and limiting gifts to relatives and close friends. Despite the insistence of the government that the Court eliminate its restriction on gifts in favor of a standard which prohibits any transmission of inside information where there is reason to believe that the recipient may trade, discussion during the argument seemed to make clear that the Justices do not favor that rule. At best there could be some reservation suggesting that the question of gifts to non-family members and friends is reserved for later consideration.

Finally, discussion during the argument seemed to suggest that the facts of Mr. Salman's case fall squarely within the rule of *Dirks.* While the Court could remand the decision for consideration by the lower court in view of the opinion, it may simply affirm the verdict but not the rationale of the circuit court. Neither the approach of the Ninth Circuit nor that of the Second Circuit in *Newman* was discussed during the argument. In view of that, as well as the overall argument, it seems apparent that the Court intends to reaffirm *Dirks* and perhaps clarify its basic holding without regard to the opinions in either circuit court case.

ENFORCEMENT CONTINUUM - FROM COMPLIANCE TO CRIMINAL ENFORCEMENT (OR NOT…)

- ❑ What is the value of an effective compliance program?
- ❑ How do we get there?

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Effective Compliance is the Destiny

What is
effective
compliance?

"Compliance is a culture, not just a policy"

- Brent Snyder, DOJ

First - Understand the Broad Operating Environment Facing All Companies

- The “Flint Effect”
- The Focus on Cases with Potential Public Health Impacts
- EPA’s National Enforcement Initiatives
- State (and local) priorities
- Public Expectations
- The “full spectrum” of environmental responsibilities
- Worker and Chemical Safety Initiatives
- The “Yates Memo” and focus on corporate and individual accountability.

Let EPA tell you what's important…National Enforcement Initiatives

(Every three years, EPA sets national enforcement initiatives to focus civil and criminal enforcement resources and expertise on serious pollution problems affecting communities.)

Air
* Reducing Air Pollution from the Largest Sources
* Cutting Hazardous Air Pollutants (Expanded for 2017-2019)**

Energy Extraction
* Ensuring Energy Extraction Activities Comply with Environmental Laws

Hazardous Chemicals
* Reducing Risks of Accidental Releases at Industrial and Chemical Facilities

Water
* Keeping Raw Sewage and Contaminated Storm Water Out of Our Nation's Waters
* Preventing Animal Waste from Contaminating Surface and Ground Water
* Keeping Industrial Pollutants Out of the Nation's Waters

****Protecting Communities from Exposure to Toxic Air Emissions**

*****Organic Liquid Storage Tanks* which can be a source of excess air emissions at many sites

**Hazardous Waste Air Emissions* which can result in toxic air emissions if improperly handled resulting in public health risks and potential for fire or explosion risks.

Understand the Distinctions Between Civil and Criminal Enforcement…..

- Civil Judicial and Administrative
  - Strict liability violations
  - Burden of Proof: Preponderance of the evidence
  - Results:
    - civil penalties
    - injunctive relief
    - SEPs
- Criminal
  - Knowing/intentional violations
  - Burden of Proof: Beyond a reasonable doubt
  - Results:
    - incarceration
    - conditions of probation
    - restitution
    - criminal fines
    - community service

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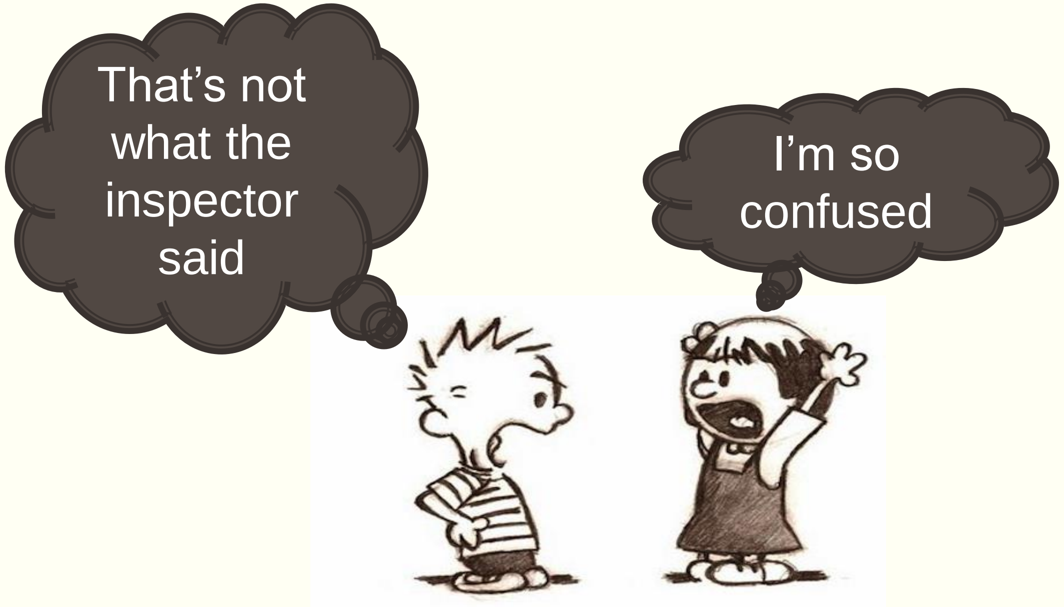
Handle Conflicting Agency Directives

What happens in a situation when a State DEQ and EPA tell you different things?



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Federal law serves as the minimum or floor.

State laws can be and often are more stringent.

EPA overfile action.

Establish Best Practices….

- Auditing Self-Disclosures
- EMS/Legal Registry
- Onsite Compliance Documents
- EHS Training
- External Outreach
- Permit Reviews (T&Cs)
- Ethics/ Compliance Hotline
- Incident Review Calls - Root Cause Analysis
- Train for Incident Response
- Management of Change
- SOPs (*sampling)

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Environmental Headlines, Priorities, and What's Next…

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Recent Enforcement Headlines

- “Company tampered with its air pollution monitoring equipment and falsely reported data to environmental regulators.”
- “Crestwood Official Convicted Of Falsifying Reports To Conceal Village’s Use Of Well In Drinking Water Supply”
- Attorney General “Charges Three with Multiple Felonies in First Stage of Flint Water Crisis Investigation”
- “Laboratory Manager Sentenced to 21 month in prison for falsifying water sampling for clients.”
- “Company and owner indicted for illegally storing hazardous waste and releasing hazardous air pollutants”

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Understanding Key Enforcement Triggers

- Significant environmental harm
or
public health impacts
- Deceptive or misleading conduct
- Operating outside of the regulatory system
- Repetitive violations

Emergence of Analytics

- Compliance reporting is becoming significantly more visible
- EPA and States are aggressively moving to electronic reporting in all environmental sectors – with DMRs at the forefront (eDMRs)
- “Governmental Data Silos” are lessening
- EPA and states will become far more efficient in spotting anomalies with the advent of electronic reporting and analytical trend analysis (NextGen Compliance)
- Third Party groups (eNGOs, community groups, and occasionally competitors) are utilizing this newly transparent data to advocate and litigate.
- Successful analysis can be a much quicker entre to enforcement

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At the end of the day . . . how do I assess my compliance?

- What permits am I required to have and do I have all of them in place? Do I know the terms?
- Am I incorporating the "what's new" in my work (environmental justice, NGO scrutiny, the latest "Flint Effect," etc.)
- Are my operators/employees trained appropriately and do they understand their responsibilities - and their "operating environment"?
- Am I confident there are external controls to oversee my team's compliance? Avoid being "one person deep…"
- How will I (and my team) respond when exceedances or incidents occur?
- Have I built effective relationships with my regulators –including local emergency response officials?
- Does the C-suite (and other business units) support and understand our work?
- Do employees ***really*** feel empowered to "stop the work" for EHS?

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Key Takeaways

- ❑ Scrutiny of operations is at an all time high
- ❑ Focus on accurate reporting – Not just "meeting the permit. . ."
- ❑ Don't delay elevating serious compliance concerns – time lags are red flags to regulators
- ❑ Exceedances are explainable, false statements are not
- ❑ Transparency is paramount
- ❑ Build redundancy and controls so individual operators cannot solely bind the company
- ❑ Beware of clients/contractors who don't share a compliance culture

THANK YOU

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