SIFMA Compliance and Legal Society New York Regional Seminar 2015: Ethical Issues for Legal and Compliance Officers

Trends and Developments: the Yates Memo, Whistleblowers and Gatekeepers

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I. GM UPDATE

Last year, this panel focused extensively on the just-released GM Report, and thus we wanted to give a brief update in that matter:

- On September 17, 2015, the U.S. Attorney's Office for the Southern District of New York announced a Deferred Prosecution Agreement with GM, whereby the Company admitted pursuant to the agreement that it failed to disclose the ignition switch, safety defect to the National Highway Traffic Safety Administration and misled U.S. consumers about the same defect. GM agreed to an independent monitor to review and assess its public safety-related statements, sharing of engineering data, and recall processes, and agreed to pay a $900 million forfeiture. No individuals were charged in the information. *See* FBI Press Release of September 17, 2015 https://www.fbi.gov/newyork/press-releases/2015/manhattan-u.s.-attorney-announces-criminal-charges-against-general-motors-and-deferred-prosecution-agreement-with-900-million-forfeiture.

II. RECENT TRENDS AND DEVELOPMENTS

There have been a number of developments affecting legal and compliance officers this past year. We want to focus on three of those: (1) the continuing emphasis by the enforcement agencies on pursing responsible individuals, including the Department of Justice's recent pronouncements on the subject in the September 19, 2015 Memo from Sally Quillian Yates, (2) recent developments in the SEC's Whistleblower program, and (3) the continuing trend in holding gatekeepers responsible for their associates' wrongdoing.

A. Sally Quillian Yates Memo of September 19, 2015

Deputy Attorney General Sally Quillian Yates issued a Memo to Department of Justice Attorneys on September 9, 2015, entitled "Individual Accountability for Corporate Wrongdoing." The Memo emphasized the need to hold individuals accountable, not just corporate entities, in order to combat corporate fraud and misconduct. It established six principals to be applied in any investigation of corporate misconduct – civil or criminal:

1. In order to qualify for *any* cooperation credit, corporations much provide to the Department all relevant facts relating to the individuals responsible for the misconduct;

2. Criminal and civil corporate investigations should focus on individuals from the inception of the investigation;

3. Criminal and civil attorneys handling corporate investigations should be in routine communication with one another;

4. Absent extraordinary circumstances or approved departmental policy, the Department will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation;

5. Department attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases, and should memorialize any declinations as to individuals in such cases; and

6. Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond the individual's ability to pay.

- While not all of these principals are new, the requirement that companies identify individual wrongdoers in order to receive *any* cooperation credit is a substantial change from the Department's prior policy. As Yates explained it in announcing the new policies: "The rules have just changed. Effective today, if a company wants any consideration for its cooperation, it must give up the individuals, no matter where they sit within the company. And we're not going to let corporations plead ignorance. If they don't know who is responsible, they will need to find out. If they want any cooperation credit, they will need to investigate and identify the responsible parties, then provide all non-privileged evidence implicating those individuals." Remarks of Sally Quillian Yates (September 9, 2015) http://www.justice.gov/opa/speech/deputy-attorney-general-sally-quillian-yates-delivers-remarks-new-york-university-school.

- Also new is the Yates' directive that the Department of Justice will not release any individuals absent undefined, "extraordinary circumstances." And that any such "extraordinary circumstances" must be personally approved in writing by the relevant Assistant Attorney General or United States Attorney.

- Opposite of a release, the Department attorneys must include a discussion of potentially liable individuals, a description of the current status of the investigation regarding their conduct and investigative work that remains to be done, and an investigative plan to bring the matter to resolution prior to the end of any statute of limitations period. If a decision is made at the conclusion of the investigation not to bring civil claims or criminal charges against the individuals who committed the misconduct, the reasons for that determination must be memorialized and approved by the United States Attorney or Assistant Attorney General whose office handled the investigation, or their designees.

- The Yates Memo does not purport to change the Department's policy with respect to attorney-client privilege and work product – which states that "[e]ligibility for cooperation credit is not predicated upon the waiver of attorney-client privilege or work product protection," but that the Company must disclose the relevant *facts* concerning misconduct. United States Attorneys Manual, § 9-28.720 http://www.justice.gov/usam/usam-9-28000-principles-federal-prosecution-business-organizations.

The measures proscribed by the Yates Memo are likely to have a number of significant impacts in how corporations conduct internal investigations, as well as with how they interact with the Department of Justice. For example:

- Cooperation by Corporations: The Department of Justice clearly hopes that the Yates Memo directives will result in more corporations finding and producing evidence against its employees and executives. But just the opposite could happen as well. By raising the bar with respect to cooperation – and making it an "all or nothing" prospect – some corporations may simply elect not to attempt cooperation out of fear they will turn over substantial fact work product to the government, yet yield nothing in return.

- Cooperation by Employees: The Yates Memo will make employees' decisions whether to cooperate with internal investigations even more thorny. If an employee wishes to stay employed, she will typically have no choice but to make herself available for an interview. But the calculus of whether the benefits of employment warrant the risks of an interview have changed. Before, employees faced the prospect of the Company sharing fact work product with the government, but leaving it for the government to conduct its own analysis and reach its own conclusions as to who might be culpable. Now, employees must make a decision whether to cooperate or not with full knowledge that the company may at some point elect to point fingers and name personnel that the company believes are responsible, and why.

- Joint Representation: The Department's emphasis on corporations identifying those responsible for any alleged wrongdoing, and providing evidence against those persons, will undoubtedly give rise to more conflicts of interest, or potential conflicts of interest, that will dictate against joint representation of the corporation and employees by outside counsel. As a result, we are likely to see corporations retaining "pool counsel" to represent employees during even the early stages of internal investigations, as well as paying for independent counsel for some employees and executives who fall within the Department of Justice's cross-hairs.

- Joint Defense Agreements: The terms of our joint defense agreements will have to be reviewed afresh in light of the Yates memo. If companies want the opportunity to claim cooperation credit, they will have to retain the right to share factual information learned from its current and former employees – even if those facts are learned during the course of an interview conducted under the purview of a joint defense agreement. Notification and withdrawal terms should also be reviewed in light of the new reporting requirements imposed by the Yates Memo.

- Length of Investigations: The new requirements are also likely to extend the amount of time it takes to conclude investigations and obtain approval for corporate resolutions. The additional planning and documentation concerning individuals, as well as the approvals

required either for releasing individuals, or subsequently determining not to charge them, will serve to lengthen the process even more, despite the Department's best efforts.

Time will tell whether the SEC follows suit and adopts similar directives aimed at increasing the number of charges against individuals. Shortly after being sworn in as the Chair of the SEC, Mary Jo White emphasized her intent to "pursue responsible individuals wherever possible":

- "Of course, there will be cases in which it is not possible to charge an individual. But I have made it clear that the staff should look hard to see whether a case against individuals can be brought. I want to be sure we are looking first at the individual conduct and working out to the entity, rather than starting with the entity as a whole and working in. It is a subtle shift, but one that could bring more individuals into enforcement cases." Speech of Mary Jo White at Council of Institutional Investors fall conference (September 26, 2013) http://www.sec.gov/News/Speech/Detail/Speech/1370539841202.

Commissioner Aguilar has also emphasized the need to hold individuals responsible – repeatedly voicing the view that the Commission is not doing enough to bring fraud charges against individuals and that it should be more aggressive in seeking permanent industry bars and officer and director bars.

- In a recent dissent in *In the Matter of Lynn R Blodgett and Kevin R. Kyser*, Commissioner Aguilar wrote: "I am concerned that this case is emblematic of a broader trend at the commission where fraud charges – particularly non-scienter fraud charges – are warranted, but instead are downgraded to books and records and internal control charges. This practice often results in individuals who willingly engaged in fraudulent misconduct retaining their ability to appear and practice before the Commission." Dissenting Statement of Commissioner Luis A. Aguilar, *In the Matter of Lynn R. Blodgett and Kevin R. Kyser, CPA* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542787855.

B. SEC Whistleblower Program

In July 2010, Congress expanded the SEC whistleblower program by enacting Section 21F of the Securities Exchange Act of 1934 as part of the Dodd-Frank Act. Section 21F requires the SEC to pay awards ranging between ten and thirty percent of the amounts recovered, subject to certain limitations and conditions, to whistleblowers who provide the SEC with original information about violations of federal securities law that leads to an enforcement action in which more than $1 million in sanctions are awarded. In August 2011, the SEC issued Regulation 21F to implement the requirements of Section 21F. The Regulations set forth the scope of and procedures for such whistleblower awards. Although the SEC was slow to implement the new whistleblower program and made only one award through 2012, the SEC subsequently ramped up the number and size of the awards.

In addition to providing the incentive of an award, the Dodd-Frank Act provides protection to "whistleblowers" who face retaliatory action from their employers. The courts continued to divide upon the question of whether an employee who reports an issue internally, but not to the SEC, can qualify as a "whistleblower" for purposes of these anti-retaliatory protections. The Second Circuit was the most recent court to weigh in on the issue, creating a split with the Fifth Circuit when it ruled that an employee could invoke the statutory whistleblower protections regardless of whether she reported the matter to the SEC:

- *Berman v. Neo@Ogilvy LLC*, 2015 U.S. App. LEXIS 16071 (2nd Cir. September 10, 2015): In *Berman*, an employee was discharged after making an internal report concerning alleged accounting fraud, but he did not report the issue to the SEC until months after his termination. Although Dodd-Frank expressly defines a whistleblower as someone who provides "information relating to a violation of the securities laws *to the Commission*," it also provides protection for "whistleblowers" who make "disclosures that are required or protected under the Sarbanes-Oxley Act of 2002" – which includes obligations to make reports internally at an employee's company. 15 U.S.C. § 78-u6(h)(1)(A)(iii). The Second Circuit found the statute ambiguous given this "arguable tension" between the reference to SOX disclosures and the definition of "whistleblower," and the incredibly narrow application the statute would have if it applied only to those who had been fired after reporting both internally *and* to the SEC. Thus, the Second Circuit deferred to the SEC's interpretative rule

on the matter, which stated that the protective provisions of the statute extended to persons reporting internally as well as those reporting to the SEC. Judge Jacobs dissented.

- The Fifth Circuit reached the opposite conclusion in *Asadi v. G.E. Energy (USA), LLC*, 720 F.3d 620 (5th Cir. 2013), holding that the definition of whistleblower "expressly and unambiguously requires that an individual provided information to the SEC to qualify as a "whistleblower" for purposes of § 78u-6. Further, the Fifth Circuit held, this did not render subpart (iii) (invoking SOX) superfluous because it would provide protection to a whistleblower who reported a problem internally and, unknown to the company, simultaneously to the SEC.

- The District Courts are similarly split on this issue – with at least four jurisdictions following the Fifth Circuit, and at least seven jurisdictions following the Second Circuit's approach. *Compare Lutzeier v. Citigroup Inc.*, 305 F.R.D. 107 (E.D. Mo. 2015); *Verfuerth v. Orion Energy Systems*, Inc., 65 F. Supp. 3d 640, 643-46 (E.D. Wis. 2014); *Banko v. Apple Inc.*, 20 F. Supp. 3d 749, 756-57 (N.D. Cal. 2013); *Wagner v. Bank of America Corp.*, No. 12-cv-00381-RBJ, 2013 U.S. Dist. LEXIS 101297, 2013 WL 3786643, at *4-*6 (D. Colo. July 19, 2013) ***with*** *Somers v. Digital Realty Trust*, Inc., No. C-14-5180 EMC, 2015 U.S. Dist. LEXIS 64178, 2015 WL 2354807, at *4-*12 (N.D. Cal. May 15, 2015); *Yang v. Navigators Group*, Inc., 18 F. Supp. 3d 519, 533-34 (S.D.N.Y. 2014); *Khazin v. TD Ameritrade Holding Corp.* No. 13-4149 (SDWQ)(MCA), 2014 U.S. Dist. LEXIS 31142, 2014 WL 940703, at *3-*6 (D.N.J. Mar. 11, 2014); *Azim v. Tortoise Capital Advisors*, LLC, No. 13-2267-KHV, 2014 U.S. Dist. LEXIS 22974, 2014 WL 707235, at *2-3 (D. Kan. Feb. 24, 2014); *Ahmad v. Morgan Stanley &* Co., 2 F. Supp. 3d 491, 495-97 n.5 (S.D.N.Y 2014); *Rosenblum v. Thomson Reuters (Mkts.) LLC*, 984 F. Supp. 2d 141, 146-49 (S.D.N.Y. 2013); *Murray v. UBS Securities, LLC*, No. 12-5914, 2013 U.S. Dist. LEXIS 71945, 2013 WL 2190084, at *4 (S.D.N.Y. May 21, 2013); *Ellington v. Giacoumakis*, 977 F. Supp. 2d 42, 44-46 (D. Mass. 2013); *Genberg v. Porter*, 935 F. Supp. 2d 1094, 1106-07 (D. Colo. 2013); *Nollner v. Southern Baptist Convention, Inc.*, 852 F. Supp. 2d 986, 995 (M.D. Tenn. 2012); *Kramer v. Trans-Lux Corp.*, No. 3:11CV1424 SRU, 2012 U.S. Dist. LEXIS 136939, 2012 WL 4444820, at *4 (D. Conn. Sept. 25, 2012); *Egan v. Tradingscreen, Inc.*, No. 10 Civ. 8202, 2011 U.S. Dist. LEXIS 47713, 2011 WL 1672066, at *4-7 (S.D.N.Y. May 4, 2011).

Meanwhile, the SEC continued the trend in expanding awards to whistleblowers this past year, utilizing statutory exemptions to grant awards to categories typically excluded – officers and compliance personnel.

- In March, the SEC awarded approximately $500,000 to a former company officer who had learned of the misconduct from another employee because the officer had reported the matter to the SEC "more than 120 days after other responsible compliance personnel possessed the information and failed to adequately address the issue. This is the first SEC whistleblower award to an officer under these circumstances." *See* SEC Press Release 2015-45 (March 2, 2015) http://www.sec.gov/news/pressrelease/2015-45.html.

- In April, the SEC made its second-ever award to a compliance officer who it said "had a reasonable basis to believe that disclosure to the SEC was necessary to prevent imminent misconduct from causing substantial financial harm to the company or investors." *See* SEC Press Release 2015-73 (April 22, 2015) http://www.sec.gov/news/pressrelease/2015-73.html.

The SEC also brought a first-of-its kind administrative action alleging that a company's confidentiality agreement violated Rule 21F-17, which prohibits persons from taking any action "to impede an individual from communicating directly with the Commission staff about a possible securities law violation."

- KBR used a form confidentiality agreement during in its internal investigations, asking employees to sign an agreement that prohibited them from talking to anyone about the substance or subject of their investigation interviews without prior authorization of the Law Department. The SEC acknowledged that it was "unaware of any instances in which (i) a KBR employee was in fact prevented from communicating" with the Staff, or "(ii) KBR took action to enforce the form confidentiality agreement or otherwise prevent such communications," but nonetheless found that the agreement "impedes such communications." KBR settled the matter, agreeing to pay a $130,000 monetary penalty. *In the Matter of KBR, Inc.,* Admin. No. 3-16466 http://www.sec.gov/litigation/admin/2015/34-

74619.pdf and SEC Press Release No. 2015-54 (April 1, 2015) http://www.sec.gov/news/pressrelease/2015-54.html.

- Chairwoman Mary Jo White subsequently stated that the SEC is not seeking to prohibit companies from issuing the standard *Upjohn* warnings that explain the scope of the attorney-client privilege in that setting, or from using confidentiality agreements to protect trade secrets. "But a company needs to speak clearly in and about confidentiality provisions, so that employees, most of whom are not lawyers, understand that it is always permissible to report possible securities laws violations to the Commission." Speech of Chair Mary Jo White at Ray Garrett, Jr. Corporate and Securities Law Institute (April 30, 2015) http://www.sec.gov/news/speech/chair-white-remarks-at-garrett-institute.html.

C. <u>Gatekeeper Liability</u>

The SEC has also continued its enforcement focus on pressing financial institutions to be "gatekeepers" who help identify and report on potential abuses by both customers and business partners:

- Andrew Ceresney discussed gatekeepers during a speech at SIFMA's 2015 Anti-Money Laundering & Financial Crimes Conference (http://www.sec.gov/news/speech/022515-spchc.html). One of the examples he provided was:
    - The Commission's settlement with Wedbush Securities and two of its officers for allegedly granting access to thousands of overseas traders without having appropriate safeguards in place, allowing potential wash trading and other forms of potential manipulation. *See In the Matter of Wedbush Securities, Inc., et al.,* Admin. No. 3-15913 http://www.sec.gov/alj/aljorders/2014/ap-1750.pdf and SEC Press Release, 2015-263 (November 20, 2014) https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543504806.
- He also discussed at length the Broker-Dealer Task Force's recent focus on firms who do not appear to have been filing Suspicious Activity Reports as required by the Bank

Secrecy Act. "The early efforts of this initiative have resulted in dozens of examinations and investigations potentially focused on BSA violations, and we will pursue recommendations for action if we conclude that Enforcement cases are warranted." One of the specific cases he discussed was:

  - The Commission's settlement with Oppenheimer & Co. for, *inter alia*, failing to file suspicious activity reports regarding potential misconduct by Gibralter Global Securities, who appeared to be conducting business without an applicable exemption from the broker-dealer registration requirements. *See In the Matter of Oppenheimer & Co., Inc.* Admin. No. 3-16361 http://www.sec.gov/litigation/admin/2015/33-9711.pdf and SEC Press Release, 2015-14 (January 27, 2015) http://www.sec.gov/news/pressrelease/2015-14.html.

- In April, the SEC announced a settlement with BlackRock Advisors LLC, resolving charges that BlackRock had breached its fiduciary duties by failing to disclose a conflict of interest created by the outside business activity of one of its top-performing portfolio managers to either the boards overseeing the funds affected, or the advisory clients. The portfolio manager (Rice) had a major financial stake-hold in a family business that formed a joint venture which eventually became the largest holding in BlackRock Energy & Resources Portfolio, which was run by Rice. The SEC also charged BlackRock's then chief-compliance officer, not only for failing to report the matter to the boards of directors overseeing the funds, but also for failing to adopt and implement policies and procedures for outside activities of employees. *See In the Matter of Blackrock Advisors, LLC, et al.,* Admin. No. 3-16501 http://www.sec.gov/litigation/admin/2015/ia-4065.pdf and Press Release 2015-71 (April 20, 2015) http://www.sec.gov/news/pressrelease/2015-71.html.

- Similarly, FINRA imposed a six month suspension from the securities industry on Gary Hume, the head trader and compliance officer for ACAP Financial, Inc., which was charged with assisting a customer's sale of unregistered securities. The SEC sustained the sanction, and Hume appealed to the Tenth Circuit, arguing that his conduct was merely supervisory, and did not meet the "egregious" case standard because it did not

involve an intentional or knowing violation. The Court affirmed, however, holding that while the SEC had previously said intentional or knowing violations were sufficient to make a case "egregious," the SEC had never held that they were a *necessary* predicate to a finding of "egregious." Moreover, the court observed that there was "unrebutted evidence of extensive supervisory failures in this case" and that "the agency concluded that Mr. Hume's conduct went so far as to cast doubt on his ability to carry out his obligations as a securities professional in any capacity. No one before us disputes this much can sometimes happen." *ACAP Financial, Inc. v. SEC*, 783 F3d 763 (10th Cir. 2015).

- In addition to enforcement activity addressing gatekeepers, the heightened focus on firm culture and ethics is also evident in both the 2015 FINRA Exam Priorities Letter and the FINRA Report on Conflicts of Interest, as well as the Group of 30 Report on Conduct and Culture.