ACA COMPLIANCE GROUP

April 13, 2015

# ACA Insight

The weekly news source for investment management legal and compliance professionals

"The SEC wants to litigate this matter in its own administrative court before its own administrative judges."

Inside Insights

**7** Bowden Will Leave OCIE, Acting Director Named

## Adviser Wants Trial by Jury: Tilton Sues SEC over Administrative Action

The self-proclaimed "turnaround queen" is seeking to turn the tables on the SEC.

The SEC on March 30 filed an order instituting an administrative proceeding against advisory firm CEO **Lynn Tilton**. The agency claimed that Tilton and her **Patriarch Partners** advisory firms, which invest in distressed companies, misappropriated almost $200 million from clients by mischaracterizing the performance of fund assets.

On April 1, Tilton, the subject of significant media attention, filed her own complaint against the SEC, challenging the agency's use of an administrative proceeding. She

continued on page 2

## SEC Sounds the Alarm on Confidentiality Agreements That May Stifle Whistleblowers

Better check the language in your employee confidentiality agreements. The SEC is on the lookout for wording that could potentially be used to prevent whistleblowers from communicating with regulatory agencies.

The Commission on April 1 levied a $130,000 civil money penalty against a Houston-based global technology and engineering firm for allegedly doing just that. It's the SEC's first enforcement action against a company "for using improperly restrictive language in confidentiality agreements with the potential to stifle the whistleblow-

continued on page 4

## Second Circuit Chooses Not to Review Key Insider Trading Decision

The new definition of insider trading may be here to stay – at least for a while.

The full U.S. Court of Appeals for the Second Circuit on April 3 denied U.S. Attorney **Preet Bharara's** petition that it review the December 10 decision of a Second Circuit three-judge panel that overturned the conviction of two hedge fund portfolio managers and makes it more difficult to prove insider trading. The Second Circuit gave no rationale for its decision not to review the panel's ruling in the case, *United States of America v.* ***Todd Newman*** *and* ***Anthony Chiasson***.

continued on page 6

ACA COMPLIANCE GROUP

## Adviser Wants Trial by Jury

continued from page 1

wants a trial by jury. An administrative hearing, which operates under different rules than litigation, would irreparably harm her constitutional rights, she argued in her complaint before the U.S. District Court for the Southern District of New York.

If Tilton gets her way, she would not only score a victory for herself and her firms, but may find herself the unexpected champion to a number of industry professionals who have argued that the SEC is relying too much on administrative actions to pursue those it charges.

"The suit was filed in response to the SEC's decision, after more than five years of investigation, to bring its claims against Tilton and Patriarch in an abbreviated administrative proceeding before an administrative law judge rather than in a U.S. District Court, where there are greater discovery rights and the right to a jury trial," said a spokesperson representing Tilton and her firms. "The SEC wants to litigate this matter in its own administrative court before its own administrative judges, without the same due process rights available to litigants in the federal courts, notwithstanding the collateral damage that may result."

"This is a new trend," said **Rogers & Hardin** partner **Stephen Councill** of attorneys for defendants filing cases against the SEC contending that administrative actions are improper. "Several have tried it," he said, noting that one resulted in the SEC dismissing the administrative proceeding voluntarily and refiling in federal court. On March 3, in another case, a judge ruled against a defendant seeking change in venue from an administrative hearing to a court.

### Administrative proceedings

What's the problem with administrative proceedings? According to SEC commissioner **Michael Piwowar**, who addressed the subject in a February 20 speech, "there is no jury and cases are presented to administrative law judges that are employees of the Commission. In addition, discovery available to defendants is more limited." (*ACA Insight*, 3/9/15)

The results tend to favor the SEC. "The Commission has an extremely high success rate when litigating through administrative proceedings," Piwowar said. He noted a November 2014 speech, "Is the SEC Becoming a Law Unto Itself?" by U.S. District Court Judge **Jed Rakoff**, where Rakoff said that the SEC won 61 percent of federal court trials but was successful in 100 percent of its administrative proceedings and that he saw "no good reason to displace that constitutional alternative with administrative fiat."

On the other hand, SEC Division of Enforcement director **Andrew Ceresney** takes a different point of view on the subject, as he did when he offered a spirited defense of the use of administrative proceedings in a November 2014 speech before the **American Bar Association's** Business Law Section (*ACA Insight*, 12/8/14).

"My bottom line is that, while we are using administrative proceedings more, we are still bringing significant numbers of contested cases in district courts," Ceresney said. "And our use of the administrative forum is eminently proper, appropriate and fair to respondents."

### The Tilton case

The agency's case revolves around the valuation of collateralized loan obligations (CLOs) in three funds, known as the Zohar funds, which collectively raised $2.5 billion from investors. That money was in turn used by the funds to make investments in distressed companies, and those loans are the primary assets of the funds. "However, many of the distressed companies have performed poorly," according to the administrative order.

The SEC charged that Tilton and three of her Patriarch Partner advisory firms "breached their fiduciary duties and defrauded clients" by failing to value those funds' assets using the methodology described to investors in the funds' offering documents. Instead, "nearly all" the loan asset valuations were reported to investors as unchanged from the time they were acquired – "despite many of the companies making partial or no interest payments to the funds for several years," the SEC alleged.

"Investors have not only been misled to believe that objective valuation analyses were being performed, but Tilton and her firms allegedly have avoided significantly reduced management fees because the valuation methodology described in fund documents would have given investors greater fund management control and earlier principal repayments if collateral loans weren't performing to a particular standard," the agency claimed. "Tilton and her firms also consequently have misled investors about asset valuations in fund financial statements."

Each of the funds' financial statements were prepared internally, then approved by Tilton, who also signed a certification stating that the balance sheet and income statements were prepared in accordance with GAAP standards, according to the administrative order. Nonetheless, the financial statements were not GAAP-compliant, nor did they present a fair picture of the funds' financial condition, the SEC said. The order does not refer to the use of any external auditors or accounting specialists.

The amount of the misappropriated management fees and other payments that Tilton and her firms allegedly received through improper valuation? Almost $200 million, the SEC said.

"Tilton violated her fiduciary duty to her clients when she exercised subjective discretion over valuation levels, creating a major conflict of interest that was never disclosed to them," said Ceresney.

Tilton and the Patriarch firms were charged with having willfully violated Sections 206(1), (2) and (4) of the Advisers Act, which prohibits fraud. In addition, they were charged with having willfully violated Advisers Act Rule 206(4)-8, which prohibits fraudulent conduct by advisers to pooled investment vehicles.

## Points of view

Of course, this is not how Tilton and Patriarch see things. "We are disappointed that the SEC has chosen to bring an enforcement action that is ill founded and at odds with Patriarch's investment strategy, which was consistently disclosed since the inception of the funds," said the spokesperson representing Tilton and her firms. "We look forward to the opportunity to vigorously defend ourselves against the SEC's allegations. ... The Zohar note holders are sophisticated investors that have extensive information to evaluate the cash flow performance of the Funds and the performance of the underlying companies."

"This SEC case is one of a long line of enforcement actions challenging the valuation methodology used by a fund adviser," said **Zaccaro Morgan** partner **Nicolas Morgan**. "As with most of these types of cases, the SEC does not allege that the adviser's valuations are false or incorrect. Rather, the SEC alleges that the adviser told its investors in fund governing documents that one valuation methodology would be used when in fact a different 'subjective,' non-GAAP compliant methodology was used. The takeaway for fund managers is to ensure that valuation methodologies set forth in representations to investors in fund governing documents match actual valuation practices used."

"It will be interesting to see what the evidence shows about whether auditors or accounting specialists were involved, something the administrative order does not mention at all," said Councill. "If they were, and if Tilton hid or concealed the actual valuation methodology from auditors, I would have expected the SEC to allege that fact. If Tilton claims she did use accounting professionals or auditors, and she's proven right, the SEC may have some challenges in showing intent to defraud."

## Valuation methodology

Each of the Zohar deals is governed by various deal documents, including an indenture and a collateralized management agreement, according to the SEC. Each CLO indenture contains certain monthly numeric tests. "If those tests are not met, the indenture outlines certain consequences, which include increased rights by the investors to control the fund and/or remove the collateral managers, and elimination of the funds' obligation to pay [one type of] fee," the SEC said. In addition, failure of the tests also changes the waterfall distribution for each fund in such a way that investors would receive earlier repayments on their principal.

ACA
COMPLIANCE GROUP

Under this arrangement, according to the agency, "Tilton and her firms are required to categorize the value of each loan asset in monthly reports by using a specific method." A loan that was current in its interest payments to the Zohar funds would be assigned the highest category, while those that are not current would fall into lower categories. The category assigned is then used in the calculation of an "overcollateralization ratio," which indicates the likelihood that investors will receive a return on their principal.

"If the overcollateralization ratio falls below a specific threshold, Tilton and her firms are not entitled to receive certain management fees and may be required to cede more control of fund management to investors," according to the SEC's administrative order.

But that formula, the SEC claimed, was not followed.

Instead, the categories of loan assets were not lowered until Tilton herself decided to cease financial support of a distressed company, the agency charged. "Thus, the valuation of an asset simply reflects Tilton's subjective assessment of the company's future. Absent an actual overcollateralization ratio test, investors aren't getting a true assessment of the actual values of their investments, which in reality have declined substantially."

### Disclosure and conflict of interest

Investors were not told about Tilton's approach to categorization, the SEC charged. That knowledge and the resulting impact on the overcollateralization ratio test "were important to investors and rendered statements about asset categories and [overcollateralization ratio test] results false and misleading," the agency said, adding that the discretionary approach to categorization, contrary to the disclosures made, "also represents a fraudulent and deceptive scheme, practice and course of business."

The SEC, which has made a point of cracking down on what it perceives to be conflicts of interest (*ACA Insight*, 3/23/15), made clear in its administrative order that it considers this case to be among them, noting that Tilton and her Patriarch firms were making decisions in a way that allowed them "to collect more money from the funds and retain absolute control over their management, regardless of the performance of the funds' assets."

## SEC Sounds the Alarm

continued from page 1

er process." As part of a settlement, it charged the firm, **KBR**, with violating Rule 21F-17 of the Securities Exchange Act, which prevents persons from taking any action that would prevent a whistleblower from coming forward.

"I think that the SEC has been looking for some time for a case with a confidentiality agreement that it could say impedes whistleblowers," said **Mayer Brown** partner **Matthew Rossi**, noting that the agency in June 2014 took action against a firm it said retaliated against a whistleblower (*ACA Insight*, 6/23/14).

Advisers should pay attention and not let the fact that the SEC's first action was against a corporation. "The SEC would not distinguish between corporate confidentiality agreements and investment adviser agreements," said **Shearman & Sterling** partner **Nathan Greene**. "This is intended as a wake-up call to any industry subject to SEC oversight."

"There is no reason the SEC could not apply the same reasoning to an investment adviser," said **Zaccaro Morgan** partner **Nicolas Morgan**.

### The original confidentiality statement

KBR, as part of its compliance program, conducts internal investigations when it receives complaints or allegations from employees of potential illegal or unethical conduct, including in the area of federal securities laws, by the company or its employees, according to the SEC's administrative order instituting the settlement. The SEC said that in KBR's interviews of company employees in such investigations, the company typically uses a form confidentiality statement that requires witnesses to agree to and sign the following:

"I understand that in order to protect the integrity of this review, I am prohibited from discussing any particulars regarding this interview and the subject

matter discussed during the interview, without the prior authorization of the Law Department. I understand that the unauthorized disclosure of information may be grounds for disciplinary action up to and including termination of employment."

The SEC found this statement problematic. "The language found in the form confidentiality statement impedes such communications [with Commission staff] by prohibiting employees from discussing the substance of their interview without clearance from KBR's law department under penalty of disciplinary action, including termination of employment. This language undermines the purpose of Section 21F [of the Securities Exchange Act] and Rule 21F-17(a), which is to 'encourage individuals to report to the Commission.'"

The SEC made clear in the administrative order that it had no evidence that KBR either prevented an employee from communicating with SEC staff or otherwise took action to enforce the confidentiality agreement.

## The new confidentiality statement

KBR, in what the SEC labeled a remedial step, amended its confidentiality statement so that employees could communicate with the SEC and other regulatory bodies, and removed the threat of disciplinary action and termination. Here is the new wording:

"Nothing in this Confidentiality Statement prohibits me from reporting possible violations of federal law or regulation to any governmental agency or entity, including but not limited to the Department of Justice, the Securities and Exchange Commission, the Congress, and any agency Inspector General, or making other disclosures that are protected under the whistleblower provisions of federal law or regulation. I do not need the prior authorization of the Law Department to make any such reports or disclosures and I am not required to notify the company that I have made such reports or disclosures."

"KBR takes its compliance obligations very seriously, and the SEC's order recognizes that the Commission is not aware of KBR having ever specifically prevented anyone from talking to the SEC or any other governmental agency," said the attorneys representing KBR. "Still, KBR agreed to resolve the matter amicably because it does recognize the SEC's concerns about confidentiality agreements. The KBR agreements were intended solely to protect the integrity of KBR's internal investigations and the attorney-client privilege, not to impede whistleblowers, and the company has agreed to modify its agreements to make this point clear."

## Issues and choices

What should an advisory firm that uses confidentiality statements do? There are several courses of action, each with some risk. "There is no perfect solution," said Rossi. Consider these options:

- **Use the same language KBR used in its amended confidentiality statement.** "This is the safest course," Rossi said. The SEC can hardly object if a firm uses it, since the agency stated that it considered KBR's use of it to be a remedial measure. It does raise some issues, however. For one, specifically mentioning the SEC and other regulators in the statement might give employees the thought of contacting them where they might not have had that thought before, he said. Morgan noted that the KBR amended language does not address the question of privileged information between an employee and a company attorney. If an employee reveals privileged information to the SEC or another regulatory body, then a prosecutor might argue that the employer has waived its rights in regard to that privileged information, he said.
- **Strike a middle ground between the original KBR statement and the new one.** A firm could draft a confidentiality statement that removes the threat of disciplinary action or termination, but that also does not explicitly state that employees are free to report to the SEC and other regulators, said Rossi. The issue here, of course, is that the SEC might say that the statement discourages employees from approaching regulators. "Any confidentiality provisions should avoid language that could be interpreted as requiring pre-clearance from an employer or threatening disciplinary action if a party to the agreement contacts regulators," he said.

ACA COMPLIANCE GROUP

- **Protect privileged information.** Specifically state that information employees learned for the first time during questioning by the legal staff is protected and cannot be reported. This preserves the firm's right to assert that information is privileged, said Morgan. Whether the SEC will find such language acceptable remains to be seen.
- **Don't use confidentiality agreements.** The only advantage to this option is that the SEC will not be able to object to anything in a confidentiality agreement, since there will not be one. The firm, however, will be unprotected in terms of privileged information.

"It's important to remember that the SEC is looking for these kinds of cases," said Rossi. "There will be more of them."

## Second Circuit Chooses

continued from page 1

"At this point, it is the Supreme Court or Congress," said **University of Michigan Law School** professor **Adam Pritchard**, referring to the remaining options before the U.S. Attorney's Office for the Southern District of New York. The SEC, which filed an *amicus curae* brief supporting Bharara's request for review and which also prosecutes insider trading, was also affected by the ruling.

An appeal to the Supreme Court is the one remaining judicial path open to the government. Congress is currently considering three bills that would, in different ways, define insider trading as a statutory crime, something that is not now the case (*ACA Insight*, 4/6/15). None of those bills is given much of a chance of passing, however.

"There is not much the U.S. Attorney's Office can do other than appeal to the Supreme Court or try to contain the Second Circuit holding in later cases," said **University of North Carolina School of Law** professor **Thomas Lee Hazen**. He added that it remains to be seen how the SEC will make use of the Newman decision, given that it was a criminal case with a higher burden of proof. Cases brought by the SEC are civil cases, which require a lower burden of proof.

"The SEC might prefer Congress, which is generally happy to crack down on white-collar crime," said Pritchard. "You could see five justices being skeptical of the government's effort to expand insider trading doctrine, particularly in a criminal context."

There is, of course, a third possibility: that the new rules for insider trading, as established by the Second Circuit three-judge panel, become, in effect, the new standard by which insider trading is judged. That would require either a government decision not to appeal to the Supreme Court or a loss from a government Supreme Court appeal, as well as no new insider trading bills passed by Congress and signed by the President. Don't expect the Department of Justice or the SEC to be happy about such a possibility, now a bit more likely than it was before the Appeals Court's decision not to review.

Barring an overturn of the Second Circuit by the Supreme Court or new statutory definitions from Congress, the main option for U.S. attorneys, given the Second Circuit's tighter definition on when tippees received inside information (*see below*), is to "draw back a bit on remote tippee liability—leaving those cases to the SEC—but otherwise business as usual," said **Georgetown University** law professor **Donald Langevoort**. "Each case is different, and different judges from those who were on the Newman panel will weigh in on precisely how heavy the burden is for the prosecution. We may well see Newman 'refined' in future cases, in ways that put to rest the worst of the prosecutors' fears."

In considering its options, the Department of Justice may well conclude not to pursue an appeal to the Supreme Court and instead see how its cases do in court, said **Wilmer Hale** partner **Douglas Davison**. A risk with going to the Supreme Court is uncertainty and the danger of further changes to insider trading that prosecutors may not like, he said. Instead, Justice Department prosecutors may choose to "pursue cases that meet the new insider trading requirements."

### The Newman-Chiasson case

The Second Circuit panel's decision in *Newman* reached near-landmark decision status almost immediately

ACA COMPLIANCE GROUP

after it was released (*ACA Insight*, 1/26/15). It not only reversed the convictions of Newman and Chiasson, but, according to legal scholars and practicing attorneys, rewrote insider trading case law.

The panel threw out the government's premise that the mere receipt of material, non-public information was, in and of itself, insider trading. Instead, it provided a stricter definition of insider trading that requires:

- Evidence of personal benefits received by the insiders who passed on the information. It must be proved that the tipper personally benefitted. Without that, there is no tippee liability, according to the decision.
- Evidence that the tippees knew they were trading on information obtained from insiders in violation of those insiders' fiduciary duties. The government presented no evidence of this in *Newman*, according to the panel.

But perhaps the most significant implication of the Second Circuit panel's decision was that it came up with a new definition of what constitutes a benefit. In doing so, it interpreted a benchmark 1983 U.S. Supreme Court case, *Dirks v. the SEC*, differently than it had been up to that point. The Second Circuit panel said, in effect, that a benefit received by a tipper would have to be quite tangible – "objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature" – for it to be considered a benefit given in return for material, non-public information.

With this tighter definition of the elements of insider trading, the U.S. Attorney's Office on January 23 petitioned both the three-judge panel and the full Second Circuit to review the decision – and the April 3 ruling by the full Second Circuit left all U.S. Attorneys' Offices and the SEC back where they were before the petition was filed.

## Bowden Will Leave OCIE, Acting Director Named

The SEC will lose the current director of its examination division on April 30.

**Andrew Bowden**, director of the SEC's Office of Compliance Inspections and Examinations since June 2013, will leave OCIE at the end of the month to return to the private sector, the SEC announced April 7.

The Commission on April 9 named **Mark Wyatt** as OCIE's acting director. He currently serves as OCIE deputy director, a post he was appointed to in October


**TO SUBSCRIBE**

**Call:**
(800) 508-4140

**Web:**
www.acainsight.com

**E-mail:**
subscribe@acainsight.com

**Fax coupon at right to:**
(301) 495-7857

**Multi-user web site licenses are available!**

☐ **Yes,** I would like to subscribe to *ACA Insight*. Please sign me up for a one year (46 issues) subscription and send me my password to www.acainsight.com.

NAME TITLE

FIRM

STREET

CITY STATE ZIP

E-MAIL ADDRESS PHONE

**Payment — $1,195 per year. Includes electronic versions, web access, and breaking news.**

DC residents add 5.75% sales tax ($68.71)

☐ Bill me ☐ Check enclosed (make payable to *ACA Insight*)

Please charge my ☐ Visa ☐ Mastercard ☐ Amex

CREDIT CARD NUMBER EXP. DATE SIGNATURE

2014. Wyatt joined the SEC in December 2012 as a senior specialized examiner focused on examinations of advisers to hedge funds and private equity funds.

Bowden joined the SEC in November 2011, starting as OCIE's national associate for the investment adviser/investment company examination program. He became deputy director of OCIE in September 2012, before becoming director the next year.

Bowden, a familiar face at industry conferences, placed a greater emphasis than was previously the case in sharing the information that OCIE collected with both the Commission and with the public, the agency said. Among the highlights of his tenure were:

- Completion of the presence-exam initiative, which "provided education, examination and guidance to newly registered investment advisers," the agency said. The presence exam program is currently expanding to include never-before-examined advisers and investment companies, as well as initial examinations of newly registered municipal advisers.
- Enhancements in OCIE's ability to collect and analyze large data sets "for the purpose of identifying examination candidates and conducting more targeted, data-reliant and impactful examinations."
- Exam initiatives in certain specified areas, including the payment of fees by advisers and mutual funds to distribution entities, risks to investors in fixed income and alternative mutual funds, and business continuity preparedness in the aftermath of Hurricane Sandy.

"The **Investment Adviser Association** and the advisory community applaud Andrew Bowden for the significant improvements he brought to OCIE during his tenure," said IAA president and CEO **Karen Barr** after Bowden's departure was announced.

Prior to joining the SEC, Bowden worked in both the broker-dealer and asset management industries, as well as in private legal practice, in a variety of roles, the agency said. He graduated from **Loyola University** in Maryland in 1983 and from the **University of Pennsylvania Law School** in 1987.

ACA
COMPLIANCE GROUP

ACA Insight

The weekly news source for investment management legal and compliance professionals

**Published by:**
ACA Compliance Group
(301) 495-7850
(301) 495-7857 (fax)
service@acainsight.com

**Publisher/Editor:**
Robert Sperber
(301) 502-8718
rsperber@acainsight.com

**To Subscribe:**
(800) 508-4140
subscribe@acainsight.com
Annual subscriptions (46 electronic issues, web access, and breaking news alerts) are $1,195.
Multi-user site licenses are available.

**Customer Service:**
(800) 508-4140
service@acainsight.com

**On the Web:**
www.acainsight.com

**Copyright:**
Want to routinely share *ACA Insight* stories with your colleagues? Please contact publisher ACA Compliance Group at service@acainsight.com or (301) 495-7850 to obtain a multi-user site license. Routine, unauthorized copying of *ACA Insight*, including routine e-mailing of issues or individual stories, violates federal copyright law. To inquire about authorization, please contact publisher ACA Compliance Group at service@acainsight.com or (301) 495-7850.

© *ACA Insight.* All rights reserved.

*ACA Insight* is a general circulation newsweekly.
Nothing herein should be construed as legal advice or as a legal opinion for any particular situation. Information is provided for general guidance and should not be substituted for formal legal advice from an experienced securities attorney.