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By Jonny Frank

This article first appeared on Law360.com.

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By Katherine Crispi

Under Dodd-Frank Section 1042 (12 U.S.C. § 5552), which became effective on June 29, 2012, a state attorney general or state regulator is authorized to bring a civil action to enforce provisions of Dodd-Frank Title 10 or regulations issued under it, including the Dodd-Frank prohibition of unfair, deceptive or abusive acts or practices (UDAAP). It can also bring action against an organization to enforce any regulation promulgated by the CPFB under the authority of Title X, such as the Consumer Financial Protection Act (CPFB).

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With billion-dollar penalties for misconduct almost becoming commonplace, it's no surprise the U.S. Department of Justice is raising the bar for compliance risk assessments — or that companies must focus more on identifying risks before they become issues.

At a recent conference of compliance officers, assistant attorney general for the Criminal Division, Leslie Caldwell, took aim at the compliance risk assessment process, commenting, “[C]ompliance programs are too often behind the curve, effectively guarding against yesterday’s corporate problem but failing to identify and prevent tomorrow’s scandals.”[1]

When confronted with misconduct, counsel and compliance officers need to be prepared to answer whether the company had identified the violation as a potential risk. If the answer is no, the company must justify "why not"; and, if yes, explain why pre-incident policies and controls failed to prevent the misconduct.

Here are five practical ways to meet heightened expectations:

1. Regulatory Risk ≠ Compliance Risk

Caldwell aptly noted that compliance risk assessments need to reach beyond regulatory risk. Some companies, particularly those in regulated industries, differentiate between regulatory and compliance requirements — the former referring to specific industry regulations, and the latter referring to general legal requirements.

Compliance risk falls generally into four areas: (1) federal, state, local and foreign law; (2) industry-specific regulations; (3) contractual requirements; and (4) compliance with internal company policies. Companies focused solely on regulatory risk often overlook other significant risks that can pose criminal or civil liability, create financial loss, or damage reputation and important relationships.

2. COSO Integrated Internal Controls and Enterprise Risk Frameworks

When it comes to evaluating ethics and compliance programs, lawyers and compliance officers typically rely on the criteria in the U.S. Sentencing Guidelines, Chapter 8 Sentencing of Organizations (USSG).[2] Auditors prefer the standards issued by the Committee of Sponsoring Organizations of the Treadway Commission, referred to simply as COSO.[3] COSO is the leading risk management framework and the standard upon which most public companies base their Sarbanes-Oxley assertion to the effectiveness of financial reporting controls.

Although the USSG speaks to assessing risk, it provides little direction on how to perform risk assessments. But COSO provides guidance.

At the risk of oversimplification, COSO defines “risk” as any event that impedes an organization to achieve its operational, reporting, strategic or compliance objective. In doing so, COSO relies on schemes and scenarios. Take, for example, payments to public officials. Many lawyers would generally describe this as Foreign Corrupt Practices Act risk. Under the COSO approach, the organization enumerates potential schemes and scenarios by which the payments might be made. Input from forensic
risks experts and experienced white collar lawyers is essential to this process, as they are in the best position to understand how such schemes are perpetrated within the context of the industry in which the company operates, its business model and its relationships.

3. Assessing Significance

A compliance risk assessment generally begins with identifying inherent risk, that is, without regard to mitigating controls. (Residual risk refers to the risk after taking mitigating controls into account). Inherent risk protects the risk assessment team from relying upon ineffective controls.

Next, the team measures significance to weed out inconsequential risks. It is at this step that companies encounter trouble. Noting that “corporations all too often misdirect their focus to the wrong type of risk,” Caldwell explained that the DOJ has “repeatedly seen corporations target the risk of regulatory or law enforcement exposure of institutional and employee misconduct, rather than the risk of the misconduct itself.”[4]

Stated differently, we often see companies measure significance by attempting to quantify the likely direct monetary penalty if they get caught. This approach is akin to assessing the significance of drunk driving to the likely penalty in the event of a police stop. Instead, companies should holistically assess significance, including the impact on potential victims, brand and reputation, and relationship with customers, suppliers, employees, etc.

Counsel and compliance officers serve an essential role. Companies often defer assessment to the business unit and functions leaders impacted by the risk. Business leaders, however, are not — and should not be — compliance experts. Their focus should be on improving and achieving operational efficiency. In doing so, however, they are vulnerable to missing the bigger picture, particularly, if the company measures them on profit and loss.

4. Overreliance and Underutilization of Other Risk Assessments


On their own, none of these factors qualify and it would be a mistake to rely upon them as a compliance risk assessment. That does not mean, however, that these assessments are unsuitable for a compliance risk assessment. Done properly, and with the inclusion of individuals knowledgeable about and skilled in compliance, the company and the industry in particular, they provide an opportunity to assess compliance risk without conducting a separate compliance risk assessment.


Effective defense of the company's compliance risk assessment process — whether it be to the board compliance committee or prosecutors and regulators — demands contemporaneous, written documentation. Verbal reconstruction of the assessment will not suffice. A variety of formats are available, although, most companies employ a simple Excel worksheet to track: (1) inherent risk; (2) impacted business units and functions; (3) reason for inclusion; (4) assessment of inherent significance and likelihood; (5) description of organization’s risk response; (6) summary of procedures to evaluate
design and validate operating effectiveness; and (7) a summary of additional planned procedures, if any.

**Conclusion**

Risk assessments form the cornerstone of an effective compliance program. If the five measures outlined above are implemented effectively and documented contemporaneously, a company stands a good chance of passing a post-incident prosecutorial assessment of its pre-incident compliance program.[5] Compliance risk assessments conducted poorly — or worse, not at all — can likely lead to criminal prosecution, enhanced fines and penalties, and possible imposition of a government compliance monitor.

—By Jonny Frank, StoneTurn Group

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Applying Newman’s Personal Benefit Requirement to Insider Trading Compliance Programs

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The U.S. Court of Appeals for the Second Circuit’s decision in United States v. Newman has had significant implications for both criminal and civil insider trading prosecutions. At bottom, this decision makes it more difficult for the government to be successful in actions against alleged remote tippees (like the Newman defendants who were three or four persons removed from the tipper) with insider trading by requiring that they have knowledge of a quid pro quo relationship between the tipper and the initial tippee.

While many criminal defendants have been able to avail themselves of Newman to dismiss insider trading charges, vacate convictions, or reduce penalties, other defendants in civil cases brought by the U.S. Securities and Exchange Commission (“SEC”) have not been as successful and despite the limitations Newman places on insider trading prosecutions, the government still seems to be pursuing insider trading cases as a high priority.

In light of these developments, hedge funds, investment banks, and other money managers should revisit their insider trading compliance programs to ensure they are consistent with Newman and the cases interpreting it.

United States v. Newman

As a result of a far-reaching criminal insider trading investigation, the U.S. Attorney for the Southern District of New York brought insider trading charges against two hedge fund portfolio managers, Todd Newman (formerly at now-defunct Diamondback Capital Management, LLC) and Anthony Chiasson (formerly at now-defunct Level Global Investors, LP). At trial, the government provided evidence that Newman and Chiasson each traded shares of Dell and NVIDIA for their funds based upon information regarding earnings announcements that were not yet public. The government showed that the corporate insiders tipped a group of research analysts, who passed along the information within the group until it was ultimately provided to Newman and Chiasson. In turn, the defendants each traded on the information resulting in profits of $4 million and $68 million, respectively, for their funds.

At the close of the six-week trial, Newman and Chiasson moved for a judgment of acquittal arguing, inter alia, that the government failed to put forth sufficient evidence to establish that the corporate insiders exchanged confidential information for a personal benefit as required by the

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3 773 F.3d 438 (2d Cir. 2014).
4 Id. at 452-53.
5 Id. at 442.
6 Id. at 443.
7 Id.
U.S. Supreme Court’s decision in Dirks v. SEC, 463 U.S. 646 (1983). Because the government failed to prove receipt of a benefit and tippee liability is derivative of the tipper’s liability, Newman and Chiasson argued that they could not be convicted. They further argued that they could not be found guilty of insider trading, because they had no knowledge of the personal benefit to the corporate insiders, and therefore “were not aware of, or participants in, the tippers’ fraudulent breaches of fiduciary duties to Dell or NVIDIA.”

On December 17, 2012, the jury returned a verdict finding Newman and Chiasson guilty on all ten counts of securities fraud and conspiracy to commit securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Following their sentencing, Newman and Chiasson appealed challenging, among other things, the instructions to the jury as failing to require that Newman and Chiasson had knowledge that the corporate insiders received a personal benefit in exchange for providing confidential information, and the sufficiency of the evidence relating to their knowledge of the corporate insiders’ personal benefit.

The Second Circuit’s Decision. On appeal, the government argued that it need not show that either defendant knew that the corporate insiders received a personal benefit to be found criminally liable. Instead, the government argued that, according to Dirks and certain cases decided by the Second Circuit after Dirks, criminal liability for insider trading only requires that the “tippee know that the tipper disclosed information in breach of a duty of confidentiality.”

The Second Circuit, however, rejected the government’s argument as being inconsistent with Dirks and cases following it on three points that are “quite clear”:

- “[T]he tippee’s liability derives only from the tipper’s breach of a fiduciary duty, not from trading on material, non-public information;”
- “[T]he corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure;” and
- “[E]ven in the presence of a tipper’s breach, a tippee is liable only if he knows or should have known of the breach.”

The Second Circuit also rejected the government’s evidence, even when viewed in the light most favorable to it, because the evidence “was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips.” This holding is significant because it limits an element of insider trading that many courts at the government’s urging for over a generation have viewed broadly to include personal relationships, pecuniary gains, and even “any reputational benefit that will translate into future earnings.” The Second Circuit emphasized this limitation noting that holding otherwise would mean that “practically anything would qualify.”
As a result, the Second Circuit made clear that in order to prove a personal benefit in the context of a personal relationship, the government must show a *quid pro quo* relationship or provide "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."\(^\text{16}\)

**Post-Newman Decisions and Enforcement Activity**

Ultimately, the *Newman* decision was a stern rebuke of the government’s aggressive insider trading prosecutions, which have been based upon unreasonably expansive interpretations of insider trading law that are inconsistent with *Dirks* and *Chiarella v. United States*, 445 U.S. 222 (1980).\(^\text{17}\) Since the Second Circuit decided *Newman*, the U.S. Attorney’s Office for the Southern District of New York has claimed in a letter requesting dismissal of insider trading charges against remote tippers in the proceeding captioned *United States v. Conradt* that *Newman* had "substantially changed the law pertaining to insider trading," even though the parameters of insider trading were made plain by Supreme Court precedent. Meanwhile dozens of defendants have sought to use *Newman* to dismiss insider trading charges, vacate their convictions, or reduce penalties. And, for the most part, courts around the country have followed *Newman* and applied it to various insider trading cases—regardless of whether the case was premised on the classical or misappropriation theory\(^\text{18}\) or whether it was brought in federal\(^\text{19}\) or administrative court.\(^\text{20}\)

Despite the clear instructions from the Second Circuit, the SEC has maintained that *Newman* will not alter its approach to similar cases because the SEC still faces a lower burden of proof than criminal prosecutors and may bring insider trading cases in its own administrative courts,\(^\text{21}\) which it has already begun to do with increasing frequency and to the consternation of many. Meanwhile, a few courts have loosely interpreted *Newman* to issue what appear to be goal-

\(^\text{16}\) Id.

\(^\text{17}\) The government’s criminal case against Newman and Chiasson suffered from similar flaws that contributed to its loss in the criminal insider trading prosecution of Rengan Rajaratnam, as well as the SEC’s losses in eleven insider trading cases or claims in 2014 in which the SEC stretched the law and/or facts beyond fairness and reason. See Marc D. Powers, Jonathan A. Forman, and Margaret E. Hirce, *A Call for Better SEC Accountability Before Bringing Insider Trading Cases*, BLOOMBERG BNA, SECURITIES REGULATION & LAW REPORT, 46 SRLR 2214 (Nov. 17, 2014).

\(^\text{18}\) Order, *United States v. Conradt*, No. 12-CR-887 (ALC), at *2 (S.D.N.Y. Jan. 22, 2015) (applying *Newman* to vacate defendants’ guilty pleas and finding that: “Specifically, this Court finds that, as indicated in *Newman*, the controlling rule of law in the Second Circuit is that ‘the elements of tipping liability are the same, regardless of whether the tipper’s duty arises under the ‘classical’ or the ‘misappropriation’ theory.’” (internal citations omitted).

\(^\text{19}\) Opinion & Order, *SEC v. Payton*, No. 14-CV-04644-JSR, at *9-10 (S.D.N.Y. Apr. 6, 2015) ("[T]he Second Circuit, in *Newman*, stated unequivocally that ‘[t]he elements of tipping liability are the same, regardless of whether the tipper’s duty arises under the ‘classical’ or the ‘misappropriation’ theory.’ … these statements seem so clearly intended to give guidance to the lower courts of this Circuit that this Court takes them as binding.’").

\(^\text{20}\) *In the Matter of Gregory T. Bolan and Joseph C. Ruggieri*, Order, SEC Admin. Proc. Rel. No. 2309 (Feb. 12, 2015) (“While our case law at times emphasizes language from *Dirks* indicating that the tipper’s gain need not be *immediately* pecuniary, it does not erode the fundamental insight that, in order to form the basis for a fraudulent breach, the personal benefit received in exchange for confidential information must be of some consequence.’”) (quoting *Newman*, 773 F.3d at 452, with emphasis in original).

oriented decisions, which have created some uncertainty about what the government must prove in an insider trading prosecution.

For example, on March 3, 2015, Southern District of New York Judge Valerie Caproni in United States v. Riley declined to reverse the insider trading conviction of David Riley finding that he provided tips about his company in exchange for “three concrete personal benefits that were ‘objective, consequential, and represent[ed] at least a potential gain of pecuniary or similarly valuable nature.’”22 Although Judge Caproni noted that the court’s instructions would have been different following Newman, the court ruled that the relationship was “clearly a quid pro quo relationship” because Riley received (i) help with his side business in the form of industry connections, (ii) investment advice in the form of stock tips, and (iii) assistance with securing his next job.23

Then, on April 6, 2015, Southern District Judge Jed S. Rakoff in SEC v. Payton denied Daryl M. Payton and Benjamin Durant, Ill’s motion to dismiss where the defendants’ guilty pleas previously were vacated in light of Newman.24 Although Judge Rakoff claimed to apply Newman, the court quoted Riley for support that: “If a tip maintains or furthers a friendship, and is not simply incidental to the friendship, that is circumstantial evidence that the friendship is a quid pro quo relationship.”25 Given what appears to be a goal-oriented decision, the court found that the SEC adequately pleaded a personal benefit where it alleged that the tipper and tippee “shared a close mutually dependent financial relationship” as evidenced by a “history of personal favors” in which the tippee “pa[id] their shared expenses,” negotiated reductions in their utilities and rent payments,” and helped the tipper defend against an unrelated criminal matter.26 The court also explained that, in contrast with the defendants in Newman who “knew next to nothing” about the tippers, the SEC alleged that “the defendants knew the basic circumstances surrounding the tip.”27 The court noted that it may draw an adverse inference against the defendants due to their knowledge, “their market sophistication,” and the apparent facts that they “recklessly avoided discovering additional details” and they “took multiple steps to conceal their own trading.”28 However, such an inference does seem to stretch the facts, which objectively are not consistent with Newman’s personal benefit requirement.

Similarly, Administrative Law Judge Jason S. Patil in the administrative proceeding In the Matter of Gregory T. Bolan, Jr. and Joseph C. Ruggieri applied Newman but deferred ruling on motions for summary disposition, noting: “Although mere friendship, particularly of a casual or social nature, will not be enough for the Division to prevail with respect to Trader A, it is in my mind an open question whether and what sort of friendship may satisfy the personal benefit element in this matter.”29

Because the evidence of a personal benefit in Riley and Payton is similar to the evidence in Newman, which the Second Circuit found to be insufficient, these decisions appear to be inconsistent with Newman. Bolan also appears to conflict with Newman because the Second

23 Riley at *10-15.
24 Payton at *16.
25 Payton at *13.
26 Payton at *4.
27 Payton at *14-15.
28 Payton at *15.
Circuit in *Newman* required more than a showing of friendship to establish a personal benefit. By allowing a prosecution to proceed on such bare-bone allegations of a personal benefit supported by a close friendship, *Bolan* skirts *Newman*'s mandate.

**Compliance Takeaways**

Notwithstanding the uncertainty presented by these cases and the possibility that the government may still seek Supreme Court review of the Second Circuit’s decision, *Newman* provides guidelines on which compliance personnel can rely in updating their insider trading policies and procedures. In particular, this can be done in at least five significant ways:

1. **First,** to be guilty of insider trading, you must know the information received is non-public. In this sense, it seems appropriate, and not a violation of the federal securities laws, to engage in a stock trade in a company where information about the company is learned from a friend or colleague who is unaffiliated with the company and there is no reason to believe that the information came from someone at the company who is in a breach of a duty of confidentiality (or other fiduciary duty).

2. **Second,** to be guilty of insider trading, the information must be material and not the kind of information that merely fills in the gaps. In this sense, it also seems appropriate, and not a violation of the federal securities laws, to use public information (e.g., observing parking lots of retail stores) to flesh out or confirm investment hypotheses and/or assumptions—indeed, that is precisely what analysts are supposed to do.

3. **Third,** it is worth highlighting that *Newman*'s boundaries are far from bright lines, particularly in light of the decisions in *Riley*, *Payton*, and *Bolan*. Given this, there is no guarantee that the government will refrain from investigating, charging, and possibly obtaining an insider trading conviction from a jury on conduct they believe to be unlawful even when it is completely legal.

4. **Fourth,** *Newman* in no way opens up the floodgates to indiscriminate trading on possible inside information. To the contrary, it clarifies what conduct is prohibited. Moreover, significant incentives for individuals toeing the line still exist outside and apart from any governmental prosecutions. For example, individuals (whether they be corporate insiders or other tippees) may be fired for breaching an employment agreement or fiduciary duty, sued by an employer or third party for breaching a confidentiality agreement, or face other stiff consequences for cavalier activity.

5. **Fifth,** firms should monitor their analysts and traders for conduct suggesting questionable and/or unlawful activity and test their investment hypotheses to verify, among other things, whether a proposed trade is based on information learned in violation of a fiduciary duty. For example, is the information the type that only corporate insiders would generally be aware of at the time? Have there

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30 The “mosaic theory”—wherein analysts piece “seemingly inconsequential data together with public information into a mosaic which reveals material non-public information”—has long been viewed as a defense to an insider trading charge. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980); see also *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981).
been any lifestyle changes by the analyst or trader? Is the analyst or trader using private cell phones and/or texts at unusual times? Does the analyst or trader have undocumented contact with particular corporate insiders? The list goes on.

So while hedge funds, investment banks, and other money managers can sleep better at night knowing that they are less likely to be caught in the government’s prosecutorial dragnet (based on, for example, a casual conversation one of their analysts may have with a former classmate or other acquaintance), they should still take appropriate measures to protect themselves. This may even mean abstaining on an otherwise innocent trade when the surrounding facts and circumstances are questionable and might pique the government’s curiosity. After all, despite Dirks, Chiarella and Newman, insider trading undoubtedly will continue to be a priority for the government, which has shown an increasing interest in money managers in recent years.
The cost of hiring an intern just went up. The Bank of New York Mellon Corp. ("BNY Mellon") last week agreed to pay the U.S. Securities and Exchange Commission ("SEC") $14.8 million to settle allegations that the company violated the Foreign Corrupt Practices Act ("FCPA") by giving six-month internships to three relatives of foreign government officials.

This settlement is noteworthy for two reasons. First, as the SEC's first-ever FCPA settlement with a financial institution, it portends the start of a wave of enforcement activity resulting from the SEC's multi-year investigation into the relationship between international financial entities and sovereign-wealth funds. Second, it illustrates that just having a compliance program is not enough; a company must ensure that all of its employees attend compliance training and demonstrate an understanding of the company's compliance policies.

The SEC alleged that BNY Mellon violated the anti-bribery and internal accounting controls provisions of the FCPA by seeking to "corruptly influence foreign officials in order to retain and win business managing and servicing the assets of a Middle Eastern sovereign-wealth fund." The SEC further alleged that BNY Mellon's internal controls were "insufficiently tailored to the corruption risks" and allowed company employees to illegally curry favor with foreign officials by providing valuable BNY Mellon internships to the officials' relatives.

According to the SEC, although BNY Mellon had a code of conduct and an FCPA policy in place during the relevant time, it failed to provide its employees proper training on how to adhere to them. Specifically, the SEC alleged that the company "did not ensure that all employees took the training or understood BNY Mellon's policies." The SEC found that while BNY Mellon employees were trained that "any money ... gift ... or anything of value" to a foreign official could constitute a bribe, BNY Mellon failed to ensure its employees understood how to apply the policy, particularly in the hiring context.

Global Financial Institutions Face Higher FCPA Scrutiny. The BNY Mellon's FCPA settlement is likely not the last. The SEC increasingly has focused its FCPA enforcement authority on financial institutions operating internationally. On August 18, Kara Brockmeyer, Chief of the SEC Enforcement Division's FCPA Unit, said that the Commission is looking closely at the sector because "[f]inancial services providers face unique corruption risks when seeking to win business in international markets, and we will continue to scrutinize industries that have not been vigilant about complying with the FCPA."
Indeed, other financial institutions, including Goldman Sachs and Citigroup, have disclosed ongoing FCPA investigations. Accordingly, financial firms and private investment funds—particularly those conducting business with foreign sovereign-wealth funds—should take a hard look at how this new level of regulator attention impacts their operations.

**Compliance Programs Should Be Tailored.** The BNY Mellon case also highlights the need for companies to construct compliance policies that employees actually understand and apply. In 2015 alone ([here](#), [here](#), and [here](#)), we have seen several companies with existing compliance policies nevertheless run afoul of the FCPA by failing to train their employees about how to apply these policies in their jobs. The result of this inattention is predictable—the company gets slapped with a multi-million dollar fine and negative press—but avoidable. We expect to see the SEC's focus on compliance training continue.

**Key Lessons.** Financial institutions with FCPA exposure—particularly through relationships with sovereign-wealth funds—are being targeted actively by the SEC. The BNY Mellon case, when taken in context with other recent settlements, illustrates the importance of robust compliance training programs. Companies in any sector with FCPA exposure must be able to document full attendance at compliance training sessions and have some degree of certainty that their employees understand and abide by company compliance policy.

Compliance is expensive, so companies have real incentive to ensure the compliance training they provide their employees tangibly reduces risk. Many companies already provide their employees with some form of basic training to "check the box." This is not enough. Employee training should be comprehensive enough that employees can identify FCPA risks easily and make choices that avoid running afoul of the law. A good compliance training program includes case studies and concrete examples designed to help employees apply company compliance policies under real-world working conditions. Finally, compliance personnel developing the training program should consult with employees actually facing the risk. Doing so will help improve acceptance of the policy and better capture the scenarios where employees are likely to encounter compliance risk.
State Regulators' Dodd-Frank Enforcement Authority: Initial Suits and Their Implications

By: Katherine Crispi

Under Dodd-Frank Section 1042 (12 U.S.C. § 5552), which became effective on June 29, 2012, a state attorney general or state regulator is authorized to bring a civil action to enforce provisions of Dodd-Frank Title 10 or regulations issued under it, including the Dodd-Frank prohibition of unfair, deceptive or abusive acts or practices (UDAAP). It can also bring action against an organization to enforce any regulation promulgated by the CPFB under the authority of Title X, such as the Consumer Financial Protection Act (CFPB).

THE STATUTE

Title X of the Dodd-Frank Act established the Consumer Financial Protection Bureau (CPFB) to regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws. Section 1042, located at 12 U.S.C. 5552, gives the Bureau its enforcement power. Section 1042(a) allows a state attorney general or regulator (“State Official”) to bring an action to enforce Title X and regulations issued under it – such as the Consumer Financial Protection Act (CFPA)’s provision on unfair, deceptive, abusive acts or practices (UDAAP).

Section 1042(b) authorizes the CPFB to intervene in an action brought by a State Official. As a party, the CPFB can remove the action to a Federal district court, and appeal any order or judgment. Section 1042(c) requires the CPFB to issue regulations implementing the requirements of Section 1042, notice procedures. While a state attorney general cannot bring an action against a national bank or Federal savings association to enforce a provision in Title X (the CFPA’s UDAAP provisions), it can bring such an action to enforce a regulation promulgated under that authority (i.e. CPFB’s regulations). Where the entity is not a national bank or Federal savings association, a state regulator may bring both UDAAP claims and claims under CPFB regulations. Section 1042 also makes the expansive remedies under CFPA available to state regulators, giving them more of an impetus to pursue these claims.1

LEGISLATIVE HISTORY

In drafting the final rule, Dodd-Frank attempted to create a process that would provide both the CPFB and, where applicable the prudential regulators, with timely notice of pending actions to allow for the investigation and litigation needs of State regulators and law enforcement agencies. The final rule makes clear that the CPFB can intervene as a party in an action brought by a State Official under Title X of Dodd-Frank. It provides for the confidential treatment of non-public information contained in the notice if a state requests it without fear of a waiver.

Legal Authority

1 12 U.S.C. § 5565(a)(2). Including Civil money penalties of up to $1 million per day for knowing violations of a federal consumer financial law, $25,000 per day for reckless violations of a federal consumer financial law, and $5,000 per day for any violation of a law, rule, or final order or condition imposed by the CFPB
Section 1042(c) of Dodd-Frank authorizes the CPFB to prescribe regulations implementing requirements of Section 1042(b).

During the notice of and comment period, legislators resisted comments requesting a more narrowly tailored definition of “in the public interest” as the language is too broad based on the CPFB’s view that such determinations should be made on a case-by-case basis.

**CASES & SETTLEMENTS**

In the early days of Section 1042, commentators voiced concerns including: the increased resources that will have to be allocated towards these costs, inconsistent construction of the UDAAP provision, increased costs resulting from concurrent actions in the case of large companies spanning multiple states and jurisdictions, and greater publicity to those institutions when an action is filed, regardless of the ultimate outcome.

As the first cases to invoke Section 1042 have materialized, the existence of joint actions and removal to federal court do well to quiet some of these fears. Those cases that have not settled have been removed to federal court, so while they give state attorneys general greater power to initiate – in consequently increasing regulatory resources – so far the law is being given consistent federal interpretation. The filing of joint cases may indicate concurrent action may not be such a concern.

The concern about publicity seems to be founded, as state prosecutors post press releases to announce the filing of actions and settlement agreements. This can be seen as an efficient way to shift costs from consumers to businesses. Consumers are more likely to be put on notice that an organization’s business practices are in question, and organizations should be more motivated to avoid questionable business practices that put them at risk for such notoriety.

**ILLINOIS**

Illinois AG, Lisa Madigan filed two lawsuits under the authority of Section 1042. In March 2014, she filed a state court suit against a small loan lender for allegedly violating Dodd-Frank UDAAP Prohibitions and state law. The defendant removed the case to IL federal court and filed a motion to dismiss. The AG also filed a Section 1042 suit against a for-profit college and its owners. In March 2014, the state court allowed her to amend her complaint and add counts alleging the defendant’s practices were unfair and abusive under Dodd-Frank. In May 2014, the defendants removed the case to IL federal district court.

**NEW YORK**

The New York State Department of Financial Services (DFS) was the first state financial regulatory agency to use Dodd-Frank’s state action power to seek remedies under the CFPA. In April 2014, Benjamin Lawsky, Superintendent of the New York DFS used his Section 1042 authority to bring a

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2 http://illinoisattorneygeneral.gov/pressroom/2014_03/20140319.html
civil action in a NY federal court for a violation of Dodd-Frank’s UDAAP prohibition against a large subprime auto lender and its CEO and president. It has been reported that subprime auto lending appears to be tracking subprime mortgage phenomenon. The defendant, Condor Capital and its sole shareholder was charged with overcharging consumers of and hiding and retaining positive credit balances owed to them. In December 2014, Lawsky announced a settlement comprised of a $3 million civil penalty and a requirement that the defendants refund all positive credit balances and interest charged in excess of the disclosed APR, plus nine percent interest on such amounts.

**FLORIDA/CT**

In July 2014, Attorneys General Pam Bondi and George Jepsen of Florida and Connecticut respectively, filed a Section 1042 suit jointly against four individuals and their four businesses for an alleged mortgage rescue scam. The court approved settlements with several defendants permanently banning them from engaging in various consumer mortgage and debt relief services and related communications.

**MISSISSIPPI**

In May 2014, Mississippi AG, Jim Hood, filed suit against Experian in Mississippi state court alleging federal and state law violations. The complaint did not expressly allege UDAAP violations, the suit was brought under Section 1042 seeking various Dodd-Frank remedies. Experian is a global information services group with operations in 40 countries, headquartered in Dublin, Ireland. The case was removed to a federal district court in Mississippi.

**VIRGINIA/NORTH CAROLINA**

In December 2014, North Carolina Attorney General Roy Cooper, and Virginia Attorney General Mark Herring, filed a federal complaint with the CPFB alleging illegal debt collection through unfair and abusive practices under the CFPA and violations of other federal and state consumer laws regulating conduct in debt collection and credit extensions within the states’ UDAAP authority. Under the consent order, the defendants agreed to pay approximately $2.5 million in monetary relief to consumers and a $100,000 civil penalty. The order, however, did not admit or deny the allegations.

**NORTH CAROLINA**

In January 2014, the North Carolina Department of Justice, the U.S. Department of Justice, and the United States Attorney’s Office for the Western District of North Carolina filed suit against two used-car dealerships alleging racial discrimination in violation of the federal Equal Credit Opportunity Act and unfair and deceptive practices under North Carolina state law by intentionally targeting African-American Consumers. In February 2015, a settlement was announced which required the dealerships to implement a number of specific practices to ensure that the terms of their loans and repossession practices are no longer unfair and predatory and to agree to certain compliance monitoring. As part of

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5 http://dealbook.nytimes.com/2015/01/26/investment-riches-built-on-auto-loans-to-poor/
8 http://www.law360.com/articles/602143/fla-conn-ags-settle-mortgage-rescue-case-for-1-1m
the settlement, the defendants denied the complaint’s allegations but agreed to establish a $225,000 settlement fund to compensate victims of their past discriminatory and predatory lending.

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