Hedge Fund Law Report
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SEC Enforcement Matters

Former SEC Senior Counsel Discusses Enforcement Trends and Whistleblowers (Part Two of Two)

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By Robin L. Barton, *Hedge Fund Law Report*

After serving as Senior Counsel in the SEC's Division of Enforcement, investigating and prosecuting complex matters involving violations of the federal securities laws, Philip Moustakis has joined Seward & Kissel LLP as counsel. The Hedge Fund Law Report recently interviewed Moustakis in connection with his move. This second article in our two-part series summarizes his thoughts on enforcement trends in general and in the digital asset space specifically, as well as on whistleblowers. The first article explored Moustakis' experience in the government, as well as the regulatory approach to digital assets and blockchain.

For commentary from other Seward & Kissel attorneys, see our two-part series "The SEC Is Calling": What CCOs Should Expect During Initial Communications With OCIE Examiners (Sep. 13, 2018); and How CCOs Can Stay Prepared for Initial Communications With OCIE Examiners (Sep. 20, 2018); as well as "HFLR and Seward & Kissel Webinar Explores Common Issues in Negotiating and Monitoring Side Letters" (Nov. 10, 2016).

Enforcement Trends

HFLR: Looking forward, what do you think we might expect in terms of enforcement in the digital-asset space?

Moustakis: Chair Clayton has already told us what to expect. There has been a pattern. The DAO Report said that digital tokens could be securities, then the SEC began bringing initial coin offering (ICO) cases. The SEC issued a statement warning of the potentially unlawful nature of the touting or promoting of ICOs by celebrities and others. Not too long after that, the SEC charged Floyd Mayweather and D.J. Khaled with touting Centra Tech Inc., which was a fraudulent ICO that the Commission had charged months earlier.

Based on other comments by the Chairman, I would now expect a focus on the gatekeepers within the industry, including counsel that assisted in the structuring of ICOs. These may be difficult cases to make, however, because of attorney-client privilege. The Chairman has also said that the SEC will focus on the cryptocurrency-related activities of market participants that the SEC regulates, including investment advisers, broker-dealers, trading platforms and the like. So, although the Enforcement Division's focus in the past was on the early investment schemes and then the unregistered offerings and ICOs, now it may shift to where registrants are interacting with cryptocurrencies.

[See "SEC Chair Outlines Approach to Dodd-Frank Rulemaking and Expectations for Fund 'Gatekeepers'" (Feb. 15, 2018).]

HFLR: Do you see any other enforcement trends in the investment management space in general?

Moustakis: Another trend I have seen of late is a continued focus on individual liability. In the SEC's last fiscal year, about three quarters of its enforcement actions involved charges against one or more individuals. That focus on individuals seems to align with the priorities and public statements of the Chairman and the Co-Directors of Enforcement. We can expect to see more of it.

[See "SEC Enforcement Division Annual Report Emphasizes Continuing Focus on Retail Investors, Individual Accountability, Cyber Misconduct and Digital Assets" (Dec. 6, 2018).]

Cases against individuals, however, are traditionally more difficult and take more time to make. After the U.S. Supreme Court's *Kokesh* decision, which applied a five-year statute of limitations to disgorgement, the SEC has to work more quickly than it did in the past, otherwise it may lose the opportunity to obtain disgorgement in certain cases. Thus, there is a tension between the SEC's desire to focus on individuals and the ticking clock created by *Kokesh*. The fact that more whistleblower tips are coming in than ever before – often accompanied by very specific information about the conduct of individuals – eases this tension for SEC enforcement staff, however.

[See "How the SEC May Circumvent the Five-Year Statute of Limitations on Disgorgement Under *Kokesh v. SEC*" (Jul. 20, 2017); and "Implications for Fund Managers of the Supreme Court's Ruling in *Kokesh v. SEC*" (Jun. 15, 2017).]

HFLR: Besides attorney-client privilege, are there other issues that make cases against individuals more difficult to make than cases against entities?

Moustakis: When you are trying to show that an individual is liable for particular conduct, there are always other people whom that individual can blame. He or she can always say, "I did it all with the knowledge and at the direction of my supervisor," or "it was the firm's custom and practice to do this." He or she can also attempt to spread blame to others involved in the conduct. In contrast, on the whole, an entity is responsible for the conduct of its employees. Individuals are smaller, faster-moving targets, often in a stronger position to litigate, so regulators need more specific information as to their particular liability. As a result, cases against individuals are traditionally harder to prove, regardless of the type of misconduct, and take more time to build.

HFLR: Over the course of your career in enforcement, did you observe any changes in terms of the types of violations or conduct targeted by Enforcement?

Moustakis: There is no question that the Enforcement Division's bread and butter in the asset management space includes undisclosed conflicts of interest, insider trading, mishandling of material nonpublic information, undisclosed fees, valuation issues and style drift, as well as market manipulation and other fraud. In my time, that was always the focus. There has been, however, a shift in emphasis in the last few years.

HFLR: How so?

Moustakis: There has been a shift from what had been a "broken windows" approach to enforcement to a greater emphasis on protecting retail or Main Street investors. The Asset Management Unit traditionally focused on advisers to private funds and mutual fund complexes. It is smaller than it once was, as is the entire Enforcement Division, because there has been virtually no hiring. If it is not a total freeze, it is very close – and that includes no backfilling of positions.

While the Asset Management Unit has shrunk a bit, the SEC recently formed its Retail Strategy Task Force, which is also in the Enforcement Division. Thus, that shift in emphasis has clearly taken place, and we will see a significant uptick in focus on the retail space by the Enforcement Division for the foreseeable future. It remains to be seen to what extent that emphasis is on retail advisers or brokers as opposed to retail assets managed by funds or larger institutions. It is likely to be both to some degree.

HFLR: Have you seen any evolution or shift in the kinds of remedies and relief that enforcement staff seek in enforcement actions?

Moustakis: Yes, but only to some degree. The emphasis has been on disgorgement, penalties and, at times, undertakings. For a period of time, admissions of liability were added to the menu. I don't believe the Co-Directors of the Enforcement Division have explicitly said that the Division is not doing that anymore, although we have not seen a case where there has been an admission of liability of late. The Commission was obviously affected enormously by the *Kokesh* decision. Also, over time, the SEC has grown more creative with undertakings and used them as a more nuanced tool.

[See "What Remedies and Relief Can Fund Managers Expect in SEC Enforcement Actions?" (Jan. 10, 2019).]

Whistleblowers

HFLR: There has been a significant increase in the use of whistleblowers in enforcement actions. How has the increase in individuals' willingness to come forward and blow the whistle on misconduct changed the nature of the Enforcement Division's work?

Moustakis: Whistleblowers are an enormous resource for the SEC. From the SEC's perspective, the whistleblower program has been tremendously successful. In the last fiscal year, the SEC paid awards exceeding the total of all awards paid since the program began in 2011. There is no reason to believe the Commission won't continue to see a robust number of whistleblower complaints coming over the transom. Whistleblowers are clearly incentivized, and a good whistleblower complaint includes specifics that can point the Enforcement staff right to the heart of the matter from the start.

[See "SEC and CFTC Whistleblower Awards Continue to Grow" (Jan. 17, 2019).]

HFLR: Is it fair to say that, in some circumstances, having a whistleblower enabled the SEC to pursue violations that the staff may not have otherwise discovered?

Moustakis: Without a doubt. There is always a possibility the staff would have discovered the misconduct independently. In a number of whistleblower cases that I worked on, however, that wasn't an obvious inevitability. The whistleblower came to us with original, valuable information and apprised us of possible violations that we had not been considering.

[See "Seward & Kissel Private Funds Forum Explains How Managers Can Prevent Conflicts of Interest and Foster an Environment of Compliance to Reduce Whistleblowing and Avoid Insider Trading (Part Two of Two)" (Sep. 29, 2016).]

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