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The SEC Speaks: Aggressive Enforcement to Intensify in 2011

By Randall J. Fons and Tiffany A. Rowe

Early each year, the SEC hosts its most important conference: The SEC Speaks. At the conference, the chairman, the commissioners, and the heads of the various divisions summarize the SEC's activities of the previous year and indicate priorities and major initiatives of the SEC for the coming year. This year the conference was held on February 4–5. Judging from the comments of the commissioners and staff, it was clear early on that the SEC's reforms of the past year will be supplemented by more aggressive enforcement, despite the agency's stressed resources.

Chairman Mary Shapiro began the conference by focusing on the importance of investor protection and the SEC's role as "the investor's advocate." The chairman highlighted that court-ordered disgorgements were up 20% in 2010 and the amount of penalties tripled. The SEC pipeline of significant cases remains full, encouraging the Commission's efforts to increase efficiency and coherence in investigations. Towards that end, the agency has created a centralized database housing tips and complaints that allows examiners and investigators to review tips received nationwide. The database will soon provide improved search and analysis capabilities and, budget permitting, will implement analytics that uncover market trends.

Chairman Shapiro noted the adverse effects of the continuing resolution under which the SEC has been operating since the 2011 fiscal year began on October 1, 2010. She noted that the budgetary issues are impacting the agency's "core mission" of investor protection and the problem is exacerbated by the expanded responsibilities under Dodd-Frank. Fulfilling the SEC's mandate has become increasingly difficult — the number of investment advisers subject to agency regulation has grown by 50% in the past decade; the workforce had been cut in years preceding the financial crisis and has yet to be restored to pre-crisis levels; and the numerous financial firms have technology budgets that dwarf the entire SEC annual budget. Chairman Shapiro suggested that we consider whether "we want our market analysts to continue to use decades-old technology" to monitor and scrutinize trading that "occurs at the speed of light."

Turning to substantive issues, various speakers addressed the past year's developments concerning the agency's cooperation initiative and specialized units within the Division of Enforcement, as well as the whistleblower program, executive compensation clawback legislation, developments related to the Foreign Corrupt Practices Act, and Enforcement's changing approach to insider trading cases. The effects of the Dodd-Frank legislation were also discussed.

Cooperation Initiatives: According to Deputy Enforcement Director Lorin Reisner, the SEC has entered 20 cooperation agreements through the initiative launched in January 2010. The agreements have been used to obtain greater cooperation in matters involving financial reporting issues, insider trading, market manipulation, and FCPA violations. Reisner stated that the agency responds to requests for agreements quickly, often within 48 hours, and tries to communicate the credit given to cooperating parties by issuing press releases that identify the cooperation agreement to demonstrate the program's use.

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For example, in December, the SEC publicized its first non prosecution agreement in a financial reporting matter involving Carter's, Inc. Reisner noted that, because of the isolated nature of the misconduct, self-reporting by Carter's, exemplary cooperation, the company's internal investigation, and remedial action taken by the company, the SEC had formally agreed not to pursue any action against the company. A copy of the Commission's press release can be found at <http://www.sec.gov/news/press/2010/2010-252.htm>.

National Specialized Units: The Division of Enforcement panel discussed the progress of the five specialized units — FCPA; Market Abuse; Municipal Securities and Public Pensions; Asset Management; and Structured and New Products — and their central role in the SEC's most important cases. The units, fully staffed since March, have, according to the staff, proven to be very effective and are currently leading dozens of investigations. Twenty-five percent of the Division of Enforcement is assigned to one of the nation-wide units. Asset Management has 60 staff members; Market Abuse has 50 members; the Structured Products Unit is composed of 45 members; 30 Enforcement members are assigned to the FCPA Unit; and the Municipal Securities and Public Pensions Unit has 25 members. The units also serve as a "think tank" for other Enforcement staff while planning investigations. In addition, the units spearhead training programs on their respective specialties for nationwide staff.

Howard Scheck, the chief accountant in the Division of Enforcement, spoke about the Division's focus on financial reporting matters. Although conceding that the Commission brought only 126 financial reporting cases in 2010, the lowest number in several years, Scheck noted that the agency charged 202 individuals, including 24 CEOs, 46 CFOs, and 31 chief accounting officers. Moreover, the issues that surfaced in the accounting-related cases are "all over the map," including revenue recognition, reserve and accrual manipulation, segment reporting, payment of personal executive expenses, and misappropriation of funds. Finally, the SEC also brought 55 administrative proceedings under section 102(e), barring individuals from practice before the agency — the highest number of such proceedings in 10 years. Looking forward, the Enforcement staff stressed that it believed its activity in the financial reporting area was going to increase dramatically, and stated that the Commission's cooperation initiative and new whistleblower programs were likely to provide significant information leading to financial reporting investigations.

EFFECT OF THE DODD-FRANK ACT

George Canellos, regional director of the SEC New York Regional Office, spoke about the reforms of the Dodd-Frank Act and the SEC's expanded authority in investigations and enforcement. Some provisions have clear implications for the Division of Enforcement — the codified recklessness standard for aiding and abetting violations of the securities laws; expanded jurisdiction of the SEC over foreign securities transactions where "significant steps in furtherance of the violation" occur in the United States; and collateral industry bars. Other Dodd-Frank provisions will impact Enforcement in yet unknown ways. Canellos noted that under Section 929K, the SEC can now share privileged information with other regulators without waiver, and vice versa — a step the SEC expects will give law enforcement the insurance needed to encourage the exchange of confidential reports. Canellos said that Section 929P(c) of the Dodd-Frank Act explicitly makes control persons at regulated entities vicariously liable for the type of penalties the agency may impose against the controlled person. Furthermore, the penalty is based on the culpability of the controlled person, not the controlling person; a change to control person liability that is expected to have significant substantive effects.

Dodd-Frank also grants the SEC authority to obtain penalties in cease and desist proceedings against anyone involved in violating the federal securities laws. While historically an individual could not be ordered to pay a penalty in an administrative proceeding unless he or she was associated with a broker, investment advisor, or other regulated entity,

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Dodd-Frank allows the SEC administratively to impose such a penalty on anyone. The SEC now has a choice of venue — administrative or judicial — when seeking a full panoply of remedies against any culpable person.

WHISTLEBLOWER PROGRAM

Thomas A. Sporkin, head of the Office of Market Intelligence, discussed the Whistleblower Program created under Section 922 of the Dodd-Frank Act. The provision substantially expands the authority of the SEC to pay whistleblower awards and enhances antiretaliation protections for whistleblowers. Sporkin noted that the agency has had an “onslaught” of whistleblower tips and complaints since July, including a marked increase in high-value complaints — one or two a day — that lead to more agency actions. The SEC is working to create a whistleblower coordination office to prioritize and track tips and monitor investigations.

Despite the staff’s trumpeting of the new Whistleblower Program, Congress’s failure to pass a budget for the SEC has affected, and will likely continue to affect, the Commission’s ability to implement the Whistleblower Program and other Dodd-Frank measures. Necessary staffing for reviewing the “high value” complaints has not yet been put in place, and many complaints and tips are, for the moment, not getting the attention that was expected. Robert Khuzami, Director of the Division of Enforcement stated that the division is doing everything possible to put resources where they are most needed, but maintaining the legislation’s regulatory accomplishments is still a “significant challenge.”

EXECUTIVE COMPENSATION CLAWBACK ACTIONS

The SEC highlighted two actions seeking reimbursement of executive compensation under the compensation clawback provision in Section 304 of the Sarbanes-Oxley Act and discussed how the clawback provision in the Dodd-Frank Act differs from Section 304.

SOX Section 304 Actions: The SEC has brought 20 actions under Section 304, two of which were standalone actions against executives. *SEC v. Jenkins*, filed in the District of Arizona, seeks reimbursement of more than \$4 million received by Maynard Jenkins, former CEO of CSK Auto Corporation. The court rejected Jenkins’s motion to dismiss, finding that “misconduct” as used in Section 304 refers to the misconduct of the issuer and the CEO need not have committed any misconduct personally. The SEC moved for partial summary judgment, arguing that Jenkins’s signing the company’s 10-K after its second restatement was an admission of CSK’s accounting fraud. A decision on the SEC’s motion is expected in the next month.

A similar action was brought against Walden O’Dell, the former CEO of Diebold, Inc. The SEC has settled that action and O’Dell has consented to the return of approximately \$470,000 in cash, 30,000 shares of stock, and 85,000 stock options received during his tenure as CEO.

Dodd-Frank Provision Applies More Broadly: The clawback provision of the Dodd-Frank Act requires that an issuer adopt reimbursement policies to recoup incentive compensation from executive officers in the event of a financial restatement. The clawback provision in Section 954 of the Dodd-Frank Act differs from SOX Section 304 in three ways: 1) while only the CEO and CFO are subject to clawbacks under Section 304, Section 954 applies to any current or former executive; 2) Section 304 requires reimbursement of any bonus or incentive compensation, but Section 954 only requires repayment of incentive compensation exceeding that which would have otherwise been paid; and 3) Section 304 applies to a 12 month period prior to restatement while Section 954 applies to a period of three years. As mandated by the Act, the SEC will soon propose a rule requiring the national exchanges to delist any issuer that fails to comply with Section

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AGGRESSIVE FCPA ACTIONS

Cheryl Scarboro, chief of the FCPA Unit, recounted a busy 2010 with more FCPA actions in a single year than ever before, and exceeding the number brought in 2008 and 2009 combined. The Division of Enforcement brought actions against 23 separate entities and seven individuals, resulting in disgorgement and penalties exceeding \$600 million. Scarboro noted that, significantly, a number of the Commission's cases involved foreign issuers, including Daimler AG and Alcatel-Lucent, S.A. As was true last year, Scarboro noted that the Enforcement staff was being more "proactive" in seeking out FCPA cases, rather than waiting for issuers to self-report. For example, the staff is continuing to focus on what it believes are "high risk" industries for investigation. Scarboro noted that, in one recent instance, the SEC charged seven oil services and freight forwarding companies, including Panalpina, Inc., Transocean, and GlobalSantaFe, with bribing foreign officials to receive preferential treatment and improper benefits during the customs process. This "oil services sweep" resulted in sanctions of more than \$230 million.

The FCPA Unit is also focusing on individuals in order to send a much stronger deterrent message. In *SEC v. Innospec, Inc.*, the SEC brought actions against the CEO, CFO, and individual agent who facilitated the bribe payments. Unlike in a traditional FCPA case, the corporate agent that facilitated bribe payments was subject to SEC disgorgement and penalties. Pursuing third parties who play an important role in carrying out the scheme is a significant change in approach for the agency and is expected to continue, as Scarboro tries to foster more creative and aggressive enforcement actions.

Cross-border collaboration of regulators is imperative to continued FCPA enforcement. Scarboro stated that she and the staff are interested in seeing the results of revisions to the United Kingdom's Bribery Act of 2010 and expects an increased number of actions by the UK Serious Fraud Office. Domestically, the number of tips related to FCPA violations has increased greatly due to the whistleblower provisions.

INSIDER TRADING STILL A HIGH PRIORITY

Insider trading and market manipulation remains one of the "highest priorities" of the Enforcement Division, and coordination with criminal regulators increasingly results in parallel proceedings. The SEC noted an evolution in insider trading over the past four to five years from a close-knit circle of people exchanging confidential material information to institutionalized networks of traders. In an action filed last week against six individual "expert consultants" and employees for the expert network firm Primary Global Research, LLC, the SEC alleged that the defendants shared material, nonpublic information with traders, allowing hedge funds to obtain more than \$6 million in illegal gains. The Market Abuse Unit is pursuing organized insider trading violations through more aggressive investigation tactics, often bringing in criminal authorities earlier in order to obtain evidence that makes the case more likely to succeed.

FINANCIAL CRISIS ACTIONS

According to Khuzami, in 2010, the SEC brought actions against issuers, mortgage origination companies, mutual funds, and other regulated entities with mortgage-based portfolios that failed to properly disclose their exposure to subprime mortgages or the health of the mortgage related assets. Khuzami stated that of the more than two dozen cases arising from the credit crisis, approximately half have been settled and more than \$1 billion has been received by the agency. Kenneth Lench, chief of the Structured and New Products Unit, recounted major actions of 2010. Of particular note was the settlement with Goldman Sachs & Co. for its failure to disclose material facts regarding a synthetic collateralized debt obligation (CDO) it marketed to clients. Goldman's \$550 million settlement, composed of \$15 million in disgorgement and

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a \$535 million penalty, is the largest-ever penalty paid by a Wall Street firm. Lench stated that the mortgage foreclosure crisis is expected to create a fresh round of actions for the SEC.

CONCLUSION

The SEC Speaks conference made clear that the Division of Enforcement, and the Commission itself, is continuing to flex its regulatory muscle in aggressively pursuing enforcement matters. The focus for the coming year is likely to be FCPA, financial reporting, insider trading, and follow up from the financial crisis. The agency will also be implementing its new Whistleblower Program, which is likely to result in many significant investigations. Those investigations will often lead to new enforcement filings, which will incorporate many of the new remedies that Dodd-Frank has given to the SEC. The SEC and the Division of Enforcement are currently being slowed by the lack of a budget, which will force them to pick and choose the battles they wish to fight. However, based on the commentary at SEC Speaks, the Division anticipates that it will choose those battles wisely, and will continue to focus aggressively on protecting investors and pursuing those they believe have violated the federal securities laws.

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