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June 2011: White Collar Litigation Update

SEC Exercises Expanded Power to Bring Administrative Enforcement Proceedings: The passage of the Dodd-Frank Act in July 2010 broadened the SEC's power to bring administrative proceedings rather than civil actions in federal court for violations of securities laws. The SEC has now begun exercising that expanded power. Before Dodd-Frank, the SEC could bring administrative cases only against individuals and entities whom the SEC directly regulates, such as broker-dealers, brokerage firm executives, investment banks, mutual funds, and brokerage firms themselves. If the SEC wanted to challenge the conduct of public companies or officers or directors who did not fit within the above groups, it had to bring civil actions in federal court. Further, the SEC could not seek monetary remedies beyond disgorgement of illegal profits in administrative proceedings.

The Dodd-Frank Act expanded the SEC's powers on several fronts. The SEC can now bring administrative proceedings against any public company and its officers or directors for violations of federal securities laws. Dodd-Frank also authorized the SEC to obtain substantial monetary penalties in addition to disgorgement in administrative proceedings. Further, Dodd-Frank expands the "collateral bar" remedy so that an individual may be barred not just from working in his specific job role again, but also from associating with any entity the SEC regulates. These expanded administrative powers are significant to SEC targets because, as described below, administrative proceedings give the SEC distinct procedural advantages not available to it in federal court proceedings. For example:

In federal court, a defendant has a right to a jury trial. An administrative proceeding is only decided by an administrative law judge, who, unlike a life-tenured and independent federal judge, is employed by the SEC itself. Administrative proceedings are subject to an accelerated schedule that excludes depositions and other forms of discovery that can take months or years in federal court.

- In federal court, a defendant has a right to a jury trial. An administrative proceeding is only decided by an administrative law judge, who, unlike a life-tenured and independent federal judge, is employed by the SEC itself. Administrative proceedings are subject to an accelerated schedule that excludes depositions and other forms of discovery that can take months or years in federal court.
- The Federal Rules of Evidence do not apply to administrative proceedings, potentially allowing the admission of hearsay and other evidence routinely barred in federal court.
- An appeal of the administrative law judge's decision does not go directly to a federal appeals court. Rather, the appeal is first reviewed by the SEC Commissioners—the same Commissioners who directed that the administrative proceeding be filed. After that review, an appeal can be taken to a federal appeals court, but the decision of the Commissioners receives deference.
- After an administrative proceeding, the SEC may still file an action in federal court, and may rely on evidence obtained in the administrative proceeding.

The SEC's expanded administrative powers may also help the Department of Justice in its prosecution of criminal securities fraud cases. Federal prosecutors and the SEC often find themselves investigating and prosecuting the same conduct in parallel proceedings. Because federal criminal proceedings do not afford defendants the same discovery tools as civil court actions, defendants charged in parallel civil and criminal securities fraud cases typically seek to use discovery from the civil court case to defend the criminal case. The government, in turn, usually seeks to stay the SEC proceeding pending resolution of the criminal action, but sometimes courts deny such requests. Because SEC rules permit stays of administrative proceedings, the SEC may resort to administrative proceedings to give the government a better chance of delaying such discovery.

The SEC recently flexed its expanded regulatory muscle by bringing administrative proceedings in parallel with the highly watched insider-trading criminal prosecution involving the hedge fund Galleon Group. Galleon was one of the world's largest hedge fund management firms before the federal government criminally charged myriad Galleon employees, including billionaire co-founder Raj Rajaratnam, with insider trading in 2009.

The SEC's parallel administrative proceeding involves Rajat Gupta, a former managing director of McKinsey & Co. and director at Goldman Sachs and Procter & Gamble. Gupta is accused of repeatedly passing on inside information to Rajaratnam, including information Gupta learned while serving at McKinsey and Goldman Sachs. In the pre-Dodd Frank world,

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the SEC would have had to bring a civil court action against Gupta to win civil penalties. The SEC has instead brought the administrative proceedings pursuant to the Dodd-Frank amendments.

Gupta is challenging the validity of the SEC's action by seeking declaration from a federal court that the SEC can not apply the civil penalty provisions of Dodd-Frank against him. Although Gupta has raised issues concerning the retroactive application of the amendments, he also contends that using administrative proceedings against him would violate his rights to due process, because of the lack of equivalent federal court protections. The SEC has yet to respond to Gupta's complaint.

Although the extent to which the SEC uses its expanded administrative proceeding powers remains to be seen, the procedural benefits that the SEC enjoys in administrative proceedings suggest that the power will not be used sparingly.

DOJ Fends Off Challenges to Concept that Employees of State-Owned Companies Fall Under FCPA: The DOJ and SEC show no signs of slowing in their aggressive stance towards possible FCPA violations. In the last few months, for example, both Kraft Foods and Las Vegas Sands Corporation received subpoenas indicating that they were being targeted under the FCPA. And the DOJ recently succeeded in persuading courts in two pending California cases that state-owned or state controlled enterprises can be "foreign officials" for the purposes of FCPA enforcement. On April 4, 2011, U.S. District Court Judge Matz in Los Angeles issued the first ruling on this issue in *United States v. Noriega*, holding that executives of state-owned corporations do count as foreign officials. The FCPA defines a "foreign official" as an "officer or employee of a foreign government or any department, agency, or instrumentality thereof." Neither the statute nor the legislative history define "instrumentality," "department," or "agency." Although past FCPA defendants have challenged claims that particular parties acted as foreign officials, the present cases appear to be the first to raise the purely legal question whether employees of state-owned companies are public officials under the FCPA.

In *Noriega*, Lindsey Manufacturing Company executives faced charges that they paid a state-owned Mexican electric utility to bribe government officials. In moving to dismiss, defendants challenged the definition of "foreign official," arguing that the government's theory has no basis in the text or history of the FCPA, and is contradicted by the plain meaning of the term "instrumentality" in the context of the "foreign official" definition (and the FCPA as a whole), the legislative history of the statute, and Congress' intent in enacting it. The government contended that whether employees at state-controlled utility companies are foreign officials is "not a difficult question." First, it argued that, under the Mexican Constitution, supplying electricity is exclusively a government function and public service. Second, it argued that "instrumentality" plainly includes state-owned entities, and that any other interpretation would leave a portion of the FCPA without effect and take the U.S. out of compliance with its OECD treaty obligations.

Judge Matz denied the motion to dismiss primarily based on the legislative history of the FCPA and on the ordinary definition of "instrumentality," which is "serving as a means or agency." He also noted that electricity is a government function in Mexico and that the utility company refers to itself on its website as a governmental agency. Trial in the *Noriega* case began in late April 2011 and, on May 10, 2011, after only a day of deliberations, a Los Angeles jury found all defendants—that is executives of Lindsey Manufacturing company and the company itself—guilty of conspiracy to violate the FCPA. Lindsey Manufacturing is the first American company to be charged and convicted under the FCPA, but Assistant Attorney General Lanny Breuer definitively stated that "it will not be the last."

In the second case raising the issue of whether employees of state-owned companies are foreign officials for purposes of the FCPA—*United States v. Carson*—former executives of valve manufacturer Control Components are charged in Santa Ana federal district court with bribing employees of state-owned companies in China, Malaysia, and the United Arab Emirates. The defendants moved to dismiss, arguing that employees of state-controlled companies are not foreign officials under the law and that the "government's sweeping and aggressive interpretation is wrong as a matter of law." They based their argument on the ordinary meaning of the term "instrumentality," the "absurd results" that would result under the government's definition, and the original legislative intent to prevent overseas bribery scandals from bringing down the foreign governments with whom our diplomats worked. On May 18, 2011, Judge Selna denied the motion, referencing the *Lindsey* case and stating that "state-owned companies may be considered 'instrumentalities' under the FCPA, but whether such companies qualify as 'instrumentalities' is a question of fact." Judge Selna included a non-exhaustive list of factors to be considered, including the level of ownership or control, how the entity and its personnel are characterized by the foreign government, the entity's purpose, its obligations and privileges under the foreign law including exclusivity or controlling power in its functional area, and the circumstances surrounding its creation.

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It is unclear if other courts will follow *Noreiga* and *Carson*, especially in cases involving state-owned companies less entwined in quintessential government functions than, for example, the utility company in *Noriega*. The scope of the FCPA will be significantly narrowed if courts hold that it applies only to “true” government officials, thus exempting transactions with state-owned or state-controlled companies from its record-keeping and anti-bribery provisions. To some, this will be viewed as a leveling of the playing field because the U.S. has been the only major economic power to prohibit its companies from bribing foreign officials. To others, it will be seen as an end-run around a law that combats corruption.