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White Collar and Government Enforcement Practice

White Collar Watch

The Newsletter of the White Collar and Government Enforcement Practice

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SEC's Dodd-Frank Whistleblower Program Report shows best practices make for an effective compliance and ethics program

By Justin B. Ettelson

IN BRIEF

- **Complaints and referrals from whistleblowers increased 8 percent compared to the previous year, particularly relating to offering fraud and manipulation.**
- **Whistleblowers span all 50 states and are particularly active in California, New York and Florida.**

The Securities and Exchange Commission's *2013 Annual Report To Congress On The Dodd-Frank Whistleblower Program* provides the second complete year of data on the activities of the Office of the Whistleblower ("OWB") since the office's establishment in 2011. The SEC distributed $14,831,965.64 in award payments during fiscal year 2013, including $14 million to one whistleblower for information that led to an enforcement action that recovered substantial investor funds less than six months after the SEC received the information.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") empowers the SEC to pay financial awards to whistleblowers who provide significant, original information that leads to a monetary sanction greater than $1 million. The SEC enjoys the discretion to award the whistleblower(s) 10 to 30 percent of the sanctions collected. Awards are paid from an Investor Protection Fund. The Dodd-Frank Act requires the SEC to establish a separate office – the OWB – to administer the whistle-blower program. The OWB is statutorily required to report annually to Congress on its activities, whistle-blower complaints, and the SEC's response.

This year's *Annual Report*, released on November 15, 2013, reveals that the SEC received 3,238 tips, complaints, and referrals from whistleblowers across the country and abroad in fiscal year 2013 (October

1, 2012 through September 30, 2013). This represents an 8 percent increase from fiscal year 2012. The most common complaint categories relate to:

- corporate disclosures and financial statements (17.2 percent, or a 6 percent decrease from the prior year);
- offering fraud (17.1 percent, or an 11 percent increase from the prior year); and
- manipulation (16.2 percent, or a 7 percent increase from the prior year).

Other categories of complaints had significantly lower reporting percentages, including:

- insider trading (6.1 percent);
- trading and pricing (5.2 percent);
- Foreign Corrupt Practices Act, also known as the "FCPA" (4.6 percent);
- unregistered offerings (3.3 percent);
- market event (2.8 percent); and
- municipal securities and public pension (1.5 percent).

Two categories not referenced above, "other" and "blank," together constituted the remaining 26.2 percent of the total tips calculated.

Geographically, whistleblowers span all 50 states, the District of Columbia, the U.S. territories of Puerto Rico, Guam and the U.S. Virgin Islands, as well as 55 countries outside of the United States. Domestically, the largest number of tipsters came from:

- California (375);
- New York (215); and
- Florida (187).

The total number of tips received from abroad was 404, which constituted approximately 11.8 percent of the total tips received for the period covered in the *Annual Report*. The largest number of tipsters from outside the United States came from:

- United Kingdom (66);
- Canada (62); and
- China (52).

Tips from Russia, India and Ireland totaled 20, 18 and 18, respectively.

There were 118 enforcement judgments and orders issued during fiscal year 2013 that potentially qualified as eligible for a whistleblower award. The OWB provided the public with notice of these actions because they involved sanctions exceeding the statutory threshold of more than $1 million and analyzed each claim for an award relating to the tips that led to these judgments. Since inception of the program in August 2011, the SEC has granted awards to six whistleblowers, four of those in fiscal year 2013.

Employers should continue to encourage employees to report possible corporate wrongdoing internally. And robust policies and procedures designed both to prevent and detect criminal and fraudulent conduct will inure to a company's benefit in the event the SEC determines that wrongdoing has in fact occurred. The SEC has made clear that it will not process awards in a manner that undercuts *bona fide* compliance programs.

But there is still work that companies can do. The complaint numbers we have reported can and should guide companies and market participants as to where they allocate their training and educational resources. For example, public reporting companies should focus on training and compliance issues related to corporate disclosures and financial statements and make certain they have a robust disclosure control program in place. In addition, market participants, including broker-dealers and investment advisers, should have robust compliance programs to prevent and detect offering fraud and stock price manipulation. Companies and market participants also should not ignore issues that trigger relatively low numbers of complaints. Some of these issues – like insider trading and FCPA violations – carry such high reputational risk, or have such a high priority for enforcement within the SEC, that they warrant educational and training resources disproportionate to their complaint rate.

In sum, the SEC's *Annual Report* provides helpful guidance on how best to allocate educational and training resources in the context of a robust corporate compliance program. We note also that periodic program assessments are an integral part of every *bona fide* compliance regime, and we stand ready to help in this regard – before an employee blows the whistle.

In unprecedented move, government seeks to extend the responsible corporate officer doctrine to product safety recall actions

By Gregory G. Schwab

IN BRIEF

- **Recall of Buckyballs® leads to lawsuit filed by the CEO of company that produces magnetic desk toy, as Consumer Product Safety Commission aims to hold him personally responsible for alleged safety risks.**

An officer of a defunct company is suing the government regulatory agency attempting to pin him with personal financial responsibility for a $57 million product recall. This lawsuit is the latest step in a public campaign waged by former Maxfield & Oberton CEO Craig Zucker against the Consumer Product Safety Commission, which recalled his company's product Buckyballs® in 2012. The Commission's unprecedented move to hold Zucker personally responsible for a non-criminal consumer safety violation broadly extends the responsible corporate officer ("RCO") doctrine in a manner previously not seen. The action stems from a newly empowered Commission.

The Commission's increased enforcement efforts

Since the enactment of the Consumer Product Safety Improvement Act of 2008 ("CPSIA"), the Commission has been actively engaged in enforcement efforts and product recalls. The CPSIA increased the maximum civil penalties for failure to report from $8,000 per violation to $100,000 per violation. Maximum total penalties for a series of violations increased from $1.825 million to $15 million. The CPSIA also increased criminal penalties, with the potential for up to five years in prison for "knowing and willful" violations. In the last year alone, the Commission announced eight settlements with civil penalties, ranging from $400,000 to $1.5 million, levied against companies for failure to report.

Increased penalties represent only one "stick" in the Commission's enforcement arsenal. The Commission has also implemented extensive compliance program obligations, requiring companies in violation to maintain strict compliance policies and report to the Commission on their implementation.

Though the Commission can seek penalties for violations, it can also seek injunctive relief in administrative law courts if a company fails to recall a product with a "substantial product hazard," as defined under the law. In the case of Buckyballs®, the Commission chose to do just that.

The Buckyballs® recall

In 2010, Maxfield & Oberton added warning labels indicating that the magnets were for adult use only, and recalled all Buckyballs® that were sold without the new label. In 2011, the Commission launched a campaign warning users not to give Buckyballs® to children. Finally, in 2012, the Commission decided warnings were insufficient to deter use by children and resorted to an administrative complaint to force withdrawal of the product. The Commission filed its complaint in July 2012 against Maxfield & Oberton. According to the Commission, it was only the second administrative complaint it filed in 11 years. Despite an aggressive public campaign against the Commission, the Commission continued to pursue its complaint against Maxfield & Oberton. The company eventually dissolved in December 2012, making the complaint moot. In February 2013, the Commission moved for leave to file a second amended complaint naming the former CEO, Craig Zucker, both individually and as an officer of Maxfield & Oberton. The Commission requested the same relief against Zucker as it had against Maxfield & Oberton – *i.e.*, recall, refund, and compliance reports.

The Commission succeeds – so far – in applying the RCO doctrine

This past May, the Commission obtained an unprecedented ruling when an administrative law judge ("ALJ") granted the request to add Zucker as a respondent in the administrative complaint.

Zucker argued that he could not be liable as he did not personally manufacture, distribute, or sell the product at issue, and that Maxfield & Oberton was the proper respondent. The ALJ agreed that, under the language of the CPSIA, Maxfield & Oberton was a manufacturer, distributor, or retailer subject to suit. In doing so, the ALJ implicitly acknowledged that Zucker was not a manufacturer, distributor, or retailer. However, the ALJ found this did not exclude Zucker as a proper respondent. The question was whether under the RCO doctrine Zucker could "be held individually responsible for the alleged CPSIA transgressions" of the corporation.

The RCO doctrine is derived from two Supreme Court decisions, *United States v. Dotterweich*, 320 U.S. 277 (1943) and *United States v. Park*, 421 U.S. 658 (1975). The RCO doctrine imposes liability on officers for the actions of the corporation, even in the absence of personal guilt on the part of the individual. The relevant inquiry is whether the individual's position within the company gave him authority and responsibility to prevent the alleged violation. *Dotterweich, Park,* and their progeny have applied the RCO doctrine to statutes involving public health and safety. Because the CPSIA "relates to the public's health and safety," the ALJ reasoned that *Dotterweich* and *Park* controlled.

At this stage, the ALJ refrained from commenting on the merits of the Commission's allegations against Zucker, but simply examined the sufficiency of the complaint. The ALJ found the complaint sufficiently alleged liability under the RCO doctrine: "Mr. Zucker was responsible for ensuring Maxfield's compliance with applicable statutes and regulations . . . [and] personally controlled the acts and practices of Maxfield, including the importation of Buckyballs and Buckycubes."

Fighting back against the Commission

The Commission's target did not take the ALJ's decision lightly. On November 12, 2013, Zucker filed suit in the U.S. District Court in Maryland against the Commission and Commission Chairman Inez Tenenbaum. Zucker seeks declaratory and injunctive relief to avoid being held personally liable in the Commission's ongoing administrative action seeking a mandatory recall of high-powered magnet products, including Buckyballs® and Buckycubes™, which were sold by Maxfield & Oberton.

Zucker alleges that naming him personally in the administrative action violates the Administrative Procedure Act ("APA") as well as his constitutional rights under the First and Fifth Amendments. The complaint alleges that the Commission acted arbitrarily and capriciously and outside the scope of its authority, in violation of the APA, because Zucker is not a manufacturer, distributor, or retailer as defined in the CPSIA. Zucker's complaint criticizes the ALJ's application of *Park* as an "unprecedented expansion" of the RCO doctrine.

Zucker further alleges that the Commission's actions infringed on his First Amendment right to free speech and denied his Fifth Amendment due process rights. The complaint states that the Commission named Zucker in order "to punish him and to chill and deter him and other corporate officers from exercising their Constitutional rights to free speech, to free association, to publicly advocate for their companies, and to petition government officials for redress of their grievances."

Zucker maintains that he has been singled out by the Commission for punishment, and that those efforts have been an attempt to "bleed first M&O and then Mr. Zucker to death." The complaint slams the Commission as an "out-of-control bureaucracy" and its actions as unprecedented and an abuse of power.

Implications for consumer product manufacturers – particularly executives

The RCO doctrine has seen a recent resurgence in the pharmaceutical context, with pharmaceutical executives facing imprisonment and criminal fines in the absence of criminal intent – or, in some cases, in the absence of any knowledge whatsoever. Extension of this doctrine to the consumer products arena could add another powerful tool to the Commission's enforcement toolbox, allowing the Commission to leverage the threat of personal liability against corporate officers. The import of that tool may be limited by the low number of administrative complaints historically brought by the Commission – though that could change at any time. While the Commission may have little to gain from individual liability where the corporation has the means to conduct a full recall and corrective action plan, the potential for individual liability could influence and pressure smaller companies that believe they cannot afford a recall.

Bid-rigging cooperator gets no prison, no probation, no fines

By Jennifer L. Beidel

IN BRIEF

- **Case against JPMorgan Chase vice president illustrates the benefits of a robust compliance program as federal prosecutors turn to mid-level executive to expose company's practices related to municipal bond offerings.**

James L. Hertz, a former JPMorgan Chase & Co. vice president, was the first JPMorgan employee to cooperate in the federal investigation of the company's alleged bid rigging for re-investment of municipal bond offering proceeds pending their use. That cooperation, according to Hertz's filings, netted the government $674 million in settlements and 16 convictions.

In 2010, Hertz pleaded guilty to the charges against him. Last month, a New York federal judge sentenced him to no prison time, no probation, and no fines – despite his guilty plea. *United States v. Hertz*, No. 10-cr-1178 (S.D.N.Y. 2013). Hertz faced up to 20 years in prison and over $1 million in fines for various charges.

State and local governments use municipal bond offerings to raise money for operating funds or specific construction or other projects. But, these projects are typically multi-year, while bond offerings result in up-front payments. Thus, municipal bond derivatives are used to invest the proceeds in the meantime.

Municipalities generally select the providers of their investment agreements through competitive bidding procedures that are designed to comply with federal laws and regulations regarding their tax-exempt status. Among other things, these regulations require that no bidder be given a "last look" at the status of the bidding before the deal closes and that a certain number of bidders participate in each deal. The government's allegation against JPMorgan, Hertz, and others was that they colluded to "rig" bids by soliciting courtesy (or intentionally losing) bids, refraining from bidding, and providing "last looks," among other things.

Hertz admittedly engaged in a bid-rigging conspiracy from 2001 to 2006. But, in court papers, he claimed that he attempted unsuccessfully to stop the misconduct at JPMorgan. And, his early cooperation with the government cost him years of pay and bonuses. These factors, and others, likely led to his light sentence.

The takeaways here are several. First, as Hertz did, if an employee suspects institutional misconduct, he or she should be encouraged to report those concerns to his or her employer through a robust compliance program that involves internal reporting, unbiased investigation, and effective resolution of employee concerns. A more effective program may have prevented Hertz from becoming a government whistleblower. Second, in an institutional setting, someone is likely to cooperate with the government in exchange for a favorable deal. When an investigation is pending, caution and circumspection are key. Finally, the government regularly targets for prosecution mid-level executives like Hertz who are likely to cooperate. If trouble is brewing, being in the middle of the corporate ladder is no defense.

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