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A New SEC Enforcement Direction for 2014

By Randall J. Fons and Tiffany A. Rowe

Each year, the SEC puts on its most informative conference of the year: The SEC Speaks. During the course of the two-day conference, held this year on February 21 and 22, the Chair and each Commissioner, as well as the most senior staff of each division of the SEC, provide their thoughts and insights into the most pressing issues currently being considered by the Commission. One of the annual highlights of the conference is the discussion of the enforcement program and its successes, failures, initiatives and priorities. Last year we noted that changes at the senior levels of the Commission and the Division of Enforcement caused the staff to remain vague in outlining priorities and initiatives (*See* http://www.mofo.com/files/Uploads/Images/130305-SEC-Enforcement-Initiatives.pdf). This year, with new management in place, the staff had no difficulty announcing that change is in the works. From new enforcement priorities to changes in long-lived enforcement policies, and from a new task force to the resurrection of long-forgotten statutes, the Enforcement Division made clear that "past performance is not necessarily indicative of future results."

AN END TO "FREE (OF) ADMISSION"

SEC Chair Mary Jo White began the conference by discussing her decision to overturn years of Commission precedent by requiring, in "appropriate cases," a defendant in an enforcement action to admit violating the federal securities laws in order to settle the matter. Chair White noted that historically the SEC, along with other civil agencies, has allowed defendants to settle without admitting or denying the government's allegations in nearly every instance. However, arguing that admissions can achieve a greater measure of accountability on the part of the SEC, and that they can "bolster the public's confidence in the safety of our markets," Chair White stated that the time had come to revisit and change the "neither admit nor deny" policy.

According to Chair White, defendants may be required to admit their violations in cases that reflect certain characteristics. Where, for example, the Commission believes that the conduct was "particularly egregious" or harmed "a large number of investors," an admission may be required. Where the wrongdoer poses "a particular future threat to investors" or "where the markets or investors were placed at significant risk," an admission may be appropriate according to Chair White. Or, if the defendants' conduct "undermines or obstructs the investigative process" or when an admission "can send a particularly important message to the markets," the SEC may now insist on an admission by a defendant wanting to settle.

Although the Commission has recently required admissions in a small handful of cases[1] the standards apparently

[1] Scottrade Agrees to Pay $2.5 Million and Admits Providing Flawed 'Blue Sheet' Trading Data (Jan. 29, 2014), *available* at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540696906 Other cases settled with admissions are: Philip Falcone and Harbinger Capital Agree to Settlement (Aug. 19, 2013), *available* at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222; JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges (Sep. 19, 2013), *available* at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965; SEC Charges ConvergEx Subsidiaries With Fraud for Deceiving Customers About Commissions (Dec. 18, 2013), *available* at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540521484.

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to be used in identifying “appropriate cases” are disconcertingly vague. One could argue, based on the SEC’s prior statements concerning the efficacy of its enforcement program, that the majority of its enforcement actions could fit within the framework outlined by Chair White. While it is clear that the SEC cannot practically go down a road toward requiring admissions in more than a small fraction of its cases, the lack of meaningful clarity in how the SEC or the staff will determine which cases will require admissions will leave companies, individuals and counsel guessing for some time.

FINANCIAL REPORTING PUT TO THE TASK

David Woodcock, Director of the SEC’s Ft. Worth Office, discussed the Division’s creation of the Financial Reporting and Audit (FRAud) Task Force. Woodcock, co-chair of the Task Force, acknowledged that the SEC’s waning number of financial fraud actions over the past several years was due, at least in part, to the Commission’s focus on other areas, such as insider trading, Ponzi schemes and matters related to the 2008 financial crisis. While noting that significant reforms resulting from Sarbanes-Oxley and Dodd-Frank should also be mentioned in the context of the diminished enforcement activity in this area, he discounted the view that financial fraud has dropped entirely because of the changes in the regulatory scheme. The Task Force was designed to help the SEC, and the Division, re-prioritize its efforts and efficiently address the potential for ongoing financial fraud feared by the staff. Woodcock stated that there will be more financial reporting investigations going forward, and that public companies and their auditors will see a much more active enforcement staff.

Woodcock then detailed the five goals of the Task Force:

- Deepen the Division’s understanding of financial fraud, not only how and where it is happening, but the psychology behind it as well. Woodcock detailed a comprehensive effort using internal tools, SEC data and “third party” data regarding a particular company to search for indicators of fraud. Noting that the SEC’s success in bringing dozens of options backdating cases began with a scholarly article written by a professor at the University of Iowa, Woodcock stated that similar reviews of academic work will be solicited and considered by the staff.

- Develop state of the art methodology for investigating and identifying financial fraud in the marketplace. Woodcock noted that the SEC has begun using cutting edge technology to assist it with analyzing and developing facts and theories surrounding financial fraud. Although he declined to be specific, Woodcock stated that industry sweeps were part of the arsenal the Division would be using in looking for financial fraud.

- Become thought leaders at the SEC in the area of fraud detection practices and investigation methods. By taking advantage of the wide array of experience the staff members on the Task Force have, Woodcock hopes that the Task Force will lead not only the Division of Enforcement regarding issues concerning financial fraud, but also have a role in devising priorities, initiatives and strategies Commission-wide.

- Engage third parties such as whistleblowers and their counsel in discovering financial fraud. Woodcock specifically discussed the success of the SEC’s whistleblower program in providing high quality tips concerning public company financial reporting and disclosure problems.

- Collaborate with regulatory and enforcement partners in order to leverage advances made by the PCAOB, SROs and others with an interest in market integrity.

ALL DRESSED UP – NOW WHERE TO GO?

Historically, the SEC has followed general guidelines in determining whether to bring enforcement cases in federal district court or in the SEC’s own administrative proceedings. Although exceptions always existed, cases

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against regulated entities were more often considered appropriate for administrative proceedings, while litigated cases against public companies or unregistered individuals were more apt to be brought in federal court. According to Assistant Chief Counsel Charlotte Buford, those well-established guidelines are about to change. As noted by Buford, legislation over the past several years has provided Administrative Law Judges with many of the powers in granting relief that were once solely in the domain of federal judges. Specifically, ALJs now have the ability to require disgorgement and impose civil penalties, among other things, against any company or individual, whether in the financial industry or not. As a result, Buford explained that the SEC will be more willing than ever before to bring cases in an administrative forum. Buford outlined several factors that the Division will consider in determining the forum it believes is appropriate in any given case: speed and efficiency of the forum in coming to conclusion; the nature of the case; litigation considerations, such as the need for extensive discovery; and the likelihood of settlement. Buford then noted that the Commission recently brought a settled insider trading matter and a settled FCPA matter in administrative proceedings, cases that would have historically be brought in federal court.

The changes outlined by Buford are likely to have both positive and negative effects for entities and individuals. On the positive side, if a defendant is willing to settle an enforcement action, the SEC may be more willing to file the action in an administrative proceeding, rather than in federal district court. However, on the negative side, the SEC may also be bringing more litigated actions administratively, where there is no jury or formal discovery for the defense, where time constraints on the administrative process can exert extraordinary pressure on defendants, and where the Division is perceived by many to have a home field advantage. Although none of the factors outlined by Buford are new, it seems unlikely that those factors are now going to be weighed by the Division with the best interest of litigating defendants in mind.

THE PONY LEADING THE PACK IN FCPA

After a slow start in fiscal 2013, the Division's FCPA staff appears to be developing its workload for the remainder of 2014, conducting investigations into matters ranging from old school bribery to charitable donations and tax matters. Kara Brockmeyer, chief of the FCPA Unit, indicated that most of the current FCPA investigations arise from travel and entertainment costs and often involve third-party agents or intermediaries of the public company issuers. Brockmeyer noted that while companies are becoming more diligent in their analysis before entering into third-party agreements acting in foreign jurisdictions, there are still far too many examples of arrangements where the third-party is charged with "getting the business" without sufficient company oversight of its methods.

Brockmeyer then highlighted a first in the SEC's approach to FCPA violations – a non-prosecution agreement with Ralph Lauren Corporation relating to allegations of bribes paid by a subsidiary to officials in Argentina. To provide context and guidance to public companies, Brockmeyer detailed the various factors that qualified Ralph Lauren for the non-prosecution agreement. First, the company self-reported to the Commission within two weeks of finding the problem. Second, the bribe was discovered by Ralph Lauren in connection with its self-policing policies and procedures. Third, the company fully cooperated with the government, going as far as to provide English translations of documents and bringing witnesses from foreign locations to provide testimony, saving the Commission significant time and effort in its investigation. Finally, Ralph Lauren took extensive remedial measures, including a worldwide review that confirmed that the issue was confined to Argentina. Although Ralph Lauren's cooperation in the matter was extraordinary, Brockmeyer made clear that extraordinary cooperation will not cure all FCPA problems. For example, Brockmeyer noted that if the FCPA violations had extended beyond Argentina, Ralph Lauren probably would not have been eligible for an NPA.

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SOMETHING OLD IS JUST AS GOOD AS SOMETHING NEW

Joseph Brenner, the Division's Chief Counsel, informed the audience that the Division has started to peruse provisions of the federal securities laws that it has seldom, if ever, relied upon in bringing enforcement actions. Stating that the Division will embrace opportunities to bring cases in historically underutilized areas, Brenner outlined several unfamiliar statutory provisions that the SEC has either recently alleged were violated, or that Brenner anticipates will be cited in upcoming enforcement cases. The three more striking examples cited by Brenner were:

- In its case against Brian D. Jorgenson, a senior portfolio manager at Microsoft, and Sean T. Stokke, the SEC alleged that Jorgenson and Stokke profited not only by purchasing shares of Microsoft while in possession of material, nonpublic information, but also by purchasing an exchange traded index fund that had a position in Microsoft stock. By purchasing the index fund while in possession of material nonpublic information concerning Microsoft, the SEC alleged that Jorgenson and Stokke violated Section 10(b) of the Exchange Act "pursuant to Section 20(d) of the Exchange Act" which prohibits the purchase or sale of, among other things, an index fund containing securities of the company about which the trader possesses material nonpublic information.
- In an administrative proceeding brought against Carl Johns, a portfolio manager at a registered investment adviser, the SEC brought its first action under Rule 38a-1(c), which prohibits any employee of an adviser from misleading the adviser's chief compliance officer in the performance of his or her duties as CCO. In imposing significant sanctions against Johns – over $350,000 in disgorgement and penalties and a 5-year bar – the SEC found that Johns violated the adviser's code of conduct, failed to get pre-clearance for his personal trading, and then misled his CCO by falsifying documents to make it appear that he had received pre-clearance.
- In what could be a reaction by the Division to the *Janus* case[2], which limited the SEC's ability to sustain fraud charges against individuals who did not have "ultimate authority" over the content of a misleading statement, Brenner stated that the Division is pursuing a case based on Section 20(b) of the Exchange Act. Under that provision, an individual may be liable for a violation which she committed "through or by means of any other person." Thus, according to Brenner, an individual who provided false information to another, with the understanding that such information would be provided to the investing public, could be liable under 20(b) even if she did not have "ultimate authority" for the public statement.

LITIGATION ON THE UP AND UP

As usually happens at SEC Speaks, the Chief Litigation Counsel for the Division – this year Mark Solomon – trumpeted the Division's successes during 2013. He also stated that the Division's litigation team is ready, willing and able to take on all cases, and predicted that the coming year will see continued focus on sustaining a strong win rate, increasing summary judgment victories, and achieving settlements that return money to investors without protracted litigation. Solomon continued to send the message, first articulated by Chair White, that the Division will not accept "cheap" settlements, but would gladly take cases to trial, either administratively or in federal court.

With regard to insider trading, Solomon did not discuss the high profile losses suffered by the SEC in 2013, including its case against Mark Cuban, who had a front-and-center seat at SEC Speaks. Without specifically acknowledging those losses, however, Solomon stated that the Division, and the litigation group, will continue to be aggressive in its enforcement of the insider trading prohibitions, litigating cases which stretch historical legal

[2] *Janus Capital Group Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

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theories. Doing so is an important part of the SEC's focus on insider trading, according to Solomon.

ENFORCEMENT IN ANY SPACE

Finally, the Division's staff reminded everyone that, despite its changing focus and priorities, it would not be neglecting other areas of historical concern. According to the staff, the evolving marketplace will continue to raise enforcement concerns in the areas of asset management, private funding and private equity. Issues concerning advisory oversight and reporting, self-dealing, and improper valuation are other areas that remain central to the Division's mandate of protecting investor confidence and market integrity. Although much of the market activity surrounding the financial collapse of 2008 is now outside of the SEC's five-year statute of limitations, the staff continues to be interested in complex financial instruments and transactions, and how public companies, banks and regulated entities participate in that esoteric market.

CONCLUSION

Chair White and Andrew Ceresney, the SEC's Enforcement Director, both hail from a background in criminal prosecution, having served as high-level prosecutors in the US Attorney's office in the Southern District of New York. As a result, it should not be too surprising that they are taking the SEC's enforcement program in a new, aggressive direction. Novel legal theories of liability, forceful litigation postures, difficult settlements and personal responsibility are likely to be the hallmarks of their administration. Where last year's conference provided little insight in terms of specificity and direction of the enforcement program, this year's conference provided warnings of a Division that has found its bearings and intends to use new technology, new ideas and new staff to enhance and improve its enforcement program.

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