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SEC Enforcement Update
The SEC Speaks in 2011

On February 4-5, 2011, the U.S. Securities and Exchange Commission (SEC) held its annual *SEC Speaks* program in Washington, D.C. While much of the event focused on the intense, often technical rulemaking activity at the Commission occasioned by the 2010 passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), staff from the Commission also provided useful information about the direction and priorities of the agency's Enforcement program.

Specialized Units

Deputy Director of Enforcement Loren Reisner reported that the Enforcement Division's five specialized units—the Chiefs of which were first announced in January 2010[i]—have been "up and running" and staffed since March 2010. He added that the units have been engaged in dozens of investigations as well as specialized training sessions for their members. According to Reisner, the size of the units ranges from a low of 25 staff (Municipal Securities and Public Pensions) to a high of 65 staff (Asset Management), with approximately one quarter of the Enforcement staff assigned to one of the units. The Foreign Corrupt Practices Act (FCPA) unit, for example, has 30 staff members across five regions and the home office. Reisner also noted that the units have hired industry experts in addition to the many lawyers and accountants that comprise the Enforcement staff. These experts include traders, managers, and analysts who formerly worked for investment banks, hedge funds, and other entities regulated by the Commission.

Cooperation Initiative

Reisner said that the Division is aggressively promoting its year-old cooperation initiative, and has already entered into 20 different cooperation agreements in cases covering a wide range of program areas, including accounting fraud, insider trading, and FCPA violations.[ii] Reisner highlighted in particular the Division's first non-prosecution agreement, announced on December 20, 2010, with Atlanta-based Carter's Inc.[iii] In that case, the SEC charged a former executive vice president of Carter's with engaging in insider trading and a financial fraud that caused Carter's to issue materially misleading financial statements, but the Commission declined to charge the company with any violations of the federal securities laws. In its press release, the SEC explained that it was declining to charge Carter's because of the relatively isolated nature of the unlawful conduct; the company's prompt and complete self-reporting of the misconduct to the SEC; exemplary and

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extensive cooperation in the investigation; and extensive and substantial remedial actions.

Students of SEC enforcement will recognize these factors as similar to those discussed in the Commission's 2001 *Seaboard* report and its progeny, which articulated a framework for evaluating cooperation by companies. However, while declining to take any enforcement action against Carter's, the Commission insisted that the company enter into a non-prosecution agreement that requires it to cooperate fully in the Commission's ongoing investigation, in any other related litigation or proceeding to which the Commission is a party, and in any investigation or proceeding by other regulators if directed by Enforcement Division staff. The agreement also requires Carter's to promptly produce all non-privileged documents and information as requested by the SEC staff, and to use best efforts to ensure that current and former personnel appear for any interviews or testimony requested by the staff, respond to all inquiries from the staff, and testify at trial or other judicial proceedings when requested to do so by the staff.

Dodd-Frank

George Cannellos, Director of the New York Regional Office, highlighted certain provisions in Dodd-Frank that could have the most significant impact on the Commission's Enforcement program. These include:

- Section 925, which essentially overruled the D.C. Circuit's decision in *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999). *Teicher* had put an end to the Commission's practice of imposing so-called "collateral bar" orders—*i.e.*, orders prohibiting association with firms in all parts of the securities industry even when the predicate violation involved conduct in only one part of the industry. Cannellos suggested that the Commission is likely to revert back to its prior practice of routinely seeking collateral bars now that Dodd-Frank has explicitly authorized them.

- Section 929K, which expressly authorizes the Commission to share information protected by any recognized privilege—including the attorney-client privilege or attorney work product doctrine—with other regulatory and law enforcement agencies, as well as to receive such information from other agencies, without either party waiving any privileges that would apply. Of course, this provision has not yet been tested in the courts with respect to whether the provision's immunity from privilege waiver will stand up against judicial scrutiny.

- Section 929M, which permits the Commission to pursue not only primary violators of the Securities Act of 1933 and the Investment Company Act of 1940, but also those who aid and abet such violations. Previously, aiding and abetting authority had not been explicit with respect to those Acts. In addition, Congress made clear in Section 929O that an individual may be held liable for aiding and abetting based on a finding of recklessness, effectively overruling several court decisions that had required proof of actual knowledge.

- Section 929P(a), which for the first time permits the Commission to impose civil penalties in administrative cease-and-desist proceedings.

- Section 929P(b), which essentially overrules the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), and gives U.S. district courts jurisdiction over any action brought by the Commission involving either: (i) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (ii) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

- Section 929P(c), which confirms the Commission's authority to pursue those who "control" primary securities law violators. Cannellos noted that although judicial decisions interpreting the concept of "control person" liability have required "culpable participation" by the controlling person, once that standard has been met, the controlling person is liable to the full extent of the primary violator's disgorgement and penalty obligation, with the penalty being determined based on the violator's misconduct, not the typically more limited culpability of the controlling person.

Cannellos speculated that the SEC's new power to impose civil penalties in administrative proceedings may significantly alter the staff's view of where to bring its enforcement actions. For example, in a typical case seeking an order prohibiting future misconduct, disgorgement of ill-gotten gains, and the imposition of a civil penalty, the staff now effectively has a choice of venue between federal district court and an administrative SEC proceeding. Cannellos noted that where a parallel criminal action exists, this may weigh in favor of bringing the action in an administrative proceeding because such proceedings are speedier and do not allow for the type of expansive discovery that is commonplace in a federal district court civil action but is not available in a parallel criminal proceeding. This would limit the ability of defendants in such parallel proceedings to take advantage of the relatively generous civil discovery rules, which often prompt the government to request a stay of the SEC's civil action pending the disposition of the parallel criminal proceeding. Cannellos also stated that settled cases may be brought more often as administrative proceedings now that civil penalties are explicitly permitted in such proceedings.

Judicial Skepticism of SEC Settlements

Matthew Martens, the Division of Enforcement's Chief Litigation Counsel, discussed the recent tendency of federal judges to question the adequacy of Commission settlements in cases filed in federal district court. He cited in particular Southern District of New York Judge Jed Rakoff's initial rejection in 2009 of a settlement with Bank of America, and District of Columbia Judge Ellen Huvelle's skepticism over a proposed settlement with Citigroup in 2010. Martens opined that the attention focused on these cases has magnified what is actually a relatively insignificant phenomenon, involving only a few cases out of the hundreds of settlements the Commission reaches each year.

Reisner added that although judicial skepticism of Commission settlements has not altered the substance of what the Commission will continue to seek in settled cases, defense counsel should be warned that their oft-heard request to limit the information included in the Commission's charging instrument—the federal complaint—may come back to haunt them if the judge overseeing the case declares that there is not enough in the record to justify the settlement. Reisner added that the SEC may need to consider a new practice whereby it would routinely file with any proposed settlement a separate document explaining to the court the Commission's rationale in agreeing to the settlement and anticipating questions the judge may have about the settlement.

In somewhat related remarks made immediately before the Enforcement panel, Commissioner Luis Aguilar noted his displeasure when, after a settlement is announced, a defendant issues a press release "explaining how the conduct was really not that bad or that the regulator over-reacted." Commissioner Aguilar expressed hope that such press releases would end and then chillingly warned that, if not, "it may be worth revisiting the Commission's practice of routinely accepting settlements from defendants who agree to sanctions 'without admitting or denying' the misconduct."[iv]

Particular Enforcement Priorities

Eric Bustillo, Director of the Miami Regional Office, discussed the formation of a Microcap Working Group within the Enforcement Division, which will focus on penny stocks and over-the-counter markets where Ponzi schemes are most likely to take hold. Bustillo said that the Commission also remains focused on related "affinity fraud" cases, where fraudsters target particular ethnic or religious groups.

Scott Friestad, Associate Director of Enforcement, noted the continuing priority of accounting fraud and issuer reporting cases. He said that, among the 126 enforcement actions in this area brought during fiscal 2010, the Commission had taken action against 24 chief executive officers, 46 chief financial officers, and 31 chief accounting officers. In addition, in 2010 the SEC filed 55 enforcement cases pursuant to Rule 102(e) of the Commission's Rules of Practice against either in-house company accountants or outside auditors, seeking to suspend or bar them from practicing before the Commission. Friestad also noted the increasing number of accounting fraud cases that resulted not from a company's own announcement of a financial restatement, but instead from the staff's initiative. In the *Diebold* case, for example, where the SEC charged the company and three former executives with engaging in a fraudulent accounting scheme to inflate the company's earnings, Friestad said that the staff had originally been investigating insider trading issues, but discovered evidence of accounting manipulations during the investigation.[v] Diebold agreed to pay a $25 million penalty to settle the SEC's charges.

Jason Flemmons, Associate Chief Accountant, emphasized the increasingly cross-border nature of the staff's accounting investigations. Flemmons said that many companies operating exclusively overseas will become registered in the United States by engaging in reverse mergers with currently U.S.-registered shell entities. With respect to such companies, he expressed the staff's concern that the foreign company may not be proficient in reporting financial results according to U.S. Generally Accepted Accounting Principles. Additionally, he said the staff will be scrutinizing the work of independent auditors of such companies to determine whether they are exercising appropriate professional skepticism regarding information provided by their foreign clients.

Cheryl Scarboro, Chief of the FCPA unit, reported that the Commission had brought more FCPA cases than ever in fiscal 2010. She said that cases brought in 2010 named 23 entities and seven individuals, and resulted in more than $600 million in disgorgement and civil penalties. Perhaps the most surprising statistic reported by Scarboro was that only one-third of the SEC's FCPA cases originated from self-reports made by companies, although it was not clear whether she meant one-third of the SEC's filed FCPA enforcement actions or one-third of all FCPA investigations opened by the SEC staff.

Scarboro highlighted in particular that several of the agency's recent FCPA cases were brought against foreign issuers and even foreign non-issuers, and she predicted that this trend would likely continue. She cited the Commission's case against Panalpina, Inc. as an example of the agency's ability to charge FCPA violations even against a foreign entity that is not an issuer—if the entity was acting as an agent of one or more issuers while committing the violations.[vi] Scarboro also cited the Commission's case against Innospec, Inc. for allegedly engaging in widespread bribery of Iraqi government officials to obtain contracts under the United Nations' Oil-for-Food Program, noting that the case had, for the first time, charged a company's individual agent who had operated overseas while arranging for the illegal payments.[vii]

Kenneth Lench, Chief of the Structured and New Products Unit, discussed the Commission's recent efforts in the subprime mortgage area, and noted that, in the future, the Commission will continue to analyze disclosures made to investors by participants in the subprime market, including in connection with the issuance of securities that are based

on subprime mortgage-related instruments. For example, Lench stated that a number of banks had in the recent past declared moratoriums on certain foreclosures involving properties secured by subprime lending, and the Commission would be investigating what disclosures were made to investors in connection with such moratoriums.

Finally, Daniel Hawke, Director of the Philadelphia Regional Office and Chief of the Commission's Market Abuse Unit, described his vision of a "more aggressive approach" to insider trading cases. He said his unit intended to focus heavily on networks and patterns that reflect "institutionalized and organized" insider trading. Not surprisingly, Hawke cited the ongoing *Galleon*, *Cutillo*, and "expert network" cases as prime examples. With respect to investigative techniques, he revealed that the SEC staff was often "surfacing" later in insider trading investigations (*i.e.*, only after it has already compiled substantial evidence against the suspected wrongdoers), in contrast with the historical approach of contacting suspects as early as possible with the hopes of catching them off-guard, prompting ill-considered admissions or false denials, and preventing them from coordinating false alibis. Hawke added that the SEC staff is now contacting criminal prosecutors in insider trading cases earlier than the staff had in the past.

If you would like to discuss any of these issues, or if you have other questions about the SEC or its Enforcement program, please do not hesitate to contact us.

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[i] *See* Robert Khuzami, *Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders*, available at http://www.sec.gov/news/speech/2010/spch011310rsk.htm.

[ii] *See* King & Spalding Client Alert, *SEC Issues Important New Guidelines on Cooperation*, available at http://www.kslaw.com/imageserver/KSPublic/Library/publication/ca011510.pdf.

[iii] *See SEC Charges Former Carter's Executive With Fraud and Insider Trading*, available at http://www.sec.gov/news/press/2010/2010-252.htm.

[iv] Available at http://www.sec.gov/news/speech/2011/spch020411laa.htm.

[v] *See SEC Charges Diebold and Former Executives with Accounting Fraud*, available at http://www.sec.gov/news/press/2010/2010-93.htm.

[vi] *See SEC Charges Panalpina with Violating the Foreign Corrupt Practices Act*, available at http://www.sec.gov/litigation/litreleases/2010/lr21727.htm.

[vii] *See SEC Charges Two Individuals for Roles in Innospec FCPA Scheme*, available at http://www.sec.gov/news/press/2010/2010-141.htm.