KING & SPALDING

Client Alert

Special Matters & Government Investigations Practice Group

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SEC Enforcement Update
The SEC Speaks in 2012

The U.S. Securities and Exchange Commission (SEC) held its annual *SEC Speaks* program in Washington, D.C. on February 24-25, 2012, and the event left no doubt that the SEC is striving to become more nimble and aggressive in pursuing those it perceives to have violated the federal securities laws. Both commissioners and senior staff lauded the results of the SEC's new emphasis on using information obtained from corporate whistleblowers, expanding enforcement liability of both companies and "gatekeepers" (such as attorneys and accountants) under negligence or recklessness-based theories, and utilizing risk-based and data mining approaches to more quickly identify potentially illegal behavior. In her keynote address, Chairman Mary Schapiro cited these and other initiatives as driving the record 735 enforcement actions brought by the SEC in fiscal 2011, and the $2.8 billion in disgorgement and penalties ordered. Clearly, the Commission and its Division of Enforcement are emerging from such world-changing events as the financial crisis and the Madoff scandal as a newly revamped and powerful force in the financial markets, seeking to use every resource to fulfill the SEC's core mission of protecting investors.

Corporate Whistleblowers and Credit for Cooperation

Sean McKessy, Chief of the SEC's new Whistleblower Office, discussed the progress of the whistleblower program that was mandated by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Dodd-Frank directed the SEC to pay monetary awards of between 10 and 30 percent of monetary sanctions collected to eligible individuals who voluntarily provide original information that leads to successful enforcement actions resulting in the imposition of sanctions over $1 million. The Whistleblower Office is now staffed with eight employees, and McKessy reported that the staff has returned over 2,000 calls that have been placed to the whistleblower hotline since the hotline was established in May 2011. In its fiscal 2011 report to Congress, the Whistleblower Office reported that from August 2011, when the SEC adopted its final program rules, through the end of the fiscal year (ending September 30), the office received 334 whistleblower tips. In addition, the investor protection fund – established by the SEC to compensate successful whistleblowers – is currently funded to the tune of almost $453 million.

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McKessy acknowledged the controversy surrounding the SEC's decision not to include in its final rules an explicit requirement that whistleblowers report suspected wrongdoing internally in accordance with a company's compliance program in order to be eligible for an award from the SEC. He noted, however, that the Commission had attempted to "thread the needle" by including incentives within the final rules that protect a whistleblower's "place in line" and that could lead to an increased percentage award if a whistleblower chooses to report internally before going to the SEC staff. In addition, McKessy volunteered that his experience was that whistleblowers were in fact making internal reports, evidenced by the significant majority of whistleblowers who indicated on the relevant forms that are filed with the Whistleblower Office that they reported internally prior to submitting information to the SEC.

David Bergers, Director of the Boston Regional Office, said that while the whistleblower program was an important new source of leads on potential defendants, the SEC's continued focus on cooperation from companies and individuals, in exchange for less severe sanctions, is also bearing fruit. Since the implementation of the new cooperation program in January 2010,[1] – which revised the longstanding framework for evaluating cooperation articulated in the Commission's 2001 *Seaboard* Report by, among other things, adopting the use of various written cooperation agreements – Bergers reported that the Enforcement Division has thus far entered into 37 cooperation agreements with individuals, and that the Commission had entered into three non-prosecution agreements and one deferred prosecution agreement with companies.

The SEC's first non-prosecution agreement was entered into in December 2010 with Carter's Inc.[2] In *Carter's*, the SEC charged a former executive vice president with engaging in insider trading and a financial fraud that caused the company 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 the company because of the relatively isolated nature of the unlawful conduct, as well as the company's prompt and complete self-reporting of the misconduct, extensive cooperation in the investigation, and substantial remedial actions. These factors are similar to those discussed in the SEC's 2001 *Seaboard* Report and its progeny. However, unlike *Seaboard*, the non-prosecution agreement in *Carter's* additionally required the company to cooperate fully in the Commission's investigation on a going-forward basis, including by promptly producing all non-privileged documents and information requested by the SEC staff and using best efforts to ensure that current and former employees appear for any interviews or testimony, respond to all inquiries from the staff, and testify at trial or other judicial proceedings.

Since *Carter's*, in March 2011 the SEC entered into its first deferred prosecution agreement with Tenaris, S.A., a Luxembourg corporation accused of violating the Foreign Corrupt Practices Act (FCPA) by making illicit payments to Uzbekistani government officials in order to secure an improper advantage in the bidding process for Uzbekistani government contracts.[3] In entering into the agreement, the SEC noted that Tenaris had "provided extensive, thorough, real-time cooperation," including the complete disclosure of conduct discovered during the company's own "world-wide investigation," which had been prompted by certain red flags. "As a result of the its internal investigation, Tenaris discovered facts and transactions in Uzbekistan which Tenaris included in [a] report provided to the staff. Tenaris also

[1] *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.
[2] *See SEC Charges Former Carter's Executive With Fraud and Insider Trading*, available at http://www.sec.gov/news/press/2010/2010-252.htm.
[3] *See Tenaris to Pay $5.4 Million in SEC's First-Ever Deferred Prosecution Agreement*, available at http://www.sec.gov/news/press/2011/2011-112.htm.

thoroughly reviewed its pre-existing compliance program and undertook steps to update and improve its compliance program, and to continue to implement enhanced compliance measures."

In December 2011, the SEC entered into non-prosecution agreements with Fannie Mae and Freddie Mac in connection with actions brought against former executives of those companies, alleging that the executives materially misstated the companies' exposures to subprime loans.[4] However, the SEC stated that the non-prosecution agreements in part stemmed from "the unique circumstances presented by the companies' current status, including the financial support provided to the companies by the U.S. Treasury, the role of the Federal Housing Finance Agency as conservator of each company, and the costs that may be imposed on U.S. taxpayers."

Finally, Andrew Calamari, Associate Director of the New York Regional Office, said that *Seaboard* itself was still alive and well, and that "cooperation does pay." Calamari cited a case brought by the SEC in February of this year against four former investment bankers and traders at an investment bank for allegedly overstating the prices of its subprime bonds. Although the mispricing eventually required the firm to correct its disclosures of subprime-related losses, the Commission did not bring any charges against the firm. In discussing the matter, the SEC referenced the *Seaboard* Report and stated that the decision not to charge the firm was based on the isolated nature of the wrongdoing and the firm's immediate self-reporting to the SEC and other law enforcement agencies, as well as prompt public disclosure of corrected financial results. The firm voluntarily terminated the four investment bankers and implemented enhanced internal controls to prevent a recurrence of the misconduct, and it cooperated with the SEC's investigation.

Focus on Corporate "Gatekeepers"

Merri Jo Gillette, Director of the Chicago Regional Office, extolled the expanded theories of liability available to the Commission under Dodd-Frank, particularly as they might be applied to so-called corporate "gatekeepers" such as attorneys and accountants. Dodd-Frank for the first time established liability for those who aid and abet violations of the Securities Act of 1933 and the Investment Company Act of 1940.[5] It also eased the SEC's burden in aiding and abetting cases by lowering the state-of-mind requirement to recklessness, effectively overruling several court decisions that had required proof of actual knowledge.[6] Finally, Dodd-Frank clarified the SEC's ability to obtain monetary penalties in aiding and abetting cases under the Investment Advisers Act,[7] thereby closing a gap that was only recently exposed by King & Spalding attorneys in briefs that successfully convinced a federal court, in a case of first impression, that the SEC previously lacked such authority.[8]

A number of the Enforcement staff also discussed the focus on holding accountants, including outside accounting firms, responsible when the staff views their accounting and auditing work as deficient in retrospect. Andrew Calamari cited cases brought against foreign affiliates of PricewaterhouseCoopers (PwC) and KPMG over the past year. In *PwC*, the SEC alleged that the firm's India-based affiliates conducted deficient audits of an Indian company's financial statements that enabled an accounting fraud to go undetected for several years.[9] In addition to agreeing to a cease-and-desist order and remedial undertakings, the foreign affiliates were required to pay a $6 million penalty to the SEC and an additional

[4] *See SEC Charges Former Fannie Mae and Freddie Mac Executives with Securities Fraud*, available at http://www.sec.gov/news/press/2011/2011-267.htm.
[5] Dodd-Frank § 929M, codified at 15 U.S.C. §§ 77o(b) and 80a-48(b).
[6] Dodd-Frank § 929O, codified at 15 U.S.C. § 78t(e).
[7] Dodd-Frank § 929N, codified at 15 U.S.C. § 80b-9(f).
[8] *SEC v. Bolla*, 550 F. Supp. 2d 54 (D.D.C. 2008).
[9] *See SEC Charges India-Based Affiliates of PWC for Role in Satyam Accounting Fraud*, available at http://www.sec.gov/news/press/2011/2011-82.htm.

$1.5 million to the Public Company Accounting Oversight Board. *KPMG* involved the firm's Australia-based affiliate, which the SEC alleged was providing non-audit services to two clients – including the secondment of KPMG affiliate personnel to the clients and the performance of other business services – all in violation of auditor independence requirements.[10] The affiliate agreed to remedial undertakings and almost $2.75 million in disgorgement.

Expanded Use of Risk-Based Investigations and Data Mining

Both Chairman Schapiro and Enforcement Director Robert Khuzami discussed the importance of using more proactive, risk-based approaches to detect signals of possible illegality, rather than chasing illegal conduct long after it has occurred. Students of SEC history will recall that the Commission's divisions have long conducted so-called "sweeps," in which the staff will request information from a broad swath of companies relating to a particular industry or issue that has garnered regulatory attention. The staff's new emphasis on risk-based investigations and data mining is an extension of these historical "sweeps," in which the staff hopes to further systematize available data in a manner that will allow for more effective, upfront analysis.

Chairman Schapiro discussed one example of such systemization – the Enforcement Division's use of an Aberrational Performance Inquiry that identifies outsized results in the performances of hedge funds.[11] In December 2011, the SEC announced fraud charges related to various hedge funds that were initially identified using the new inquiry. The SEC described the inquiry as the usage of "proprietary risk analytics to evaluate hedge fund returns. Performance that appears inconsistent with a fund's investment strategy or other benchmarks forms a basis for further scrutiny." On the basis of information obtained through the inquiry, the SEC investigated and eventually brought charges against three advisory firms and six individuals, alleging fraudulently valued hedge fund holdings, misuse of fund assets, and misrepresentations about fund performance, assets, liquidity, investment strategy, and conflicts of interest.

Foreign Corrupt Practices Act

Kara Brockmeyer, Chief of the FCPA Unit, said that the 30 staff members assigned to the unit had brought or assisted in bringing more FCPA actions in fiscal 2011 than ever before – a total of 20 actions against 19 companies and one individual, representing $255 million in sanctions. Brockmeyer cited in particular the SEC's actions against pharmaceutical and medical device manufacturers as examples of a trend she said would continue. In *Smith & Nephew*, brought in February 2012, the SEC charged a London-based medical device company with bribing Greek doctors for more than a decade in order to win business.[12] The Commission noted in its press release that "Greece has a national health care system in which most Greek hospitals are publicly-owned and operated, and doctors who work at those publicly-owned hospitals are government employees and 'foreign officials' as defined in the FCPA." As such, in the SEC's view, the alleged illicit payments to such doctors constituted FCPA violations. To settle the SEC's charges, the

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[10] *In the Matter of KPMG Australia*, available at http://www.sec.gov/litigation/admin/2011/34-63987.pdf.

[11] *See SEC Charges Multiple Hedge Fund Managers with Fraud in Inquiry Targeting Suspicious Investment Returns*, available at http://www.sec.gov/news/press/2011/2011-252.htm.

[12] *See SEC Charges Smith & Nephew PLC with Foreign Bribery*, available at http://www.sec.gov/news/press/2012/2012-25.htm. Brockmeyer noted that the Smith & Nephew action came on the heels of the SEC's earlier FCPA settlement with New Jersey-based manufacturer Johnson & Johnson, which paid $48.6 million to the SEC and an additional $21.4 million fine to the DOJ. In that case, the SEC credited the company for having "voluntarily disclosed some of the violations by its employees," and for having "conducted a thorough internal investigation to determine the scope of the bribery and other violations, including proactive investigations in more than a dozen countries by both its internal auditors and outside counsel." *See SEC Charges Johnson & Johnson With Foreign Bribery*, available at http://www.sec.gov/news/press/2011/2011-87.htm.

company paid $5.4 million in disgorgement, and an additional $16.8 million criminal fine as part of a deferred prosecution agreement with the Department of Justice.

Financial Crisis Cases

Jason Anthony in the Structured and New Products Unit reported that to date, the SEC has brought 95 actions against entities and individuals in investigations arising out of the financial crisis, and has obtained almost $2 billion in monetary relief. He said the staff is currently focusing on the packaging of residential mortgage loans and sale of securities based on pools of such mortgages, as well as the structuring and sale of collateralized debt obligations (CDOs). Anthony stated that in the CDO investigations, in particular, the staff has discovered "a lot of troubling conduct," such as firms selling CDOs while taking adverse positions with respect to the underlying collateral in the same securities. However, Anthony stated that the staff is acutely aware that not all troubling conduct is necessarily illegal, and cited the *Goldman Sachs*, *J.P. Morgan*, and *Citigroup* matters as examples of cases where the SEC considered the firms' disclosures to be misleading in light of other information the firms had disclosed. Anthony said that additional actions in this area were on the way, and that the staff was considering all available theories of liability including negligence and recklessness-based charges. With respect to negligence-based liability, he cited in particular the SEC's options under the securities offering provisions of Section 17(a) of the Securities Act of 1933, as well as Section 206 of the Investment Advisers Act of 1940.

Insider Trading

Sanjay Wadhwa, Associate Director of the New York Regional Office, described the insider trading investigations underway in multiple offices as "sprawling." He reported that a total of 31 defendants have been charged in the *Galleon* line of cases, which involved total alleged illicit gains of $93 million and trading in 15 different securities.[13] Separately, the so-called expert network line of cases has resulted in actions brought against 22 defendants, and involved alleged illicit gains of $110 million.[14] Wadhwa cited the case brought in February of this year against expert consulting firm Broadband Research and its principal, John Kinnucan.[15] The SEC alleged that Kinnucan obtained nonpublic information from company insiders, which he then passed to portfolio managers and analysts at various hedge funds in return for significant consulting fees. Wadhwa said that despite the record numbers of insider trading actions brought in recent years, there are "a lot more in the pipeline."

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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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.

[13] *See SEC Charges Billionaire Hedge Fund Manager Raj Rajaratnam with Insider Trading*, available at http://www.sec.gov/litigation/litreleases/2009/lr21255.htm.
[14] *See SEC Brings Expert Network Insider Trading Charges*, available at http://www.sec.gov/news/press/2011/2011-38.htm.
[15] *See SEC Charges Oregon-Based Expert Consulting Firm and Owner with Insider Trading in Technology Sector*, available at http://www.sec.gov/news/press/2012/2012-30.htm.