

# **24th Annual Institute on Federal Securities**

## **Significant SEC Enforcement Developments**

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# Focus today on several hot and even breaking developments in the Enforcement world:

- January 4, 2006 SEC Statement Regarding Corporate Penalties: A new template?
- First SOX Officer-Loan Case: clear violation provides little real guidance
- Regulation FD: *Siebel II* is not the end of enforcement
- Cases Against Lawyers: much ado about not so much?

# SEC Statement Concerning Financial Penalties January 4, 2005

- SEC penalty program much criticized in last 3-4 years for being arbitrary and inconsistent
  - much discussion of lack of transparency in how SEC reaches a penalty amount
  - much uncertainty about when and upon whom SEC will impose a penalty
  - much internal disagreement among the Commissioners about these issues
    - generally, Republican members have argued against corporate penalties as merely punishing innocent shareholders

# SEC Statement Concerning Financial Penalties January 4, 2005

- Statement clearly intended by Chairman Cox to bridge the gap between Democrats and Republicans and to bring at least some clarity to how the SEC approaches these decisions
  - Statement expressly indicates that “a statement of principles” was adopted unanimously by all of the Commissioners
  - Unanimity theme repeated by Cox in press statements

# SEC Statement Concerning Financial Penalties January 4, 2005

- But the Statement only addresses the “when and upon whom” issue, and not the “how much” issue:
  - Statement addressed only under what circumstances will the SEC seek to impose a penalty upon a public company
    - penalties vis-à-vis individual violators explicitly not addressed by Statement
    - and no discussion at all about amounts
      - in the McAfee, Inc. case underlying the Statement, McAfee sanctioned *\$50 million* for inflating revenues by hundreds of millions

# SEC Statement Concerning Financial Penalties January 4, 2005

- SEC carefully reviewed legislative history of relatively recent statute (1990 Remedies Act) giving SEC penalty authority
  - noted that Congress had expressed concerns about damage to innocent shareholders from penalties
- But Statement stressed importance of deterrent effect of penalties:
  - “We proceed from the fundamental principle that corporate penalties are an essential part of an aggressive and comprehensive program to enforce the federal securities laws, and that the availability of a corporate penalty, as one of a range of remedies, contributes to the Commission’s ability to achieve an appropriate level of deterrence through its decision in a particular case.”

# SEC Statement Concerning Financial Penalties January 4, 2005

- SEC stated that decision whether to impose penalty on a corporation in a particular case turns principally on two factors:
  - The presence or absence of a direct benefit to the corporation as a result of the violation:
    - for example, the fact that a corporation itself has received a direct and material benefit from the offense, through reduced expenses or increased revenues, weighs in support of the imposition of a corporate penalty
  - The degree to which the penalty will recompense or further harm the injured shareholders:
    - the imposition of a penalty on the corporation itself carries with it the risk that shareholders who are innocent of the violation will nonetheless bear the burden of the penalty. The presence of an opportunity to use the penalty as a meaningful source of compensation to injured shareholders is a factor in support of its imposition.

# SEC Statement Concerning Financial Penalties January 4, 2005

- SEC also identified several other considerations:
  - The need to deter the particular type of offense
  - The extent of the injury to innocent parties
  - Whether complicity in the violation is widespread throughout the corporation
  - The level of intent on the part of the perpetrators
  - The degree of difficulty in detecting the particular type of offense
  - Presence or lack of remedial steps by the corporation
  - Extent of cooperation with SEC and other law enforcement

# SEC Statement Concerning Financial Penalties January 4, 2005

- Open Questions:
  - In what circumstances can it really be said that shareholders will not be injured by a penalty paid by the corporation from corporate coffers?
  - Discovery of fraudulent revenue recognition schemes always results in a massive market punishment. Although the corporation benefited – at the time – from the fraudulent revenue recognition, isn't the market punishment enough?
  - Most fundamentally, when will the SEC tell us how it reaches its penalty numbers? When will it allow us to look inside its black box?

# First SOX Officer Loan Case

## *In the Matter of Goodfellow and Molaris*

- Announced December 1, 2005 (SEC Release No. 52865)
- First case to enforce Section 402 of SOX – codified at Section 13(k) of Securities Exchange Act of 1934 – prohibition against officers receiving loans from corporation
  - “It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.”
- SEC charged former CEO and CFO with causing company to violate this provision.

# First SOX Officer Loan Case

## *In the Matter of Goodfellow and Molaris*

- *Goodfellow* involved two officers of *Greek private issuer*.
  - In October 2003, CFO Molaris approved *interest free* 90-day loan to CEO *Goodfellow* of about \$125k
  - and CEO *Goodfellow* approved *interest free* 90-day loan to CFO Molaris of about \$170k
- SEC alleged that these loans equaled about 50% of *Goodfellow's* salary and 70% of Molaris's salary for 2002

# First SOX Officer Loan Case

## *In the Matter of Goodfellow and Molaris*

- SEC further alleged that:
  - loans were not disclosed to Board
  - both officers were aware of SOX prohibition
    - but claimed loans were salary advances (recorded in account labeled “Loans/Advances to Personnel”)
  - neither consulted counsel or outside auditors

# First SOX Officer Loan Case

## *In the Matter of Goodfellow and Molaris*

- Outside auditors discovered loans, reported to Audit Committee
- Company fined officers (\$50k and \$30k – they had already repaid loans), and imposed controls on their spending
  - public record does not reflect circumstances, but both CEO and CFO no longer with company
- SEC characterized Section 402/Section 13(k) as “an important investor protection”



# First SOX Officer Loan Case *In the Matter of Goodfellow and Molaris*

- Matter noteworthy for several reasons:
  - first case to enforce this provision
  - involved *foreign private issuer* with securities trading in US
  - rapid and firm response of company
  - company not charged – see Cooperation Guidelines



# Regulation FD Developments *Siebel II*

- Far and away most significant development in Reg FD this year was SEC's loss in the Siebel case in September 2005 – SEC did not appeal the loss
- Siebel had previously settled a Reg FD case with the SEC (in 2002) and SEC decision to charge and Siebel decision to litigate in second case undoubtedly affected by this prior case
  - SEC likely to have felt compelled to bring action against what it perceived as “serial Reg FD violator”
  - Siebel likely had to fight given SEC's likely settlement demands – high money penalty, injunction versus CFO and SVP
- Bad facts make bad law?



# Regulation FD Developments *Siebel II*

- SEC alleged that Siebel CFO improperly shared four pieces of material nonpublic information in two private investor meetings:
  - activity levels were “good” or “better”
  - new deals were coming back into the pipeline
  - deal pipeline was “building” and “growing”
  - “there were some \$5 million deals in Siebel’s pipeline for the second quarter of 2003”
- SEC alleged that following private meetings, Siebel’s stock price increased significantly as trading surged



# Regulation FD Developments *Siebel II*

- Case extremely important for several reasons:
  - First, in little noticed by critically important procedural aspect of decision, Court ruled that in considering SEC's complaint it was *not* limited to reviewing only statements alleged in SEC's complaint
  - rather, Court held that it was appropriate and necessary for it to consider the statements in context
  - so it reviewed and relied upon full transcript of meetings, as well as upon Siebel's other statements to put allegedly violative statements in context
  - This means companies can make powerful contextual arguments in future SEC enforcement actions.



# Regulation FD Developments *Siebel II*

- Second, Court rejected SEC’s approach of analyzing and scrutinizing “at an extremely heightened level, every particular word used in the statement, including the tense of verbs and the general syntax of each sentence”:
  - Court found no support in Reg FD for this approach; according to the Court:
    - this approach “places an unreasonable burden on a company’s management and spokespersons to become linguistic experts, or otherwise live in fear of violating Regulation FD should the words they use later be interpreted by the SEC as connoting even the slightest variance from the company’s public statements. Regulation FD does not require that corporate officials only utter verbatim statements that were previously publicly made.”
  - Court cited SEC’s own statements regarding Reg FD enforcement against it:
    - Reg FD not intended to be “a trap for the unwary” and would be “extremely cautious” in bringing cases

# Regulation FD Developments

## *Siebel II*

- Third, Court found that each statement was “equivalent in substance” to previously disclosed public information
- Fourth, Court held that stock movement alone is not enough to establish a Reg FD violation:
  - “The regulation does not prohibit persons speaking on behalf of an issuer from providing mere positive or negative characterizations, or their optimistic or pessimistic subjective general impressions, based upon or drawn from the material information available to the public. The mere fact that analysts might have considered [the CFO’s] private statements significant is not, standing alone, a basis to infer that Regulation FD was violated.”



# Regulation FD Developments *Siebel II*

- Finally, Court dismissed SEC's claim that Siebel lacked adequate disclosure controls even in light of SEC's allegations that Siebel had no formal Regulation FD policies or training, and retained no notes of the private meetings
  - Court's dismissal seems to make clear that violation of disclosure controls requirement may not be asserted independently of an underlying violation of disclosure rules, such as Reg FD



# Regulation FD Developments *Siebel II*

- Fair to say that *Siebel II* is watershed development in Reg FD enforcement landscape.
- Gives companies considerable comfort that they can engage in informal investor communications, such as “Q&A” at one-on-one meetings and industry conferences and the fast-growing phenomenon of corporate “blogging” by senior executives, without violating Reg FD



# Regulation FD Developments *Flowserve*

- But Siebel II not the end of enforcement:
- Earlier in year, in March 2005, SEC charged Flowserve, its CEO and its Director of Investor Relations with Reg FD violations.
- SEC alleged Flowserve violated Regulation FD by reaffirming its previous earnings guidance in private analyst meetings.
- SEC stated this was first earnings “reaffirmation” case, and first settled FD action against Director of IR.



# Regulation FD Developments *Flowserve*

- Flowserve and CEO consented to civil penalties of \$350,000 and \$50,000, respectively.
  - Flowserve, CEO and DIR also consented to the Commission's issuance of a cease-and-desist order.
- Importantly, SEC specifically stated that the sanctions reflected lack of cooperation
  - allegedly, both CEO and DIR denied that a reaffirmation occurred at the private meeting with the analysts, despite Form 8-K filed by Flowserve to the contrary

# Cases Against Attorneys: Much Ado About Not So Much??

- Much *sturm und drang* lately over SEC's alleged increased pursuit of attorneys, particularly inside attorneys.
- However, recent studies indicate that, although number of cases has doubled, overall *absolute* number of cases remains very small, particularly as a percentage of all enforcement cases.
  - Approximately 10 SEC cases against in-house counsel from 1998-2001
  - About 20 SEC cases against in-house counsel from 2002-2005

# Cases Against Attorneys: Much Ado About Not So Much??

- Nevertheless, these cases get a lot of attention, for obvious reasons.
- Three recent cases worthy of particular mention:
  - *Weiss* matter: December 15, 2005 Commission opinion regarding bond lawyer
  - *Millenium* matter: December 1, 2005 settled administrative proceeding regarding inside lawyer in market-timing case
  - *Loev* matter: November 29, 2005 settled federal injunctive proceeding involving outside securities counsel

# Cases Against Attorneys: Much Ado About Not So Much??

## Weiss Matter – December 15, 2005

- Commission found – in a fully litigated administrative proceeding – that outside counsel to Pennsylvania town violated antifraud provisions of securities laws by issuing a legal opinion that the interest was tax-exempt
  - Case originally brought as *fraud* action against lawyer
  - SEC ALJ *dismissed* that case

# Cases Against Attorneys: Much Ado About Not So Much??

## Weiss Matter – December 15, 2005

- Commission *reversed* ALJ decision
  - But only found lawyer liable for *negligence* in violating truth-telling provisions of securities laws
    - Specifically, found lawyer violated sections 17(a)(2) and 17(a)(3) of 1933 Securities Act, which prohibit misrepresentations in connection with securities sales
    - sections *do not* require showing of intent – can be violated even if person making statements acts negligently

# Cases Against Attorneys: Much Ado About Not So Much??

## Weiss Matter – December 15, 2005

- Commission found that lawyer:
  - Did not exercise even “minimal care” in carrying out his duties
    - Did not make adequate factual inquiry to determine whether facts supported tax-exemption
      - “[K]new or should have known” that facts were to the contrary

# Cases Against Attorneys: Much Ado About Not So Much??

## Weiss Matter – December 15, 2005

- SEC ordered lawyer to cease-and-desist from future violations and to disgorge \$9,000.00  
Significantly, however, SEC did not
  - assess any penalty or
  - bar/suspend the lawyer

# Cases Against Attorneys: Much Ado About Not So Much??

## *Weiss* Matter – December 15, 2005

- *Weiss* noteworthy for several reasons:
- First, rare for SEC to sanction lawyers for negligence, absent bad faith or other factors
  - Unclear precisely what drove this outcome
    - Existence of facts contrary to opinion surely significant
    - But this will frequently be the case – array of facts to be considered in reaching legal judgment

# Cases Against Attorneys: Much Ado About Not So Much??

## *Weiss* Matter – December 15, 2005

- Case also noteworthy because SEC made clear it will decide what constitutes “reasonable prudence” in lawyer cases
  - SEC referred to applicable bond industry legal standards
  - But noted that compliance with such standards only one factor to be considered
- So *Weiss* a little frightening – raises specter of SEC regulating the bar – and SEC can make out negligence case pretty easily
- Still, sanctions quite light – C&D only, no penalty, no bar/suspension

# Cases Against Attorneys: Much Ado About Not So Much??

## *Millenium* Matter – December 1, 2005

- *Millenium* matter more straightforward and less problematic
  - Case against (among others) in-house counsel allegedly deeply involved in market timing scheme
  - In-house counsel specifically alleged to have participated in allegedly fraudulent efforts to hide timing from funds
    - creation of 100 entities and 1000 accounts
    - receipt of “sticky assets” – form of kickback

# Cases Against Attorneys: Much Ado About Not So Much??

## *Millenium* Matter – December 1, 2005

- Enormous alleged market-timing scheme, with resultant harsh penalties – hedge fund paid \$121 million penalty
- In-house counsel suffered severe sanctions:
  - Fraud cease-and-desist order (could have been worse – no federal court fraud injunction)
  - Three-year bar from investment advisory industry
  - Six-month suspension from appearing before SEC
  - \$1 million disgorgement and \$25,000 penalty
- Case perhaps not terribly meaningful given nature of allegations and conduct.

# Cases Against Attorneys: Much Ado About Not So Much??

## Loev Matter – November 29, 2005

- Settled action against outside securities counsel in alleged “pump and dump” scheme
- Fraud action against principals still on-going in federal court
- Lawyer not charged with fraud
  - Settled charges that he violated Section 5 registration provisions
    - Paid \$25,785.50 in disgorgement and \$25,000 civil penalty

# Cases Against Attorneys: Much Ado About Not So Much??

## Loev Matter – November 29, 2005

- Case noteworthy for other provisions of settlement
- Lawyer also prohibited from:
  - “issuing any legal opinions that the securities of any issuer are exempt from the securities registration provisions of the federal securities laws pursuant to Rule 504 of Regulation D” and
  - “accepting securities of any issuer whose securities are quoted on the Pink Sheets in consideration for legal or consulting services rendered”
- SEC as regulator/conduct proscriber of the bar??

A blue-tinted photograph of a building facade with the word "WALL" visible in large, white, sans-serif letters. The image is partially obscured by a dark blue curved shape that frames the title.

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Mr. Bartholomew is a partner at Morgan Lewis with offices in Washington, D.C. and Miami. Prior to joining Morgan Lewis, he spent five years as Senior Trial Counsel of the Southeast Regional Office of the SEC, where he specialized in accounting and financial disclosure cases and litigated the seminal W.R. Grace “earnings management” case. Mr. Bartholomew now represents public companies and their senior officers and directors in connection with SEC enforcement matters and securities class actions. He can be reached at 202.739.6400, 305.415.3400, or [cbartholomew@morganlewis.com](mailto:cbartholomew@morganlewis.com).