

The SEC Speaks 2011: Aggressive Enforcement to Continue Post-Reorganizational and Legislative Changes

February 10, 2011

At the annual “The SEC Speaks” conference on February 4 in Washington, D.C., the Securities and Exchange Commission (SEC or the Commission) Chairman Mary Schapiro and senior officials from the Division of Enforcement reported on the progress of enforcement efforts, which continued at a rapid pace in 2010. The reorganization of the Enforcement Division, which began in 2009 and included the creation of five new specialized units, is now complete and is bearing fruit in the form of more enforcement actions.¹ In addition, senior enforcement officials provided insights about the new cooperation tools introduced in 2010 and their view of the various provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) affecting the SEC’s enforcement program and powers. These include new whistleblower provisions as well as provisions permitting the SEC to obtain penalties against public companies in administrative proceedings, expanded aiding-and-abetting power, and other changes that provide the Enforcement Division with a wider range of options in pursuing violations of the federal securities laws. These new developments significantly enhance the Commission’s ability to continue its aggressive enforcement program in 2011; however, budget constraints placed on the agency may limit the effectiveness of some of these new enforcement tools.

SEC Enforcement: A Post-Reorganization Perspective

In 2010, the Enforcement Division underwent major restructuring, which included fully staffing five new national specialized investigative units, as well as forming a new Office of Market Intelligence to analyze tips according to internally developed risk criteria and SEC priorities. In addition, the Enforcement Division adopted a new initiative designed to encourage companies and individuals to cooperate in investigations and enforcement actions. In her opening remarks, Chairman Schapiro reported that in 2010 the newly restructured Enforcement Division instituted the highest number of enforcement actions in many years and tripled the amount of civil monetary penalties levied from 2009.²

1. A more detailed description of these changes can be found in our February 11, 2010 LawFlash, “The SEC Speaks 2010: Fast-Paced Reform Continues in 2010,” available at http://www.morganlewis.com/pubs/SecuritiesLF_SECSpeaks2010_11feb10.pdf, and in our January 2011 White Paper, “2010 Year in Review: SEC and SRO Selected Enforcement Cases and Developments Regarding Broker-Dealers,” available at http://www.morganlewis.com/pubs/LIT_2010YearInReview.pdf.

2. The full text of Chairman Schapiro’s remarks can be found at <http://www.sec.gov/news/speech/2011/spch020411mls.htm>. The SEC’s fiscal year begins on October 1. FY 2010 enforcement statistics (Oct. 1, 2009–September 30, 2010) are available at Select SEC and Market Data – FY 2010 report, <http://www.sec.gov/about/secstats2010.pdf>.

Lorin Reisner, Deputy Director of the Enforcement Division, reported that, as a result of the delegation of the authority to issue formal orders to the enforcement staff that began in 2009, the pace of investigations leading to the filing of enforcement actions has quickened. Approximately 70% of enforcement actions are now filed within two years of the commencement of an examination or investigation.

Specialized Units

In January 2010, the Enforcement Division announced the leadership of the five national specialized units: the Asset Management Unit, the Market Abuse Unit, the Structured and New Products Unit, the Foreign Corrupt Practices Act (FCPA) Unit, and the Municipal Securities and Public Pensions Unit. Mr. Reisner reported that these units are now fully staffed nationwide and represent 25% of all enforcement staff. The units are handling dozens of investigations, serving as think tanks, and spearheading specialized training programs. The Enforcement Division has pledged “smart” enforcement through these units and has hired industry experts with specialized knowledge in each of these areas to assist the staff in all aspects of its enforcement matters, including investigative planning and strategy, witness testimony, and market data analysis.

Daniel Hawke, Chief of the Market Abuse Unit, reported that his unit has continued its aggressive pursuit of insider traders and, in 2010, instituted several high-profile cases against large-scale organized rings of tippers and traders. Most recently, the Enforcement Division brought civil injunctive charges against four consultants and two former employees of an “expert networking” firm for allegedly improperly tipping hedge funds and other investors about sales figures, earnings, and the financial performance of technology companies. This latest action demonstrates the unit’s continued close coordination with the Department of Justice; all six of these individuals had previously been charged criminally by federal prosecutors. In addition, on February 3, 2010, a federal jury found an associate of a private equity firm liable for illegally misappropriating and tipping a former investment banker’s confidential information about a merger transaction.

Kenneth Lench, Chief of the Structured and New Products Unit, reported on his unit’s continued focus on corporate misconduct involving collateralized debt obligations (CDOs) and other complex financial products. The unit brought several high-profile cases against large financial firms and advisers related to misleading disclosures in the marketing and sale of CDOs, as well as investor disclosures related to subprime mortgage holdings. In these cases, the Commission obtained record civil penalties, including the largest civil penalty ever imposed against a Wall Street firm.

The Municipal Securities and Public Pensions Unit, with the help of Commission rulemaking, has been active—and aggressive—in ensuring that issuers provide proper disclosures to municipal bond investors and an even playing field for municipal market participants. In August 2010, the Enforcement Division obtained a cease-and-desist order against a state predicated on negligence (the first municipal securities case of its kind) for the state’s failure to disclose material information related to its underfunding of the state’s two largest pension plans.³

Cheryl Scarboro, Chief of the FCPA Unit, reported that 2010 represented a substantial uptick in FCPA enforcement. The Enforcement Division instituted twice as many cases as in any prior year and collected

3. The Commission recently adopted new rules designed to ensure that market participants provide investors with meaningful and timely information regarding the health of municipal securities, and adopted rules to curtail pay-to-play practices by investment advisers seeking to manage public pensions.

more than \$600 million in penalties. Ms. Scarboro noted that most of the Commission's cases are brought as a result of either the Enforcement Division's investigative efforts or tips from whistleblowers, with only one-third of its cases coming from company self-reporting. Going forward, an even larger percentage of cases are expected to result from whistleblowers as a result of the Dodd-Frank Act provisions discussed in more detail below. Enforcement efforts in this area have been enhanced by increased cooperation among domestic and foreign government agencies and increased access to violators through extraterritorial jurisdiction.

Cooperation Initiatives

Mr. Reisner also highlighted the success of the Commission's 2010 cooperation program, which introduced new cooperation tools similar to those used by the U.S. Department of Justice. In December 2010, the Commission entered into its first nonprosecution agreement under this program. The Commission entered into this agreement with Carter's, Inc., which had cooperated extensively with the Enforcement Division's investigation into accounting improprieties. In deciding to forgo an action against the company and only pursue an action against its former executive vice president, the Enforcement Division took into account the isolated nature of the behavior at issue, the company's prompt self-reporting, exemplary cooperation, and extensive remedial action.⁴ Mr. Reisner also reported that the Cooperation Committee (formed to promptly review cooperation agreements) has approved approximately 20 cooperation agreements spanning a wide range of cases, including those related to financial statements and accounting, insider trading, investment advisers, market manipulation, and the FCPA. Mr. Reisner further indicated that the Enforcement Division will look to provide more detail in its releases announcing settlements that award cooperation credit so that the public can better understand the types of actions that will be rewarded.

Enhanced Enforcement Under the Dodd-Frank Act

Chairman Schapiro underscored the many challenges the Commission—and the Enforcement Division—faced as a result of the numerous rulemaking mandates contained in the Dodd-Frank Act. In 2010, the Commission proposed 28 rules, adopted six final rules and two interim rules, and approved two proposals from self-regulatory agencies. In addition, Chairman Schapiro said that the Commission will consider additional rules stemming from its staff's recent study recommending that financial professionals who provide investment advice about securities adhere to a fiduciary standard of conduct similar to that currently imposed on investment advisers.

Provisions Affecting Liability, Remedies, and Enforcement Decisionmaking in Prosecuting Securities Violations

George Canellos, Director of the SEC's New York Regional Office, commented on several provisions of the Dodd-Frank Act that will significantly increase the Enforcement Division's authority and impact its internal decisionmaking processes for determining whether to file cases in federal court or administratively.

4. For additional details on the cooperation program, see our January 2010 White Paper, "The Securities and Exchange Commission Announces New Cooperation Initiative," available at http://www.morganlewis.com/pubs/WP_SECAnnouncesNewCooperationInitiative_Jan2010.pdf. For additional details on the Carter's agreement, see our December 22, 2010 LawFlash, "SEC Enters Into First Nonprosecution Agreement as Part of Its New Cooperation Initiative," available at http://www.morganlewis.com/pubs/SecuritiesLF_SECEntersIntoFirstNonprosecutionAgreement_22dec10.pdf.

Chief among these provisions is the Enforcement Division's new power to obtain penalties in cease-and-desist proceedings against nonregulated entities and persons, which greatly expands the Enforcement Division's choice of venue. In particular, the Enforcement Division can now proceed against public companies and officers and directors administratively without having to file a federal court action to obtain a civil penalty. Mr. Canellos noted that, particularly in cases involving parallel criminal proceedings, the administrative forum could be appealing to the Enforcement Division because of the lack of discovery options available to respondents there, as compared to the civil discovery allowed in federal court, which, according to Mr. Canellos, defendants often use to aid their defense of the parallel criminal action. Mr. Canellos pointed out, however, that there are still benefits to pursuing parties in federal injunctive actions, including the ability to seek to invoke the broad equitable powers of the federal courts, and the extraterritorial application of the federal securities laws now permitted under the Dodd-Frank Act. Mr. Canellos observed that these choice-of-forum issues are likely to have an impact on settlement discussions.

The expansion of the Commission's administrative jurisdiction also gives the Enforcement Division flexibility to resolve more cases without subjecting the settlements to the scrutiny of the federal courts, which recently have been critical of several high-profile proposed settlements. Matthew Martens, Chief Litigation Counsel, discussed the federal courts' recent criticism of the SEC's proposed settlements in cases against large financial institutions. Mr. Martens noted, however, that this scrutiny related to very few cases (a handful out of the approximately 700 cases filed during the year), all of which ultimately were approved, and stressed that this criticism has not changed the Enforcement Division's approach to settlements. Nonetheless, he suggested that, because courts are increasingly interested in hearing more about the underlying basis of a settlement, settling parties may be required to include more information in the complaint, provide courts with supplemental information, or appear in court to answer questions.

The Dodd-Frank Act also expands the arsenal of charges available to the Enforcement Division. For example, the Dodd-Frank Act extends the SEC's authority to prosecute those who aid and abet primary violators of the Securities Act of 1933 and Investment Company Act of 1940. Most significantly, the Dodd-Frank Act explicitly amends the Securities Exchange Act of 1934 (Exchange Act), which previously required that aiders and abettors must have *knowingly* provided substantial assistance to the primary violator, to permit the SEC to pursue aiders and abettors for *reckless* conduct. The Dodd-Frank Act also expressly grants the Commission authority to charge control persons for the acts of controlled persons, and impose joint and several liability, including the recovery of penalties and disgorgement to the same extent as the controlled person.

In addition, under the Dodd-Frank Act, the Enforcement Division can now seek broad collateral bars (or suspensions) against securities laws violators. For example, a person who violated the Exchange Act provisions related to broker-dealers could be barred not only from the broker-dealer business, but also from the investment advisory business regulated by the Investment Advisers Act of 1940.

Mr. Canellos also noted that the Dodd-Frank Act enhances information sharing, including the sharing of privileged work product, among the SEC and its federal criminal counterparts. Mr. Canellos reported that this development has been valuable to the Commission's enforcement program, as the criminal authorities have been willing to share FBI investigative reports with the Enforcement Division; in the past, sharing of this kind of information was controversial, and other agencies were reluctant to provide their work product.

Finally, on the litigation front, Mr. Martens noted that he expects the Dodd-Frank Act to also assist the effectiveness of the Trial Unit. In particular, the Act permits the SEC to serve subpoenas nationwide in federal civil actions, which will greatly assist the Trial Unit's ability to obtain discovery and use more

live witnesses at trial. Mr. Martens added that in 2010 the Trial Unit had a successful year, prevailing in 76% of federal trials and 95% percent of administrative proceedings.

Office of Market Intelligence and Whistleblower Issues

Thomas Sporkin, Chief of the Office of Market Intelligence (OMI), discussed the Commission's whistleblower program, the dramatic changes that the Dodd-Frank Act brought about in this area, and the proposed rules that have been issued to implement the Dodd-Frank whistleblower provisions.⁵ Among other things, the Dodd-Frank Act requires the SEC to create a separate whistleblower office to administer the program. The creation of the office, however, has stalled due to budget issues. Mr. Sporkin noted that OMI currently is handling the intake and referral of complaints to the appropriate enforcement staff.

Mr. Sporkin said that, since the enactment of the Dodd-Frank Act, tips from whistleblowers have increased significantly, and that OMI often receives one to two "high quality" tips per day—some good enough to allow the enforcement staff to follow up quickly. He described these tips as often well organized, with attachments, and coming from whistleblowers represented by counsel, insiders, competitors, and even from a "jilted spouse."

In November 2010, the Commission released proposed rules implementing the whistleblower provisions, and Sporkin said that final rules will be forthcoming over the next few months. Mr. Sporkin noted that the biggest debate that has surfaced in the comments to the proposed rules is whether whistleblowers should be required to report complaints to internal corporate compliance; he also signaled that company advocates and whistleblowers have agreed through the comment process that the 90-day grace period for reporting to the SEC for employees utilizing internal corporate compliance programs is too short and that this period may be extended.

Clawback Cases: SOX Section 304 and Dodd-Frank Section 954

Rhea Dignam, Director of the Atlanta Regional Office, discussed the Enforcement Division's recent clawback proceedings under Section 304 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or SOX) and the related language of Section 954 of the Dodd-Frank Act. Ms. Dignam focused in particular on two Section 304 actions—the first against CSK CEO Maynard Jenkins in July 2009 and the second against Walden O'Dell, the former chief executive officer of Diebold, Inc., in June 2010. In each of these matters, the Commission did not charge wrongdoing on the part of the officers, and Ms. Dignam emphasized the Commission's willingness to proceed against chief executive and financial officers under SOX Section 304 even in the absence of wrongdoing by those executives. Bolstering the Commission's position, in *Jenkins* the district court upheld the SEC's use of the SOX clawback provision to recoup bonuses and stock sale profits from Jenkins and ruled that the misconduct alleged need only be committed by the issuer, not the executive.

Ms. Dignam compared Dodd-Frank Section 954 with SOX Section 304. Specifically, Dodd-Frank's clawback provision applies to all current or former executive officers (SOX applies only to CEOs and CFOs) and covers a three-year look back period from the point of the issuer's restatement (SOX covers

5. For additional details on the changes to the whistleblower regime under the Dodd-Frank Act, see our November 12, 2010 LawFlash, "SEC's Proposed Rules for Implementing Dodd-Frank Whistleblower Provisions: Important Implications for Employers," available at http://www.morganlewis.com/pubs/LEPG_LF_WhistleblowerProvisionsImplicationsForEmployers_12nov10.pdf.

one year). Further, Dodd-Frank Section 954 requires only the clawback of incentive-based compensation that the officer received “in excess” of what would have been paid under the restated financial results, but requires this clawback regardless of whether any misconduct occurred; whereas SOX Section 304 requires the clawback of any incentive-based or equity-based compensation received by the CEO or CFO during the 12-month period following a restatement that occurs “as a result of misconduct.” Ms. Dignam would not comment on whether the SEC will take the fault of the individual into account when deciding whether to pursue a charge under Dodd-Frank Section 954.

Other Notable Comments

Enforcement Division Director Robert Khuzami noted that credit crisis cases remain a priority for the Enforcement Division and, in 2010, resulted in \$1.1 billion in disgorgement and charges against 19 chief executive, financial, and senior corporate officers. Director Khuzami and other panelists noted that investigations and cases involving financial fraud are on the rise, with a total of 126 issuer reporting cases instituted in 2010. These cases increasingly target individuals: the Commission charged 24 CEOs, 46 CFOs, and 31 CAOs in 2010.

Going forward, Director Khuzami envisioned a “smart” enforcement program, one that makes better use of risk analytics and effective investigative coordination. In keeping with this theme, Scott Friestad, Associate Enforcement Director, noted that the enforcement staff not only looks at the subject area initially targeted, but will expand the investigation to include any other potential misconduct uncovered. One recent example is the settlement in *SEC v. Diebold*, in which the investigation initially involved insider trading, but ultimately led to charges for accounting and financial fraud.

On the issue of settlements, SEC Commissioner Luis Aguilar advocated that the Commission seek stiffer sanctions against financial firms for federal securities laws violations to “stop similar conduct in its tracks,” and for remedies to be “meaningful and not routine.” He also called for firms to take accountability for misconduct in public press releases announcing settlements rather than downplaying the conduct at issue. If not, Commissioner Aguilar suggested that it might be worth revisiting the Commission’s practice of routinely accepting settlements from defendants who agree to sanctions without admitting or denying the misconduct.⁶

Budget Constraints Impact Rulemaking, Examinations, and Enforcement

Chairman Schapiro, Commissioner Aguilar, and Director Khuzami each candidly discussed the budget pressures that the increased workload from the Dodd-Frank Act was placing on the Commission. Chairman Schapiro noted that while the Dodd-Frank Act imposes numerous additional responsibilities on the Commission, it provides no funding sources for implementing these provisions, in contrast to the larger budgets available to bank regulators. Director Khuzami pledged to make the enforcement staff lean and to focus in the right places. Lamenting that the underfunding of the Commission is creating investor harm, Commissioner Aguilar noted that the Commission cannot implement several actions required under the Dodd-Frank Act due to budget uncertainty, and that the lack of funding has led the SEC to institute a hiring freeze and to cut back on examiner travel. In addition, the SEC has limited the ability of the Trial Unit to hire expert witnesses for some cases.

6. The full text of Commissioner Aguilar’s remarks can be found at <http://www.sec.gov/news/speech/2011/spch020411laa.htm>.

What to Expect in 2011

The whistleblower incentives in the Dodd-Frank Act already have already resulted in a substantial increase in the number of cases being investigated through tips. As the Enforcement Division receives an increasing amount of tips from whistleblowers, companies can expect a resultant increase in the number of requests coming to them from the Commission. The whistleblower provisions of the Dodd-Frank Act likely will lead to an uptick in enforcement cases brought across all program areas.

In addition, we expect that the Commission will use its new authority under the Dodd-Frank Act to proceed administratively in cases against public companies, and will continue to aggressively seek reimbursement of executive compensation under the clawback provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act. The Enforcement Division also is likely to increase the number of cases it brings against individuals, as changes to the standards for aiding and abetting and control person actions have made it easier for the Commission to pursue those types of cases and as the public and federal courts are increasingly demanding information as to whether specific individuals were at fault when securities violations occur. Finally, as it settles applicable cases, the Enforcement Division has indicated that it will provide more detail on the types of cooperation that will be rewarded, which should allow companies and individuals to better assess the costs and benefits of cooperation with the Commission in the early stages of an investigation.

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