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TOP SEC ENFORCEMENT ISSUES FOR PUBLIC COMPANIES

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DODD-FRANK WHISTLEBLOWER PROVISIONS

- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank")[2] amended the Securities Exchange Act of 1934 to add Section 21F and to provide for payments to whistleblowers of 10-30% of monetary sanctions exceeding $1 million

- Under new Section 21F:

  - whistleblower must report violation to SEC voluntarily

  - tip must be comprised of "original information" obtained from "independent knowledge or independent analysis"

  - tip must lead to successful enforcement "action" or "related action"

- Dodd-Frank requires the SEC to propose rules and to establish a special Whistleblower Office

  - SEC has deferred formation of Whistleblower Office pending budget

  - SEC issued proposed rules—Regulation 21F—in November 2010;[3] these must be finalized by April 21, 2011

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2 The whistleblower provisions are Sections 922-25. The full text of the Dodd-Frank bill is available at http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf.

3 Available at http://www.sec.gov/rules/proposed/2010/34-63237.pdf.

- proposed SEC whistleblower rules:
    - define "voluntary" so as to exclude any tips made following any inquiry by SEC or other federal regulatory authority or self-regulatory organization
        - but would permit tip to be considered for payment even if provoked by internal corporate inquiry or investigation
    - do not require whistleblower to first report issue to corporate compliance
        - but do allow 90-day grace period if whistleblower first reports to corporation; at end of 90-day period, whistleblower must report to SEC to get credit
    - exclude lawyers, accountants, internal auditors and the like who learn of misconduct in course of their employment duties and others who are under contractual or legal duties to report wrongdoing

- Many issues to consider:
    - new provision undoubtedly will result in order of magnitude increase in number of tips and leads to SEC
        - anecdotal evidence from SEC staffers suggests they are already under siege and spending a great deal of time, in both Home office and regional offices, dealing with new tips
    - unless SEC specifically requires whistleblowers to first report issue to corporate compliance, likely that many if not most whistleblowers will go around corporate compliance and report directly to the SEC in effort to be first in line
        - anti-retaliation provisions of Dodd-Frank appear to forbid corporations from requiring whistleblowers to first report to corporate compliance
        - SEC proposed rules even permit whistleblowers who learn of issue in course of internal investigation
    - 90-day reporting requirement means that, even if whistleblower first reports to corporate compliance, corporation will have 90-day clock to conduct internal investigation re the tip

- 90 days is very brief period in which to investigate allegations of wrongdoing

- since whistleblower presumptively will report out to SEC on day 89 or 90, corporation must decide whether to self-report in advance or at same time

- SEC likely to weigh corporate findings against information and facts provided by whistleblower; will this create some kind of a rebuttable presumption against the corporation?

FCPA ENFORCEMENT

- 2010 represented substantial uptick in SEC FCPA enforcement
  - collected more than $600 million in penalties
  - brought twice as many cases as ever before
- Pace of FCPA actions will continue to increase
  - SEC formed national FCPA enforcement unit in 2010
    - one of five such specialized units;[4] headed by aggressive, very experienced, very knowledgeable SEC lawyers
      - unit includes senior lawyers in all regional offices, including senior lawyers in Miami Regional Office
      - includes regional office headquartered in San Francisco
  - FCPA unit head recently made clear that many cases already come from Unit's own investigative efforts and from whistleblowers
    - last year, only 1/3 of SEC's FCPA cases resulted from self-reporting
    - must expect this trend to increase, particularly with respect to whistleblowers, see above

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[4] The five units are: FCPA, Asset Management (advisors, mutual funds, hedge funds, etc.), Market Abuse (insider trading, market manipulation, etc.), Structured and New Products, and Municipal Securities and Public Pensions. *See* http://www.sec.gov/news/press/2010/2010-5.htm for a further description of these units and their leadership; *see also* Morgan Lewis November 23, 2010 Memorandum regarding SEC Enforcement Leadership remarks at ABA November 2010 meeting.

- further enforcement efforts also fueled by
    - increased cooperation among domestic and foreign government agencies
    - increased access to violators through extra-territorial jurisdiction
    - Dodd-Frank requirement that public companies in oil, gas, and mineral extraction industries report royalties, licensing, and other payments made to U.S. and foreign governments
    - focus on industry-specific conduct
        - pharmaceutical industry
        - oil services industry
        - reported current focus on financial services firms and dealings with sovereign wealth funds

- Changes imposed by Dodd-Frank and recent cases highlight the need for companies to develop and maintain effective internal compliance programs
    - *SEC v. Alcatel-Lucent, S.A.*, Civil Action No. 1:10-CV-24620-GRAHAM (S.D. FL. Dec. 27, 2010)
        - paid more than $137 million to settle with the SEC and DOJ
        - allegations center around numerous bribes made by Alcatel-Lucent's foreign subsidiaries, which were undocumented or falsely recorded as consulting fees and consolidated into Alcatel-Lucent's books and records
        - Alcatel-Lucent allegedly failed to detect or investigate numerous red flags suggesting that the improper payments were made

FINANCIAL STATEMENTS AND ACCOUNTING CASES

- Interestingly, although the SEC formed five specialized enforcement units in 2010 (see footnote 4, above), these did not include a unit devoted to financial fraud cases
    - some have wondered whether this reflects a de-emphasis on such cases; others have speculated that, since such cases historically represent a very significant portion of the SEC's overall case count, no specialized unit is necessary

- Whatever the case may be, at a recent SEC meeting, one of Enforcement's most senior and experienced officials led the discussion of such cases, and emphasized that there will be more to come

- This seems likely, particularly given SEC's new aiding-and-abetting, penalty, and jurisdictional powers, all discussed below

- The SEC is increasingly looking at individual conduct and bringing cases against individuals; the following cases highlight this trend:

    - *SEC v. Diebold, Inc.*, Civil Action No. 1:10-CV-00908 (D.D.C. Jun. 2, 2010); *SEC v. Gregory Geswein, Kevin Krakora, and Sandra Miller*, Civil Action No. 5:10-CV-01235 (N.D. Ohio Jun. 2, 2010)

        - Diebold settled charges that it filed at least 40 annual, quarterly, and other reports with the SEC that contained material misstatements and omissions about the company's financial performance; Diebold allegedly misstated the company's reported pre-tax earnings by at least $127 million

        - Diebold consented to a final judgment ordering the company to pay a $25 million civil penalty and permanently enjoining the company from future violations

        - SEC also filed contested actions against Geswein (former CFO), Krakora (former Controller and later CFO), and Miller (former Director of Corporate); the SEC is seeking reimbursement of compensation under Section 304 of Sarbanes Oxley against Geswein and Krakora (*see* discussion below)

    - *SEC v. Citigroup, Inc.,* Civil Action No. 1:10-CV-01277 (ESH) (D.D.C. July 29, 2010); *In re Gary L. Crittenden and Arthur H. Tildesley, Jr.*, Sec. Exchange Act Rel. No. 62593 (July 29, 2010)

        - Citigroup and two of its executives settled charges that on four occasions in 2007 they represented that the company's exposure to sub-prime assets was less than $13 billion, when in reality it was more than $50 billion

        - The misrepresentations were allegedly a result of Citigroup's excluding from its calculations two types of subprime debt: "super-senior" tranches of CDOs and liquidity puts. The two executives were allegedly provided with information regarding these additional

categories of subprime debt on numerous occasions, and yet helped draft and approve the disclosures that included the misrepresentations

- Citigroup consented to a final judgment ordering it to pay $75 million; Crittenden and Tildesley consented to the issuance of an administrative and cease-and desist order, and agreed to pay penalties of $100,000 and $75,000, respectively

▪ *SEC v. Dell Inc., Michael S. Dell, Kevin B. Rollins, James M. Schneider, Leslie L. Jackson, Nicholas A.R. Dunning*, Civil Action No. 1:10-cv-01245 (D.D.C. July 22, 2010)

- Dell and five of its executives settled charges that they failed to disclose exclusivity payments received by the company, which allowed the company to meet its earnings target; the SEC also claimed that once the exclusivity payments ended, they failed to disclose to investors the true reasons for the company's decreased profitability
- the individuals charged included Dell Chairman and CEO Michael Dell, former CEO Kevin Rollins, and former CFO James Schneider for their roles in the disclosure violations; and former regional Vice President of Finance Nicholas Dunning and former Assistant Controller Leslie Jackson for their roles in the improper accounting
- Dell Inc. consented to a final judgment ordering it to pay a $100 million penalty; Michael Dell and Rollins each agreed to pay a $4 million penalty; Schneider agreed to pay $3 million; and Dunning agreed to pay $50,000

AIDING-AND-ABETTING LIABILITY

- Dodd-Frank extends the SEC's authority to prosecute aiders and abettors to actions brought under the Securities Act of 1933 and Investment Company Act of 1940
  - previously, such actions were only permitted under Securities Exchange Act of 1934 and Investment Advisers Act
- But, the bigger news is that Dodd-Frank explicitly amends a prior statute and overturns numerous court rulings finding that aiders and abettors must have "knowingly" provided substantial assistance to the primary violator
  - the aiding-and-abetting provision was originally added in 1995 in connection with Private Securities Litigation Reform Act of 1995 ("PSLRA") as Section 20(e) of Exchange Act

        - at the time, Congress explicitly considered and rejected notion that aider and abettor could act "recklessly"

        - accordingly, most courts have construed Section 20(e) strictly, and have said that "knowingly" means what it says and that aiders and abettors must have had "actual knowledge" of the underlying violation and their role in furthering it

            - this has frequently been a tough standard for the SEC to meet

            - and has meant that the SEC had to have a stronger case against the aider and abettor than against the primary violator, since the latter can violate many securities laws recklessly but the former could not

- Section 929O of Dodd-Frank amends relevant section to add "or recklessly" after the word "knowingly"

    - this means that companies are more likely to be pursued by the SEC as aiders and abettors where they allegedly turn a blind eye or ignore the financial effects of transactions upon their counterparties

        - companies must ensure, therefore, that they understand the effects of a transaction—whether it be a sale, loan, swap, or otherwise—not only upon their own financials but also upon the counterparty's financials

    - it also means that public accounting firms, lawyers, investment bankers and other so-called "gatekeepers" are likely to be pursued more frequently by the SEC for "assisting" in a financial fraud

EXECUTIVE COMPENSATION CLAWBACK PROVISIONS

- Section 304 of the Sarbanes-Oxley Act of 2002 requires a CEO or CFO to return incentive-based compensation where financial misstatement or restatement occurs "as the result of misconduct"

- The precise meaning and interpretation of this statute has long been unclear: could clawback be ordered where "misconduct" occurred without knowledge or participation of CEO or CFO; would reckless disregard by CEO or CFO suffice; what exactly was meant by "misconduct"—hard fraud or negligent accounting?

- Early statements by SEC enforcement officials suggested that vigorous pursuit of this statute might not occur given definitional ambiguities

- But that has all changed recently; SEC now clearly under great pressure, after financial crisis, to pursue such claims

  - *SEC v. Jenkins*, No. CV 09-0150-PHX-GMS (D. Ariz. June 9, 2010)

    - clawback case brought against CEO where no misconduct by CEO was alleged

    - in denying defendant's motion to dismiss, District Court found that the triggering event is misconduct ***by the issuer*,** not by the individual

  - *SEC v. O'Dell*, No. 1:10-CV-00909 (D.D.C. June 2, 2010)

    - settled action against Walden O'Dell, former CEO of Diebold

    - required O'Dell to reimburse bonuses and other pay, again despite lack of any allegation that O'Dell engaged in misconduct

- Dodd-Frank's new clawback provisions further up the ante

  - Section 954 (now Section 10D of the Exchange Act) requires public companies to implement policies regarding (i) disclosure of incentive-based compensation and (ii) mandating the recovery of performance-based incentive compensation from current or former executives paid during the three-year period prior to a financial restatement where the compensation would not have been provided under as-restated financials

    - like SOX 304, Section 954 requires recovery of compensation regardless of whether any misconduct is shown; only requires "material noncompliance . . . with any financial reporting requirements under the securities laws"

    - but, unlike the SOX provision, Section 954 applies to ***all*** current and former executives, not just the CEO and CFO

- So, it would be appear that we can expect much more activity in this area.

PENALTIES AGAINST COMPANIES IN ADMINISTRATIVE PROCEEDINGS

- Section 929N of Dodd-Frank gives the SEC the ability to seek penalties in administrative cease-and-desist proceedings from public companies

  - previously, SEC could bring administrative action against company, but would have to bring related federal civil action in order to get penalty
  - so, more often than not, SEC brought cases against public companies in federal court in order to get full relief

- New ability to get total or near-total relief—C&D and penalty—in administrative forum may lower the bar for cases against public companies
  - administrative process is viewed as potentially less demanding/more friendly forum than a federal action
    - this is particularly true in light of recent scrutiny of SEC settlements by federal judges, *see, e.g.*, Judge Rakoff and Bank of America
    - administrative law judges are SEC employees deeply experienced in intricacies of securities law and SEC enforcement
  - other benefits to SEC of administrative proceedings include
    - limited discovery (no depositions)
    - lack of a jury trial
    - *de novo* standard of review on appeal by the SEC commissioners who approved the original filing of the complaint

<u>COOPERATION</u>

- Increasing focus by Enforcement Division on cooperation as in DOJ model
  - Not surprising given overall remake and reorganization efforts undertaken by new Director and Deputy Director, both of whom are former criminal prosecutors from the Southern District of New York
- SEC recently announced first non-prosecution agreement since new cooperation initiative, involving Carter's Inc.:[5]
  - Carter's involved alleged multi-year scheme by former EVP to inflate net income by manipulating unrecorded discounts to largest customer

[5] *See* www.sec.gov/news/press/2010/2010-252.htm.

- SEC explained that, in deciding to forego action against Carter's while pursuing the EVP, it considered the following factors
  - Carter's discovered the violation on its own and promptly conducted a thorough internal investigation
  - Carter's self-reported the violation to the SEC and fully cooperated with the SEC's investigation
  - Carter's took extensive remedial actions; and
  - misconduct was "relatively isolated" in nature
- What SEC press release does not say is that litigating against Carter's would have been very tough in light of this conduct and other exemplary conduct by company officials
  - for example, SEC's complaint cites President and CFO as reminding EVP several times that discounts had to be properly recorded and linked to sales in same periods
- Carter's also executed a formal "Non-Prosecution Agreement"[6]
  - agreement provides that Carter's must fully cooperate in any case related to scheme
    - this means producing documents, appearing for interviews, and testifying
    - and includes using "best efforts" to secure testimony and cooperation of *former* executives
  - agreement also provides that, as in settlement with SEC, Carter's may not publicly deny allegations

- SEC has also formed Cooperation Committee
  - Committee formed to promptly review cooperation agreements and has approved approximately 20 cooperation agreements spanning wide range of cases, including financial statements and accounting, insider trading, investment advisers, market manipulation, and the FCPA

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[6] *See* http://www.sec.gov/litigation/cooperation/2010/carters1210.pdf.

EXTRATERRITORIAL JURISDICTION

- Section 929P(b) of Dodd-Frank gives federal courts extra-territorial jurisdiction in cases brought by the SEC or DOJ alleging violations of the antifraud provisions of the Securities Act, Exchange Act, and the Advisers Act

- Provision intended to rebut the presumption against extraterritorial application of the federal securities laws that the U.S. Supreme Court announced recently in its decision in *Morrison v. National Australia Bank*, No. 08-1191, in private litigation context

  - Dodd-Frank does not overturn *Morrison* but does prevent its potential extension to actions brought by the SEC or DOJ

- Section 929P applies where the alleged violation

  - involves "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

  - involves "conduct occurring outside the United States that has a foreseeable substantial effect within the United States"

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