Chapter 15

SEC Investigations and Enforcement Actions

Jonathan C. Dickey, Barry R. Goldsmith, Mark K. Schonfeld & Marc J. Fagel

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§ 15:1 Introduction

The U.S. Securities and Exchange Commission (SEC or “Commission”) is the federal government’s principal regulatory and enforcement arm with respect to the securities activities of corporate America. This chapter provides an overview of SEC investigations and enforcement actions as they relate to public companies and their officers, directors, and employees, as well as third parties such as auditors, and suggests how these entities and affiliated persons may most effectively deal with SEC investigations and enforcement actions.¹

The onset of an SEC investigation can be both the symptom of, and the cause of, a major corporate crisis. SEC investigations frequently raise questions about the performance or integrity of corporate management, the integrity of a corporation’s financial reporting specifically, and corporate stewardship generally. An enforcement action against a public company issuer may result in the assessment of large corporate penalties, reduced access to capital markets, and the imposition of restrictive corporate governance structures. With respect

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to individuals, the SEC may seek not just monetary relief in the form of disgorgement and penalties, but temporary or permanent restrictions on an individual’s ability to serve as an officer or director of a public company. An enforcement action by the SEC may also have significant collateral effects. It may cast doubt on the reputation of the corporation; it may lead to lawsuits by shareholders or other persons (who may in turn obtain access to the SEC’s investigative record); and it may ultimately require significant changes in key management. And while the SEC itself is a civil agency that cannot seek criminal remedies, its investigations are frequently referred to criminal authorities, such as the Department of Justice (DOJ), which has access to broader investigative powers (such as search warrants and wiretaps) and more daunting sanctions (including incarceration).

Even if the investigation is concluded without an enforcement action, the pendency of an investigation places a cloud over the corporation, which can chill relationships with customers and shareholders, and distract and demoralize management.

How a corporation responds to an indication of misconduct is often as important to the future of the corporation as remediating the underlying conduct itself. Any business enterprise may have a rogue employee or officer who engages in misconduct either for personal benefit or because of a misguided belief that it will assist the corporation. In the eyes of the SEC and, in many instances, the DOJ, such conduct will not necessarily be attributed to the corporation, as the conduct may be inconsistent with the policies, values, and interests of the corporation. On the other hand, the failure to detect the misconduct may reflect upon the quality of the company’s internal accounting and other controls. More important, the manner in which the company responds to indications of misconduct or to a government investigation will directly affect the SEC’s views of the integrity of the company and may have a significant impact on the outcome of an investigation.

§ 15:2 SEC Investigations

§ 15:2.1 Investigation Participants

SEC investigations are conducted by the Division of Enforcement (or “Enforcement Division”). Enforcement Division staff are located at the SEC’s headquarters in Washington, D.C., as well as around the country in eleven regional offices. The Enforcement Division conducts investigations, recommends enforcement actions to the Commission, and negotiates settlements (subject to the Commission’s approval). The Enforcement Division also litigates enforcement actions before SEC administrative law judges and in federal court.
SEC investigations are conducted by staff attorneys and, where appropriate, staff accountants. As part of their investigation, staff attorneys may collect and review documents, conduct interviews, and take sworn testimony. Investigations are supervised by assistant directors, each of whom manages several staff attorneys. These assistant director groups are in turn managed by associate directors in the regional offices and in Washington, D.C. At a high level, the enforcement program is overseen by the regional directors, unit chiefs (in the case of investigations handled by the specialized units described below), and ultimately the Director of the Enforcement Division in Washington, D.C.

§ 15:2.2 Triggering Events

[A] Generally

Nothing more than official curiosity is required for the SEC to start an investigation. This is not to say, however, the investigations are started for no reason. Usually some event or market activity prompts the SEC to begin an inquiry. Examples include the following:

1. Review of periodic filings and registration statements, as well as Forms 8-K, by the Division of Corporation Finance.
2. Referrals, particularly in the insider trading context, from self-regulatory organizations, such as the Financial Industry Regulatory Authority [FINRA], which carefully monitor securities trading activity.
3. Surveillance of newspaper and other media reports, industry publications, and stock-related websites and bulletin boards by Enforcement Division staff.
4. Tips from self-appointed corporate watchdogs (including professional short-sellers).
5. Complaints from investors, including formal “whistleblowers” seeking cash rewards pursuant to recently enacted SEC regulations (described below).
6. Complaints from competitors who may believe they are competing against a company that has been falsely stating its performance or which improperly secured business through a bribe to a foreign official.
7. Complaints from class action plaintiffs’ counsel who hope to benefit from the fruits of an SEC investigation or the filing of an SEC enforcement action.
In addition, many SEC investigations of public companies originate from the self-reporting of potential irregularities by the issuer itself (through counsel). As discussed in section 15:3.4 below, the SEC expects, and may credit, cooperation by public companies, and thus it is often in the best interest of the company to inform the Enforcement Division of a potential violation of the federal securities laws identified internally before it becomes public or is shared by a whistleblower.

Given the tremendous volume of tips, complaints, and referrals that reach the SEC (referred to informally as “TCRs”), as well as its own surveillance, the SEC enforcement staff has endeavored to evaluate such complaints with a critical eye, and in recent years has designed sophisticated systems and procedures to help evaluate and prioritize the information it receives. These reforms became an agency imperative in the wake of the Bernard Madoff scandal, in which the SEC was criticized for apparent failures to timely pursue tips suggesting Madoff may have been running a Ponzi scheme. Hence, the Enforcement Division established the Office of Market Intelligence, which serves as a central office for handling all such information. Similar concerns led Congress to incentivize whistleblowers to come forward and report fraud, as described below.

[B] Whistleblowers

The Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in 2010, provides for the payment of cash awards to whistleblowers. Under Dodd-Frank, whistleblowers who voluntarily provide original information that leads to a successful enforcement action and imposition of monetary sanctions of over $1 million may be entitled to between 10% and 30% of the funds ultimately recovered by the SEC. The whistleblower program went into effect on August 12, 2011. According to the SEC’s 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program, the Whistleblower Office received 3,238 tips in fiscal year 2013 and 6,573 tips since the program’s inception. The three largest categories of tips

5. U.S. SEC. & EXCH. COMM’N, 2013 ANNUAL REPORT TO CONGRESS ON THE DODD-FRANK WHISTLEBLOWER PROGRAM, at 1 [Nov. 2013] [hereinafter
were those involving market manipulation, offering frauds (Ponzi schemes), and misleading corporate disclosure and financial statements, each constituting about a sixth of the total.6 Other categories included the Foreign Corrupt Practices Act,7 unregistered offerings, and insider trading.8

To date, the SEC has publicly announced awards to whistleblowers in a handful of matters, most notably a $14 million award in a case involving a fraudulent property development scheme in which the defendant sold over $145 million in securities.9 The remaining awards have been significantly smaller, ranging from $125,000 to $875,000.10 Although the facts made available by the SEC are scant, these matters appear to involve the fraudulent offering of securities and do not involve reporting by public companies. However, as the typical investigation of a complex financial reporting matter can take several years, and the whistleblower program did not go into effect until 2011, the absence of any awards to date by no means suggests that public company executives and directors do not need to be concerned about the impact of the whistleblower program. To the contrary, SEC officials have suggested that there is a pipeline of large payouts anticipated.11

A controversial aspect of the SEC’s whistleblower rules is the extent to which the financial incentives could undermine corporate compliance programs by leading employees to bypass internal reporting mechanisms in favor of reporting directly to the SEC. In promulgating

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6. Id. at app. B.
8. Dodd-Frank Whistleblower Report 2013, supra note 5, at app. B.
the regulations under Dodd-Frank, the SEC rejected recommendations that the rules require corporate whistleblowers to first report their concerns internally to allow the company to investigate the allegations before triggering a government investigation. Instead, the SEC’s rules do not require an employee to report a complaint internally in order to be eligible for a reward; however, the rules provide that the amount of the reward may be higher if the employee reports the complaint internally first, and that the effective date of the complaint will be deemed to have been the date the information was reported to the company (as long as the information is then reported to the SEC within 120 days). The rules also permit principals, compliance personnel, accountants, and individuals retained to conduct an inquiry to qualify for a reward if they report the alleged violation to their compliance program and the company fails to act or appears to be impeding an investigation of the conduct. In August 2014, the SEC announced a $300,000 award to a compliance employee who had reported wrongdoing to the SEC only after her employer had failed to take action.

Dodd-Frank further provides for anti-retaliation provisions to protect lawful whistleblowers. The SEC has indicated it would take an aggressive position in response to allegations that companies retaliated against whistleblowers or took steps to prevent them from reporting to the regulators. In June 2014, the SEC brought its first action in which it alleged that, among other things, a hedge fund advisor had retaliated against an employee who had reported improper conduct to the SEC.

While the formal establishment of the Office of Market Intelligence and the Office of the Whistleblower provide the staff with greater ability to identify meritorious tips warranting further investigation,

13. Id. at Rule 240.21F-4[b][4][v].
15. See, e.g., Susan Beck, Susan Beck’s Summary Judgment: SEC’s Whistleblower Chief Disappointed in Questions from Corporate America, AM. LAW. LITIG. DAILY, Nov. 26, 2012 [interview with Sean X. McKessy, Chief of the Office of the Whistleblower] (“If [lawyers] are drafting very aggressive language to intimidate employees, we want to know about it. The authors of that language might be held accountable”).
the reality is that since the Madoff affair (as well as amid more generalized criticisms that the agency could have done more to avoid or alleviate the financial crisis of the late 2000s), the enforcement staff remains under tremendous pressure to avoid missing another large fraud, and the staff may err on the side of opening an investigation rather than run that risk. Corporations and their associated persons, thus, may find themselves at the receiving end of an SEC request for information, or an SEC subpoena, despite any obvious indicia of misconduct.

§ 15:2.3 Phases of SEC Investigations

[A] Informal Inquiry

An SEC investigation typically begins with the staff member opening a matter under inquiry (referred to by the staff as a “MUI”). As noted above, there is a very low threshold for doing so, and opening the MUI can be done at the staff level with management approval; authorization by the commissioner is not required.

During this stage, the staff may request documents from individuals and companies, and may seek witness statements in the form of interviews or sworn testimony, but only on a voluntary basis. (There is an exception for certain entities regulated by the SEC, such as investment advisers and broker-dealers, who are obligated to share many records with the SEC. Hence, the SEC may obtain an individual’s securities trading records from a broker without resorting to a subpoena.) The staff may also solicit information through witness proffers, in which the staff agrees that the witness’s statements may not be used against him or her in an enforcement proceeding. Though more frequently used in matters in which criminal authorities are actively involved (as prosecutors often prefer to avoid putting cooperating witnesses on the record), the SEC is increasingly using proffers (and interviews generally) in lieu of sworn testimony.

While the SEC cannot compel the production of documents or witness testimony at this stage and a corporation and its employees are under no obligation to comply with such a request, it is usually in the company’s interest to do so. First, voluntary cooperation will put

16. See SEC. & EXCH. COMM’N, DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL § 3.3.7 (Nov. 1, 2012) [hereinafter SEC ENFORCEMENT MANUAL], available at www.sec.gov/divisions/enforce/enforcementmanual.pdf (“A proffer agreement is a written agreement providing that any statements made by a person, on a specific date, may not be used against that individual in subsequent proceedings, except that the Commission may use statements made during the proffer session as a source of leads to discover additional evidence and for impeachment or rebuttal purposes if the person testifies or argues inconsistently in a subsequent proceeding”).
the company in a more positive light in the staff’s consideration of the issues posed by the investigation. Second, voluntary cooperation may encourage the SEC staff not to issue a formal order of private investigation, which could implicate disclosure obligations or suggest that the matter has reached a more serious level of scrutiny by the SEC. Third, voluntary cooperation gives the company some greater degree of control over the scope of the investigation and the amount and type of information that must be produced.

In any event, whether the company chooses to cooperate or not, once it is advised of an informal inquiry, it should preserve relevant documents. The destruction of relevant documents in these circumstances could lead to charges of obstruction of justice.\textsuperscript{17} In determining which materials it is obliged to preserve or disclose in an informal inquiry, the company should consider the potential relevance of the materials to the matters under inquiry, not the informal or formal nature of the inquiry.

\textbf{[B] Formal Investigation}

In order for the staff conducting the investigation to issue subpoenas and compel witnesses to produce documents or appear for testimony under oath, the Commission must first issue a “formal order of private investigation.” A formal order is not a finding of fact or a form of adjudication, but rather asserts the possibility of a violation of delineated provisions of the federal securities laws by certain entities and/or individuals.\textsuperscript{18} Formal orders tend to be very general in nature, with only a bare-bones recitation of the facts which form the factual predicate for issuing the order and the statutory and regulatory provisions that may have been violated; the staff will often broaden the scope of an investigation, or revise its theory of the case, as the evidence develops.\textsuperscript{19}

Until recently, formal orders were subject to full review at a meeting of all five commissioners, the same process used by the staff when recommending that an enforcement action be commenced or settled. While the Commission would rarely deny this authority to the staff,

\textsuperscript{17} See 18 U.S.C. §§ 1505, 1512.
\textsuperscript{18} See SEC ENFORCEMENT MANUAL § 2.3.3.
\textsuperscript{19} Somewhat confusingly, the Enforcement Division also uses the term “investigation” more broadly to define an inquiry that has reached a more advanced state—that is, where the staff has reason to believe that the matter justifies the resources needed to proceed further. The staff is advised to convert a MUI to an investigation within sixty days of opening, and in some cases may open the matter directly as an investigation. See SEC ENFORCEMENT MANUAL § 2.3.2. However, and most significantly, it is not a formal investigation, and no subpoenas may be used by the staff, until the formal order has been issued.
the process by which the proposed formal order was reviewed by other divisions of the SEC and considered by the commissioners could take several weeks [or even months].\textsuperscript{20} As one of several reforms enacted in 2009 under then-Chair Mary Schapiro and then-Director of the Enforcement Division Rob Khuzami, the SEC delegated the authority to issue formal orders directly to senior staff of the Enforcement Division “so investigations can be launched without the prior—and time-consuming—approval of the Commission.”\textsuperscript{21} As a practical matter, the process of obtaining a formal order and serving subpoenas can now take just hours, rather than weeks.

The staff may have various reasons for obtaining a formal order. A witness may be non-cooperative and refuse to provide documents or testify voluntarily, in which case the staff will need subpoenas to compel the production or testimony (and to create the mechanism by which it may ultimately seek federal court intervention to enforce the subpoena if the witness fails to comply).

In addition, the staff will typically need to obtain information from various third parties. Some institutions, such as banks and Internet service providers, can only produce records to the government pursuant to a subpoena.\textsuperscript{22} In cases where such information is needed, the staff will have to obtain a formal order, regardless of how cooperative the company or individual witnesses may be.

In other instances, certain third parties, even if not precluded by statute from providing the information voluntarily, might be reluctant to provide information to the government absent a subpoena requiring them to do so. For example, in the typical financial disclosure case, the staff may seek information from the company’s auditors, customers, vendors, lenders, or business partners, depending on the nature of the issues. These persons or entities may be [or believe themselves to be] limited in their ability to share information voluntarily, either because of contractual duties or simply to preserve business relationships, and the staff will thus frequently obtain a formal order as the investigation proceeds.


\textsuperscript{22.} See, e.g., SEC ENFORCEMENT MANUAL § 4.5 (production of bank records under the Right to Financial Privacy Act of 1978); id. § 4.6 (production of account identifying information from ISP’s under the Electronic Communications Privacy Act of 1986).
The order itself is kept confidential by the SEC during the investigation, though there are mechanisms for individual witnesses to request a copy. There is no specific requirement that a public company disclose a formal investigation to investors. Nonetheless, companies continue to struggle with whether a formal investigation rises to the level of materiality warranting disclosure. Item 103 of Regulation S-K requires only that companies disclose “legal proceedings,” and the mere initiation of a formal investigation by the SEC staff would not appear to constitute such a proceeding. The fact that a formal order has been issued is not in and of itself indicative that an enforcement action is likely. Indeed, as noted above, since formal order authority was delegated by the Commission in 2009, the staff may readily obtain a formal order with minimal burden; moreover, there are at times reasons to issue subpoenas that have no bearing on the seriousness of the investigation or the likelihood that it will result in an enforcement action. Nonetheless, there remains a perception that once the staff begins issuing subpoenas, some determination has been made by managers in the Enforcement Division that the matter warrants further scrutiny and has advanced into a more serious stage, and companies need to give consideration as to whether the investigation, or the allegations giving rise to the investigation, should be disclosed to investors.

[C] Wells Notices and the Authorization Process

After completing its investigation, the staff will make a decision as to whether it will recommend to the five-member Commission that a particular company or individual should be charged with a violation of the federal securities laws, which laws are believed to have been violated, and the nature of the relief to be sought. In virtually every case other than those requiring emergency relief, the staff will contact counsel for the prospective defendant, state its conclusion, and summarize the basis for that conclusion. This is known as a “Wells” notice. Counsel then has a time-limited opportunity to make a Wells submission—essentially a brief setting forth factual, legal, and policy arguments why an enforcement action is not appropriate [or at least why certain charges or remedies are unwarranted]. Before making a Wells submission, the prospective defendant and counsel generally have an opportunity to meet with the staff to discuss the basis for its conclusion. Such a meeting can be a helpful means to obtain greater insight into the evidence the staff believes supports its theories. The staff has the discretion, upon request, to allow the prospective defendant and counsel to review non-privileged portions of the investigative

23. See id. § 2.3.4.2.
file. Viewing such information may allow counsel to more intelligently respond to the staff and assess the risks of litigation.

Meetings with and Wells submissions to the staff are sometimes fruitful. Often counsel or the company can inform the staff of significant factual and legal defenses that may change its recommendation. Moreover, even if the staff decides to go forward with an enforcement recommendation to the Commission, counsel and the company may be successful in persuading the staff that some defendants should be excluded altogether or that the severity of charges should be reduced.

Although there are substantial benefits that may result from a Wells submission, there are also possible tactical disadvantages to submitting one. To begin with, Wells submissions are commonly sought, and sometimes considered discoverable, in private civil litigation. In addition, the SEC considers Wells submissions to be party admissions, which may be used by the SEC in any enforcement action it brings against the person making the submission (and, in appropriate circumstances, perhaps the corporation for whom the person was or is employed). A Wells submission may also provide the SEC with a "roadmap" to the defense in the event of litigation. In addition, federal prosecutors may obtain Wells submissions from the SEC and, in turn, make use of the Wells submission in a parallel criminal proceeding. Thus, counsel must weigh carefully the benefits and pitfalls of making a Wells submission and, if one is made, give careful consideration to the content of the submission.

If the investigating staff decides to go forward and recommend an action, it sends its recommendation to the Commission in the form of an "action memo," together with any Wells submissions. Before the recommendation is considered by the Commission, it will face several levels of internal review. Senior personnel within the Enforcement Division (including the division director) will review the matter. The memo and Wells submissions will also be reviewed by the

24. See id. § 2.4.
26. See SEC ENFORCEMENT MANUAL § 2.4 (written Wells notice or written confirmation of an oral Wells notice should, among other things, "inform the recipient that any Wells submission may be used by the Commission in any action or proceeding that it brings," and attach a copy of SEC Form 1662); see also id. (the staff may reject a submission if the person making the submission "limits its admissibility under Federal Rule of Evidence 408 or otherwise limits the Commission's ability to use the submission pursuant to Form 1662").
appropriate policy-making divisions within the agency. (For example, in a financial disclosure case, the Division of Corporation Finance and the Office of the Chief Accountant will have an opportunity to review the matter and provide input to the commissioners.) In addition, all recommendations are reviewed for consistency and for compliance with Commission policy and applicable law by the Office of the General Counsel.

Finally, following a process that can take several months from the date of the initial Wells notice, the commissioners will review the recommendation in a meeting open to the staff but not to the public or to the prospective defendants. The commissioners will vote on the recommendation, and assuming it is approved (as the vast majority are), the staff will file the action shortly thereafter.

Under Dodd-Frank, the SEC staff, within 180 days of issuing a Wells notice, is required to either file the enforcement action or notify the director of the Enforcement Division of its intent not to do so. Although the statute includes mechanisms for the granting of extensions beyond the 180-day period for actions deemed “sufficiently complex,” SEC leadership may be concerned about the optics of freely granting such extensions, placing some pressure on the staff to proceed quickly and push back on requests from defense counsel for additional time to prepare a Wells submission or negotiate settlement terms. While six months would seem like more than adequate time for the staff to prepare and file an enforcement proceeding, complex investigations often involve numerous potential parties, the involvement of multiple civil and criminal authorities, protracted settlement discussions, and difficult questions of law and policy to be evaluated by the SEC’s divisions and commissioners, and thus it is not uncommon for significant time to pass before the case is actually filed.

In some cases, it is possible to engage with the staff in a “pre-Wells” process in which counsel may make a submission akin to a Wells submission and engage in a dialogue with the staff, but without the receipt of a formal Wells notice. This can potentially alleviate the company’s disclosure obligations, while possibly reducing the pressure on the staff to move forward quickly with an enforcement action in order to avoid running afoul of the Dodd-Frank 180-day rule.

27. Dodd-Frank § 929U(a).
28. See SEC ENFORCEMENT MANUAL § 2.4 (“If the staff intends to provide a written Wells notice, the staff may give advance notice of the intention to the recipient or his counsel”).
29. It is unclear whether a public company has an obligation to publicly disclose that it has received a Wells notice, and in at least one private class
§ 15:2.3 SECURITIES LITIGATION

[D] Resolving Enforcement Actions

If a prospective defendant is unsuccessful in persuading the staff to forgo an enforcement action during the Wells process, meeting with the staff may also provide an opportunity for companies and individuals to explore settlement options with the SEC. If the party seeks to avoid trial and resolve the matter, there may be advantages to reaching settlement with the SEC before the enforcement action is filed. Although the remedies the SEC seeks in settlement may not be dramatically different from what it seeks in litigation (including injunctive relief, monetary payments, and potential ancillary relief such as suspensions or bars, as described below), there may be more room to negotiate less onerous allegations in the pleadings and reduced charges before the case has been filed. In a litigated action, the staff will typically include more detailed allegations [among other things, to avoid a motion to dismiss based on a failure to plead with particularity] and more charges [such as both scienter- and non-scienter-based causes of action, to provide more options for the finder of fact]. Resolving the matter in advance of filing also provides an opportunity for the party to seek the inclusion of mitigating language in the SEC’s press release announcing the action, including references to the company’s cooperation or remedial efforts.

One additional benefit to settling parties has been the SEC’s historical practice of settling matters on a “neither admit nor deny” basis. By not admitting wrongdoing, the party avoids some of the serious collateral consequences of a finding of liability, which can be used against the party in a related class action or derivative lawsuit, or by another state or federal regulator in a separate proceeding. At the same time, SEC settlements prohibit settling parties or their representatives from publicly denying the allegations [although parties retain certain rights to defend themselves in matters to which the SEC is not a party].

Notably, in recent years the SEC’s “neither admit nor deny” policy has come under fire in some quarters for failing to provide sufficient corporate accountability. Several courts have rejected SEC settlements, holding that the defendant’s failure to admit the allegations prevented the court from assessing the adequacy of the settlement terms. Most notably, Judge Rakoff of the Southern District of New York in November 2011 rejected a proposed $285 million settlement between the SEC and Citigroup. See SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011). Judge Rakoff held that the absence of a party action the court held to the contrary. See Richman v. Goldman Sachs Grp., Inc., 868 F. Supp. 2d (S.D.N.Y. 2012) [nondisclosure of Wells notice did not render the firm’s earlier disclosure that it had received information requests from the government materially misleading].

admission “deprives the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact.”

Both Citigroup and the SEC moved for interlocutory appeal. In a June 4, 2014, opinion, the Second Circuit vacated Judge Rakoff’s ruling and remanded the case for further proceedings, reaffirming the SEC’s discretionary authority to enter into settlements under its “neither admit nor deny” policy. During the pendency of the appeal, several other courts rejected or at least criticized SEC settlements due to the absence of admissions, but it is unclear whether courts outside of the Second Circuit will continue to do so in light of the Second Circuit’s decision.

During the lengthy interim between the district court’s 2011 ruling and the Second Circuit’s 2014 decision, the SEC revisited its policy of neither-admit-nor-deny settlements, publicly announcing in 2013 that, in certain cases, the agency would require parties to admit liability as a term of the settlement. The SEC has invoked the new policy sparingly, in fewer than a dozen cases to date. However, while the SEC initially pledged to limit the admissions requirement to only the most egregious cases, more recent settlements including party admissions have charged more technical violations that do not appear to involve serious fraud. It remains to be seen how frequently the SEC will seek such admissions, but the impact of the policy change could be dramatic, exposing settling parties to significant collateral consequences and raising the incentives for defendants to litigate.

Even beyond the admissions issue, SEC settlements have faced greater scrutiny in the courts in recent years. Judge Rakoff, in addition to challenging the SEC’s neither admit nor deny policy in Citigroup, has also challenged the SEC’s penalty assessments. In 2010, Judge Rakoff rejected the SEC’s $33 million settlement with Bank of America, finding the settlement unfair and unreasonable. Several months later, after the parties submitted additional evidence supporting the settlement and the bank agreed to pay a $150 million penalty

32. Id. at 332.
33. See, e.g., Order Denying Entry of Final Judgments, SEC v. Bridge Premium Fin., LLC, No. 1:12-CV-02131-JLK [D. Colo. Jan. 17, 2013], available at about.bloomberg.com/files/2013/01/bridge.pdf (“I refuse to approve penalties against a defendant who remains defiantly mute as to the veracity of the allegations against him. A defendant’s options in this regard are binary: He may admit the allegation or he may go to trial”).
and implement certain remedial measures, the court reluctantly accepted the settlement.\(^{35}\)

In all events, any settlement offers submitted to the staff, as with all litigated enforcement actions, must be authorized by Commission vote. On occasion, a party may reach an agreement in principle with the staff, only to have the commissioners reject the agreement or demand material changes to the settlement agreement before accepting it. Hence, public companies disclosing a settlement in principle with the staff must be cautious in describing the tentative nature of the agreement until it has been formally authorized by the Commission.

[E] Closing Investigations

When a determination has been made not to pursue an enforcement action, the Enforcement Division’s policy is to send a termination letter “at the earliest opportunity” after such decision has been reached.\(^{36}\) The policy provides that such a letter may be sent by the staff even where the investigation is ongoing as to other potential defendants; however, as a practical matter, the staff will usually wait until the entire matter has been closed (or at least until an enforcement action has been filed against certain parties). The policy further provides that letters should be sent to, among others, anyone who received a Wells notice or otherwise “reasonably believes that the staff was considering recommending an enforcement action against them.”\(^{37}\) Of course, in a broad investigation involving a large number of witnesses, not everyone involved in the investigation may be notified when the matter has been closed, and an individual or entity unsure about the status of the matter may contact the staff and request a termination letter.

Termination letters expressly provide that they “must in no way be construed as indicating that the party has been exonerated or that no action may ultimately result from the staff’s investigation of that particular matter.”\(^{38}\) Nonetheless, while it is possible that a decision not to pursue charges at that time may be revisited by the staff if new evidence comes to light, a termination letter at least provides some comfort, particularly where an individual or company has been placed under a cloud due to publicity surrounding the investigation.


\(^{36}\) See SEC ENFORCEMENT MANUAL § 2.6.2.

\(^{37}\) Id.

\(^{38}\) Id.
§ 15:3 SEC Enforcement Actions

§ 15:3.1 SEC Enforcement Trends

The SEC’s Enforcement Division investigates cases in a wide range of subject matter areas. Classifications of SEC actions include:

- issuer reporting and disclosure;
- securities offerings;
- insider trading;
- investment advisers and investment companies;
- broker-dealers;
- market manipulation; and
- municipal securities and public pensions.

The Enforcement Division files several hundred cases per year; in fiscal year 2013, for example, the SEC filed a total of 676 actions against 1,598 individuals and entities. Of these, 207 were filed in federal court, and 469 were administrative proceedings. In addition, hundreds of investigations are conducted by the staff but do not actually culminate in the filing of an enforcement action. For fiscal year 2013, the SEC reported that it had opened 908 investigations, closed 1,187, and had 1,444 ongoing investigations.

At least until recently, financial reporting and disclosure cases usually represented the single largest component of the Enforcement Division’s caseload, typically in excess of one quarter of all cases filed by the SEC. More recently, there has been a significant decline in the number of financial reporting cases filed by the SEC. In 2013, for


40. Id. Note that the totals reported by the SEC include, for 2013, 132 actions against companies for delinquent filings, a relatively summary proceeding; in addition, many of the cases are “follow-on proceedings,” such as administrative proceedings suspending or barring investment advisers and brokers previously sued by the SEC. Hence, the actual number of significant new actions filed each year is somewhat lower than the reported total.

41. Id.

example, this category represented only 10% of SEC enforcement actions. This decline may reflect improvements in public company accounting and internal controls in the wake of the Sarbanes-Oxley Act of 2002 and the various high-profile financial fraud cases of the early 2000s. It also reflects a dramatic shift of SEC enforcement resources into other areas, with a significant increase in the number of enforcement actions focused on investment advisers (including private fund managers) and broker-dealers. Finally, some of the shift in priorities is undoubtedly cyclical, such as the expenditure of significant enforcement resources on investigations of large financial institutions in the wake of the financial crisis of the late 2000s.

The shift away from public company financial fraud cases may be reversing, however. In July 2013, the SEC announced the formation of a Financial Reporting and Audit Task Force. The Task Force intends to use qualitative and quantitative analyses of public filings to identify indicia of potential accounting irregularities and other signifiers of fraud. For example, the SEC may compare discretionary accruals reported by peer companies and target outliers to determine whether improper earnings management is occurring. In the months following the announcement, the Task Force began sending informal document requests to some companies inquiring into potential accounting issues.

One subset of financial reporting fraud, and the focus of its own specialized investigative unit, is the Foreign Currupt Practices Act (FCPA), which bars corrupt payments to foreign officials to obtain or keep business. For decades, the SEC seldom used its authority, shared with the DOJ, to enforce this thirty-year-old statute. But recent years have seen the number of FCPA cases increase dramatically, rising from zero cases in 2003 to twenty cases in 2011. Indeed, in 2011, the SEC began reporting FCPA cases as a stand-alone category in its public reports, rather than including those cases in its tabulation of issuer reporting matters.

By 2012 and 2013, the number of SEC FCPA actions began to decline, suggesting that heightened government scrutiny may have led to improved compliance and controls by public companies with foreign operations. Nonetheless, notwithstanding their relative rarity

among SEC enforcement actions, an FCPA investigation can take a significant toll on a company. The disgorgement and penalty assessments in these matters can be quite large, often in the tens or hundreds of millions of dollars. Recent actions of note have included cases against Siemens AG ($350 million settlement), Halliburton Co. and its former subsidiary, KBR, Inc. ($177 million settlement), Daimler AG ($91.4 million settlement), and Total, S.A. ($153 million settlement). These figures represent only SEC settlements; FCPA cases are also typically accompanied by criminal penalties of a comparable magnitude.

In addition, because of their cross-border nature, as well as the involvement of the DOJ as well as foreign authorities, these investigations can be unusually protracted. For instance, the above-referenced matter against Total, S.A., was filed in May 2013, but involved allegedly improper payments made between 1995 and 2004.47

§ 15:3.2 Civil Remedies

The typical SEC enforcement action filed in federal court, involving public companies and related persons, will seek several categories of relief: an injunctive order prohibiting future legal violations; disgorgement of any ill-gotten gains; monetary penalties; and, where appropriate, ancillary relief, such as an order barring an individual from serving as an officer or director of a public company. Some amalgam of these remedies will generally be sought by the SEC either from the court in a litigated action, or from the parties as part of a negotiated settlement.

[A] Civil Injunctions

The SEC may obtain a civil injunction prohibiting any person or entity from future violations of the federal securities laws based upon a showing that the person or enterprise has violated or is about to violate the federal securities laws. Injunctions are issued by a federal district judge after commencement of a lawsuit by the SEC, either following a successful trial by the SEC or pursuant to a settlement in which the defendant stipulates to entry of the proposed injunction by the court. The standard for issuing an injunction requires that the SEC show a reasonable likelihood of future violations. Courts usually look to factors that include:

1. the egregiousness of the conduct;
2. the isolated or recurring nature of the conduct;

(3) the degree of scienter involved;
(4) the defendant’s opportunity to engage in future violations; and
(5) the degree to which the defendant has recognized the wrongfulness of his conduct.\(^48\)

In both the litigated and settled context, the SEC typically seeks to have the court impose general injunctions under which the defendant is enjoined from violations of the provisions of the federal securities laws deemed by the SEC (or found by the court) to have been violated. Such injunctions provide a basis for the SEC to charge individuals with contempt of court in the event of future violations; more generally, injunctions provide a mechanism for the SEC to explain how the alleged misconduct ran afoul of the law. Notably, in recent years several courts have pushed back on broad “obey the law” injunctions as lacking sufficient specificity to guide a defendant’s future conduct.\(^49\) In response, the SEC has begun, in some cases, to seek more targeted “conduct-based” injunctions that prohibit the defendant from engaging in the specific activities that led to the violation (even though such activities may in and of themselves be legal).\(^50\)

The SEC is also able to obtain temporary equitable relief—such as an asset freeze or receivership—under emergency circumstances. The SEC generally seeks such relief when there is an ongoing fraud (such as a Ponzi scheme), or significant reason to believe that a defendant might destroy evidence or move assets outside the SEC’s jurisdiction. For example, in several recent insider trading cases, the SEC has sought and obtained emergency orders freezing brokerage accounts controlled by foreign traders following suspiciously timed trading, even before it had evidence establishing the source of the inside

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49. For example, in SEC v. Goble, 682 F.3d 934 (11th Cir. 2012), the Eleventh Circuit vacated the generic “obey the law” injunctions issued by the district court after trial, holding that they violated Rule 65(d)(1) of the Federal Rules of Civil Procedure by failing to describe in sufficient detail the acts sought to be restrained.

50. See, e.g., SEC Litigation Release No. 22,494, Former “Teach Me To Trade” Salesman Agrees to Settle Securities Fraud Charges and Pay a $200,000 Penalty (Sept. 26, 2012), available at www.sec.gov/litigation/litreleases/2012/lr22494.htm (in case alleging fraud in connection with sales of seminars and software purportedly teaching how to profitably sell securities, defendants enjoined from participating in the development, marketing, or sale of any classes, workshops or seminars concerning securities trading).
information ostensibly being traded upon\textsuperscript{51}—or, in some cases, before it had even identified the trader who owned the brokerage account.\textsuperscript{52}

[B] Monetary Sanctions

[B][1] Disgorgement

In most enforcement actions, the SEC will seek to have the defendant “disgorge,” or repay, money obtained as a result of alleged violations of the federal securities laws. Such improper gains may include, for example, profits from insider trading; proceeds obtained from unregistered or fraudulent securities offerings; bonuses and stock sale proceeds obtained by an executive during a period in which the company’s stock price was artificially inflated due to the alleged fraud; and any assets misappropriated by the defendant. The SEC will seek prejudgment interest on these sums as well.

[B][2] Civil Penalties

As a result of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990,\textsuperscript{53} the SEC also has the authority to obtain civil money penalties from issuers of securities and persons associated with issuers. The amounts of such penalties are based upon the nature of the violation and whether the defendant is an individual or an organization. Note that a separate statute provides for penalties in insider-trading cases; these penalties can reach three times the total profits gained (or losses avoided) through the unlawful trading.\textsuperscript{54}

Historically, penalties recovered by the SEC would be paid into the U.S. Treasury. However, the Sarbanes-Oxley Act permitted the SEC to add the amount of any civil penalties it recovers to any disgorgement fund established for the benefit of victims of the securities law violation. This “Fair Funds” provision in section 308 arguably increases the SEC’s ability to make victims whole when the amount of disgorgement otherwise obtainable from wrongdoing officers and directors is insufficient, whether due to the limited assets of the individuals, or other factors mitigating against the imposition of a


more severe disgorgement amount. The “Fair Funds” provision correspondingly increased the SEC’s incentive to seek penalties, and in larger amounts, as seen by a series of significant penalties paid by public companies over the past decade. In 2012, the SEC distributed $815 million from thirty-one different Fair Funds.55

Notwithstanding the SEC’s expanded statutory authority to seek penalties from public company issuers, these settlements remain somewhat controversial, insofar as extracting penalties from public companies can be viewed as penalizing the company’s shareholders, rather than the individual officers or directors responsible for the underlying misconduct. In an effort to bring more predictability to its assessments of corporate penalties, in 2006 the Commission issued a “Statement Concerning Financial Penalties,”56 in which it said that the appropriateness of seeking penalties from a corporation in a particular case turns principally on two factors: (1) the presence or absence of a direct benefit to the corporation as a result of the violation, and (2) the degree to which the penalty will recompense or further harm the injured shareholders. In addition, the SEC noted other subsidiary factors, which included the extent of cooperation exhibited by the company in connection with any SEC investigation. On that issue, the 2006 statement said that “the degree to which a corporation has self reported an offense, or otherwise cooperated with the investigation and remediation of the offense, is a factor that the Commission will consider.”57 The stated purpose of the guidelines was to provide “clarity, consistency, and predictability.”58 Since that time, the composition of the Commission, as well as the leadership of the Enforcement Division, has undergone significant changes, raising questions as to the continuing viability of the 2006 penalty guidance; however, at this time, there has been no formal revision or revocation of the policy.

[B][3] Clawback of Executive Compensation

Section 304 of the Sarbanes-Oxley Act provides that, if an issuer “is required to prepare an accounting restatement due to material non-compliance of the issuer, as a result of misconduct, with any financial

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57. Id.
reporting requirement under the securities laws,” the CEO and CFO shall reimburse the issuer for any bonus or other incentive-based or equity-based compensation received, and any profits realized from the sale of the securities of the issuer, during the year following issuance of the original financial report. The statute does not specify whose “misconduct” is required in order to trigger the remedy. In the years immediately after the enactment of the Sarbanes-Oxley Act, the SEC only asserted section 304 claims against CEOs and CFOs who were also alleged to have been personally involved in wrongdoing leading to the restatement. For example, several early cases involved CEOs or CFOs named as defendants in cases alleging improper backdating of stock options. Another case involved an officer who allegedly participated in an accounting fraud and misappropriated company funds.

In 2009, the SEC for the first time used section 304 in an action seeking to “claw back” bonuses and proceeds of stock sales from an officer who was not accused of personally violating the securities laws. The SEC filed a stand-alone enforcement action against the CEO of CSK Auto Corporation, alleging only that he had earned (and failed to reimburse the company for) $4 million in bonuses and stock sale profits while the company was engaged in an accounting fraud that had resulted in a financial restatement. The CEO moved to dismiss, but the district court denied the motion, finding that section 304 does not require personal misconduct by the defendant. Later courts similarly endorsed this interpretation of section 304 and upheld the SEC’s ability to bring stand-alone clawback actions. Since CSK, the SEC has increasingly brought settled proceedings against

63. SEC v. Jenkins, 718 F. Supp. 2d 1070, 1074 (D. Ariz. 2010) (“the text and structure of Section 304 require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer’s CEO or CFO”).
64. See SEC v. Baker, 2012 WL 5499497, at *6 (W.D. Tex. Nov. 13, 2012) (“The absence of any requirement of personal misconduct . . . ensures corporate officers cannot simply keep their own hands clean, but must instead be vigilant in ensuring there are adequate controls to prevent misdeeds by underlings.”); SEC v. Microtune, Inc., 783 F. Supp. 2d 867, 886 (N.D. Tex. 2011) (“Section 304 contains no personal wrongdoing element, in contrast to disgorgement, that would require scienter or misconduct on behalf of the officers in order to trigger reimbursement”).
corporate executives solely under section 304 without alleging any personal wrongdoing.\(^{65}\)

A second provision of the Sarbanes-Oxley Act similarly expanded the ability of the SEC to limit the ability of executives to profit from alleged financial misconduct. Section 1103 of the Sarbanes-Oxley Act authorizes the SEC to obtain an order temporarily freezing assets of an individual accused of a securities law violation where it is “likely” that the issuer will make “extraordinary payments” to an officer suspected of violating the federal securities laws. The freeze order can extend to payments in the form of compensation “or otherwise,” and requires the issuer to escrow such funds for a period of up to forty-five days, presumably to permit the SEC to then seek additional relief to prohibit the movement of funds. However, this statute has been only rarely invoked by the agency.\(^{66}\)

[C] Ancillary Relief

[C][1] Officer and Director Bar

The Remedies Act expressly authorized the SEC to obtain an order from a district court prohibiting an individual from serving in the future as an officer or director of a public company. Such orders could be obtained where the SEC charged the individual with scienter-based fraud (that is, section 10(b) of the Exchange Act or section 17(a)(1) of the Securities Act), and where the SEC made a showing that the defendant was “substantially unfit” to serve as an officer or director.\(^{67}\) While the courts had the ability to impose this relief under their general equitable powers even before 1990, the remedy had been sought relatively infrequently until recent years.\(^{68}\)

In 2002, the Sarbanes-Oxley Act reduced the threshold for the imposition of a bar, substituting the less rigorous standard of

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66. See SEC v. Gemstar-TV Guide Int’l, Inc., 401 F.3d 1031, 1045 [9th Cir. 2005] (defining “extraordinary payments” as a “payment that would not typically be made by a company in its customary course of business” and stating the “nexus between the suspected wrongdoing and the payment itself may further demonstrate that the payment is extraordinary, although such a connection is not required”).

67. See Remedies Act § 201[2].

mere “unfitness” (rather than “substantial unfitness”). In 2013, the Second Circuit in SEC v. Bankosky held that the legislative history of section 305(a) “demonstrates that Congress’s intent was to lower the threshold of misconduct for which courts may impose director and officer bans,” referencing the 2002 Senate Report that stated that the “substantial unfitness’ standard . . . [was] inordinately high, causing courts to refrain from imposing bars even in cases of egregious misconduct.”

The SEC has the ability to seek either a permanent or a time-limited bar. In settled cases, the SEC staff will frequently be willing to negotiate a five-year or ten-year bar (or occasionally less), depending on the egregiousness of the allegations and the risks of litigating the case to trial.

[C][2] Corporate Governance Changes

On occasion, the SEC will seek an order requiring a structural change in a business, such as the adoption of internal controls, the establishment of an audit committee or other committees, or, in extreme cases, the appointment of a receiver to take control of the enterprise. In actions brought under the FCPA alleging improper payments to foreign officials, it is not unusual for the SEC’s settlement with the company—like the parallel DOJ agreement—to require that extensive compliance procedures be implemented.

§ 15:3.3 Administrative Remedies

[A] Cease-and-Desist Proceedings

Before 1990, the SEC had relatively little jurisdiction in administrative proceedings over public companies and their officers. Such actions were generally limited to charges against financial services providers regulated by the SEC—investment advisers, broker-dealers, and mutual funds, among others.


69. Sarbanes-Oxley Act § 305.
70. SEC v. Bankosky, 716 F.3d 45, 48 (2d Cir. 2013) (but continuing to apply same factors for assessing “unfitness” as the courts had applied before Sarbanes-Oxley).
In 1990, as part of the Remedies Act, Congress gave the SEC the authority to seek cease-and-desist orders against public companies and their officers. The Remedies Act authorized the SEC to issue its own orders against persons who have directly violated the securities laws or who are found to be “a cause” of another person’s violation. For example, a cease-and-desist order may compel an issuer to maintain its books and records in accordance with the federal securities laws and forbid the CFO from being a “cause” of the issuer’s violation.

Since 1990, hundreds of cease-and-desist orders have been issued. The SEC contends that it may obtain an order upon a lesser showing than a “reasonable likelihood of future violation” as is required for civil injunctions. In *KPMG, LLP v. SEC*, the District of Columbia Circuit held that the SEC could use a negligence standard as the basis for issuing a cease-and-desist order.72

Cease-and-desist proceedings are tried before an administrative law judge, a full-time Commission employee, with a right of appeal to the Commission and from there to a U.S. court of appeals. There is no right to a jury, very limited (if any) discovery, and limited applicability of the rules of evidence.73 Moreover, in contrast to a federal court action, which can take several years to reach a trial, an administrative law judge is required to issue his or her initial decision, following a hearing, no more than 120, 210, or 300 days from the date the initial order instituting the proceedings was served (depending on the complexity of the case).74

Notably, while the SEC could obtain disgorgement in a cease-and-desist proceeding, the Remedies Act did not provide for the recovery of penalties (except against regulated persons) or the issuance of officer and director bars. As a result, for many years most cases brought against public companies and their executives continued to be filed primarily in federal court. In contrast, the SEC has long been able to obtain penalties and bars in administrative proceedings against regulated persons and entities, and thus until recently most administrative actions filed by the SEC involved investment advisers and brokers.

Subsequent legal developments have expanded the ability of the SEC to obtain additional remedies in administrative cease-and-desist proceedings. The Sarbanes-Oxley Act authorized the SEC to obtain officer and director bars administratively. And Dodd-Frank authorized the SEC to seek civil monetary penalties ranging from $7,500 to $150,000 for individuals, and $75,000 to $725,000 for companies and other entities.75

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74. *Id.* at Rule 360.
75. Dodd-Frank § 929P.
In light of a respondent’s dramatically curtailed procedural rights in administrative proceedings, the more widespread use of administrative proceedings poses challenges for corporate actors. In a recent case arising out of the sweeping Galleon hedge fund insider trading investigation, discussed below, a respondent in an SEC cease-and-desist proceeding filed a request for an injunction in the Southern District of New York, arguing that the SEC had unfavorably singled him out for an administrative proceeding without discovery or a jury, compared to all the other Galleon-related defendants whose cases were filed in district court, in violation of his equal protection rights. He also argued in part that the SEC could not use an administrative proceeding to seek civil penalties for conduct that occurred prior to Dodd-Frank granting the SEC the power to impose such penalties. The SEC challenged jurisdiction and argued that the claims were not ripe for review. Presiding over the suit, Judge Rakoff found that, with the passage of Dodd-Frank, the law now provides the SEC with more flexibility in its choice of forum and the ability to seek civil monetary penalties in administrative proceedings against all individuals, not just registered persons.76 However, Judge Rakoff ruled that the defendant could proceed with his equal protection claim against the Commission under the relatively unique circumstances presented.77 The SEC elected to dismiss the administrative proceeding, thus averting full discovery on the issue and litigation on the merits of the respondent’s equal protection claim.

[B] Professional Discipline

In addition to injunctive actions and administrative proceedings seeking a cease-and-desist order, the SEC may also take action against professionals. These actions traditionally have arisen under Rule 102(e) of the SEC’s Rules of Practice, which permits the Commission to limit the ability of a professional who has engaged in improper professional conduct or who has violated the federal securities laws to practice and appear before the Commission. Rule 102(e) proceedings are brought before an administrative law judge. Section 602 of the Sarbanes-Oxley Act amendments to the Exchange Act codified Rule 102(e) of the SEC’s Rules of Practice.78

Rule 102(e) proceedings clearly extend to outside professionals, such as accountants and lawyers. Rule 102(e) proceedings in this context commonly consider whether previously issued financial statements were audited in accordance with generally accepted auditing standards or whether professionals, such as lawyers, violated the

77. Id.
federal securities laws in connection with the preparation of prospectuses, registration statements, or other disclosure documents. The Commission takes the position that practice before the Commission includes advice by a lawyer on the application of the federal securities laws.

The Commission also has taken the position that Rule 102(e) extends to management professionals within a corporation, such as chief financial officers, controllers, and in-house counsel. Thus, an order prohibiting a professional from practicing and appearing before the SEC may preclude a professional from assisting in the preparation of financial statements to be filed with the SEC, even if the professional is not associated with an outside firm.

The Sarbanes-Oxley Act added provisions specifically regulating the practice of attorneys before the Commission. In section 307, Congress reacted to the widespread perception that in scandals such as Enron and WorldCom, lawyers had failed in their role as gatekeepers and otherwise permitted unlawful conduct to take place.79 Accordingly, Congress imposed a “reporting up” provision, requiring that if a lawyer becomes aware of evidence of a “material violation of securities law, or breach of fiduciary duty or similar violation,” the lawyer must report it to the chief legal officer or chief executive officer. Second, if the lawyer is not satisfied that an appropriate response to the evidence has been made, the lawyer must escalate his or her concerns to the audit committee or other committee of the board. In 2003, the Commission adopted detailed rules implementing section 307.80 The SEC’s rules under section 307 empower the SEC to bar an attorney from practicing before the Commission in the event of a section 307 violation.81

§ 15:3.4 The Role of Cooperation

[A] The Seaboard Report

In the past decade, the SEC has become increasingly vocal about the role of cooperation in deciding the severity of punishment it will seek against a corporation whose employees are believed to have been involved in violations of the federal securities laws. The trend began in 2001 with the so-called Seaboard Report,82 in which the SEC laid

80. 17 C.F.R. § 205 et seq.
out the factors that are considered in determining whether a company should receive credit for good cooperation. The release stressed four key concepts—self-policing, self-reporting, cooperation with law enforcement authorities, and remediation—and listed a detailed set of factors the SEC may consider when bringing an enforcement action. The Seaboard factors continue to be assessed in the SEC’s charging decisions and are incorporated in the SEC Enforcement Manual. 83

The Seaboard Report concerned credit for cooperation by corporations, not individuals. In January 2010, the Enforcement Division amended its Enforcement Manual to add new provisions designed to foster cooperation by individuals. The new provisions offer guidance for evaluating an individual’s cooperation and authorize new cooperation tools, including cooperation agreements, deferred prosecution agreements, and non-prosecution agreements. 84

In evaluating an individual’s cooperation, the Enforcement Division will consider:

(a) assistance provided by the individual;
(b) importance of the underlying matter;
(c) interest in holding the individual accountable; and
(d) profile of the individual.

The standards track the typical DOJ considerations for evaluating cooperation.

Once the Enforcement Division determines that an individual should be given credit for cooperation, the Enforcement Manual provides the Division and the Commission with a nonexclusive list of tools to encourage and facilitate such cooperation.

(1) Cooperation agreements. The Enforcement Division may agree to recommend to the Commission that the individual or company receives credit for giving substantial assistance. The Enforcement Division may also make specific enforcement recommendations to the Commission where appropriate. In return, the individual or company agrees, among other things, to cooperate fully and truthfully, and waive applicable statutes of limitations.

(2) Deferred prosecution agreements. The Commission may forgo an enforcement action against an individual if the individual agrees to cooperate fully and truthfully, to waive applicable

83. SEC ENFORCEMENT MANUAL § 6.1.2.
84. Id. § 6.
statutes of limitations, to comply with prohibitions and undertakings, to pay any agreed disgorgement or penalty amounts, and to admit or agree not to contest the relevant facts underlying the alleged offenses. Deferred prosecution agreements are for a set amount of time that cannot exceed five years, after which the Commission may agree not to pursue any further enforcement action if the individual adheres to the terms of the agreement.

(3) Non-prosecution agreements. The Commission may agree not to pursue an enforcement action if the individual agrees to cooperate fully and truthfully, comply with express undertakings, and pay any agreed disgorgement or penalty amounts. The guidelines make clear that these should generally be used in limited circumstances and that other forms of obtaining cooperation should be considered first.

(4) Expedited immunity requests. The Director of Enforcement may now submit expedited immunity requests to the DOJ in to provide a cooperator with protection against criminal prosecution. Approval of the Commission is no longer required for such requests.

(5) Proffer agreements. Statements made by an individual in an investigation may not be used against that individual in subsequent proceedings except as a source of investigative leads or for impeachment or rebuttal if the person testifies inconsistently in a subsequent proceeding.

(6) Oral assurances. Assistant directors may give assurances to individuals that based on currently available evidence the Enforcement Division does not currently anticipate recommending an enforcement action against an individual or a company.

In 2012, the SEC announced for the first time publicly that it credited the substantial cooperation of a former senior executive of an investment adviser by declining to take enforcement action against him. The executive’s cooperation assisted in the settled enforcement action against institutional money manager AXA Rosenberg, where, without admitting or denying wrongdoing, the firm agreed to pay $217 million

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to clients plus a $25 million penalty. The Commission issued a corresponding litigation release where it analyzed the former executive’s cooperation by applying it to the four factors outlined in the Commission’s Cooperation Policy Statement:

1. **Assistance provided.** The executive possessed intimate knowledge relating to the investment adviser and provided his assistance to the SEC without conditions, which bolstered his credibility.

2. **Importance of the underlying matter.** The SEC was able to return to clients their alleged losses, and AXA Rosenberg agreed to pay a penalty totaling $25 million.

3. **Interest in holding the senior executive accountable.** The cooperating executive played a limited role in the alleged conduct at issue, and his cooperation maximized the SEC’s law enforcement interests by efficiently and successfully resolving the issues against the firm.

4. **The executive’s profile.** The executive, who had no prior disciplinary history, was not an associated person of any regulated entity, a fiduciary for other individuals or entities regarding financial matters, or an officer or director of a public company.

In addition, in November 2013, the SEC announced it had entered a deferred prosecution agreement with a former hedge fund administrator whose “voluntary and significant cooperation” enabled the SEC to file an emergency enforcement action alleging that the fund’s founder and manager had misappropriated more than $1.5 million from the hedge fund and overstated its performance to investors. As a part of the deferred prosecution agreement, the individual defendant admitted that he aided and abetted violations of the securities laws and, as a result, he cannot serve as a fund administrator or associate with any broker, dealer, investment adviser, or registered investment

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company for a period of five years, and was forced to disgorge approximately $50,000 in fees that he received for serving as the fund administrator.

With respect to corporations, the SEC has made public use of two of its new cooperation tools. In 2010, the SEC entered into its first non-prosecution agreement. In resolving the alleged accounting fraud, the corporate defendant did not have to pay a monetary penalty, but agreed to cooperate in the SEC’s investigation for an unlimited period of time and to forgo raising a statute-of-limitations defense if it were to violate the agreement. In 2011, the SEC entered into its first deferred prosecution agreement. To resolve alleged FCPA violations, the agreement required the corporate defendant to pay disgorgement and to toll the statute of limitations during the three-year agreement period.

While there have been a few examples of enforcement actions in which cooperation agreements were credited by the SEC, it still remains to be seen whether these initiatives will result in a significant increase in cooperators coming forward and assisting the agency.

[B] Privilege Waivers As an Element of Cooperation

While the Enforcement Manual generally defines cooperation as “providing the Commission staff with all the information relevant to underlying violations and the company’s remedial efforts,” the Seaboard Report itself specifically referenced the fact that the company provided to the SEC staff “notes and transcripts of interviews” and “did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.” In light of the Seaboard Report and subsequent


90. As another example, in April 2013, the SEC announced a non-prosecution agreement with Ralph Lauren after it agreed to disgorge some $700,000 obtained through alleged bribes to Argentine officials. The SEC decided not to charge the company with FCPA violations “due to the company’s prompt reporting of the violations on its own initiative, the completeness of the information it provided, and its extensive, thorough, and real-time cooperation with the SEC’s investigation [including flying in witness and translating and summarizing documents].” See Press Release No. 2013-65, U.S. Sec. & Exch. Comm’n, SEC Announces Non-Prosecution Agreement with Ralph Lauren Corporation Involving FCPA Misconduct [Apr. 22, 2013], available at www.sec.gov/news/press/2013/2013-65.htm.


92. See SEC ENFORCEMENT MANUAL § 6.1.2.

93. See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of
SEC enforcement actions in which large penalties have been imposed for alleged non-cooperation, a particular concern has arisen over the question of whether companies must waive their attorney-client privileges in order to garner greater credit for cooperation. Some companies and commentators have raised concerns that a new “culture of waiver” had arisen that threatened the very fabric of the attorney-client privilege. Moreover, companies that waived their privileges in connection with an SEC investigation have been exposed to the additional risk that such privileges also were deemed waived in connection with any parallel private class action litigation. Indeed, in a number of prominent cases, district courts ordered companies to produce otherwise privileged documents to the civil class action plaintiffs’ lawyers, based upon the fact that the companies previously had produced those same documents to the SEC or other government agencies.  

Responding to these concerns, the Enforcement Manual provides that the staff should not ask a party to waive the attorney-client or work-product privilege, and it is not directed to do so. The manual further provides that voluntary disclosure need not include a waiver of privilege to be an effective form of cooperation, as long as all relevant facts are disclosed.  

The DOJ encountered similar criticism for its own cooperation policies, and its most recent policy memo on the topic, known as the “Filip Memorandum,” made clear that credit for cooperation in a criminal investigation cannot be tied to an agreement by the company to waive attorney-client or work-product protections. Rather, credit for cooperation will be based on disclosure of relevant facts not necessarily embodied in privileged communications.  

Notwithstanding the official SEC and DOJ policies, public companies continue to be placed in the difficult position of determining how much information they can share with the authorities without being deemed to have waived applicable privileges in a parallel private lawsuit.

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94. See In re Qwest Sec. Litig., 450 F.3d 1179 (10th Cir.), cert. denied, 549 U.S. 1031 (2006).
95. See SEC ENFORCEMENT MANUAL § 4.3.
96. Id.
§ 15:3.5 **Parallel Criminal Cases**

The SEC does not have independent authority to prosecute criminal cases. However, any willful violation of the federal securities laws can be prosecuted as a crime. Thus, the SEC maintains a close working relationship with federal prosecutors and frequently refers more egregious violations of the federal securities laws to them. According to the SEC, in fiscal year 2013 prosecutors filed 126 indictments, informations, or contempts relating to SEC actions.98

[A] **Common Grounds for Prosecution**

In recent years, federal criminal authorities have been most visibly active in insider trading matters. Particularly newsworthy were multiple civil and criminal cases filed involving the improper sharing of information among corporate employees and executives, hedge funds, and “expert networks.” Criminal authorities also frequently prosecute matters involving financial reporting by public companies, FCPA violations, and Ponzi schemes.

In addition to securities law violations, prosecutors frequently will charge the following:

1. mail and wire fraud;
2. money laundering; and
3. RICO violations.

In addition to investigating and prosecuting the underlying securities law violations, the criminal authorities frequently pursue claims that a witness interfered with the SEC investigation by falsifying or destroying evidence or providing false testimony to the SEC staff, invoking either 18 U.S.C. § 1505 (obstruction of agency proceedings) or 18 U.S.C. § 1001 (making false statements to the government). As a civil agency, the SEC itself does not have authority to file charges under these statutes, and thus relies on criminal referrals to protect its processes. Notably, it is often easier for the prosecutors to prove obstruction than it is to prove the underlying securities fraud, and thus an SEC enforcement action may sometimes be accompanied by a stand-alone criminal obstruction case.

The Sarbanes-Oxley Act added a number of new sanctions to the criminal enforcement arsenal, including:

* section 802, prohibiting the alteration or destruction of documents in connection with a federal investigation, and
* section 1102, prohibiting such conduct in connection with

any “official proceeding”—both statutes authorize fines and prison terms of up to twenty years;

• section 807, authorizing a prison term of up to twenty-five years for criminal securities fraud;

• section 902, expanding the criminal remedies for persons found guilty of an “attempt” to commit a securities law violation, and now subjecting persons guilty of an “attempt” to the same penalties as those prescribed for the offense that was the object of the attempt;

• sections 903 and 904, authorizing greater prison time—twenty years instead of five—for acts of mail fraud and wire fraud, and increasing the fines for violations of the Employee Retirement Income Security Act (ERISA);

• section 906(c), authorizing fines and prison terms for the filing of false certifications by the company’s CEO and CFO that the company’s financial statements are sound—fines for “willfully” false certifications may be as high as $5 million, and the prison term as high as twenty years;

• section 1106, amending the criminal sanctions under section 32(a) of the Exchange Act, increasing the fines from $1 million to $5 million, and increasing the prison time from ten years to twenty years.

[B] Cooperation Between SEC and DOJ

The SEC and DOJ (including local U.S. attorneys’ offices) frequently conduct parallel investigations. In some cases, the investigations may be closely (and visibly) aligned, with SEC staff attorneys, FBI agents, and assistant U.S. attorneys conducting joint proffers with witnesses. In others, the criminal investigators may play a more passive role, waiting for the SEC investigation to become sufficiently advanced before the criminal authorities determine whether the case warrants criminal investigation and prosecution.

For the most part, the federal securities laws permit the SEC to share virtually all information gathered during its investigation, including documents and testimony transcripts, with other government agencies. The SEC’s Form 1662, a disclosure form shared with all witnesses asked to provide documents or testimony to the staff, expressly advises witnesses of the SEC’s “Routine Uses of Information,” including the potential sharing with criminal authorities. That said, the SEC staff will not generally advise witnesses whether there is a related criminal investigation beyond this general disclosure, though
in some instances, depending on the criminal prosecutor involved, more information may be shared.

In contrast, the criminal authorities are not as free to share information with the SEC. Documents and information obtained through grand jury subpoenas are subject to strict privacy requirements and, with some exceptions, may not be shared with the SEC. Information obtained outside of the grand jury—such as through the execution of a search warrant or an FBI interview—is not subject to grand jury secrecy, however. In light of these limitations, the SEC will often take the lead in developing evidence where parallel investigations are underway.

Coordinated law enforcement efforts have not gone unchallenged. In United States v. Stringer, the defendant in a financial reporting case argued that his due process rights were violated because the SEC did not expressly warn him that the agency was sharing information with the FBI and U.S. attorney’s office.⁹⁹ The district court agreed and, in a stinging rebuke of the government, held that dismissal of the indictment was warranted because the government misconduct was “shocking” and “egregious.”¹⁰⁰ The Ninth Circuit ultimately reversed, holding that the Form 1662 had put the defendant on sufficient notice that information he had provided could be shared with the criminal authorities.¹⁰¹ Though ultimately affirming the ability of the SEC and DOJ to conduct parallel investigations, the case did serve as a wake-up call to potential pitfalls for the government when conducting parallel investigations.¹⁰²

The SEC Enforcement Manual provides direct guidance to the staff in the area of parallel proceedings that largely follows the prescription for proper coordinated law enforcement investigations set forth by the courts. First, the manual provides that a civil investigation should have “its own independent civil investigative purpose” and should not be initiated solely for the benefit of or to obtain evidence for a criminal investigation. Second, the staff should make its own independent decisions regarding investigative strategy, such as what documents to request, what testimony to take, what questions to ask, and where testimony should be taken. Third, if asked by individuals or their counsel whether there is a parallel criminal investigation, the manual advises the staff to direct the individual or their counsel to a section in SEC Form 1662 that provides that the “Commission often makes its

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¹⁰⁰. Id. at 1089.
¹⁰¹. United States v. Stringer, 535 F.3d 929 (9th Cir. 2008).
¹⁰². See also United States v. Scrushy, 366 F. Supp. 2d 1134, 1139 (N.D. Ala. 2005) (in criminal securities fraud case, suppressing SEC testimony and dismissing related charges where SEC agreed to DOJ request to move location of testimony to ensure jurisdiction over potential perjury charge).
files available to other government agencies, particularly the United States Attorneys and state prosecutors. Fourth, the staff is directed to have supervisors involved “in all significant discussions and written communications with criminal authorities.” In addition, the manual provides that sharing information with criminal prosecutors is generally permissible to assist a criminal prosecution, and in certain circumstances, it is permissible for the staff and criminal prosecutors to advise each other to refrain from taking certain actions that may harm their respective investigations.103

§ 15:4 Insider Trading Cases

Though insider trading has been a fairly consistent component of the SEC’s enforcement program, typically accounting for about 8–10% of the agency’s annual case filings,104 recent years have seen these actions growing in both size and public prominence. For the three-year period ending in 2013, the SEC reported filing 159 insider trading actions against several hundred individuals and entities with illicit profits or losses avoided totaling several hundred million dollars.105 In recognition of this trend (and partly responsible for furthering it), the Market Abuse Unit created in 2010 had as one of its objectives the targeting of large-scale insider trading matters. The DOJ has similarly ramped up its criminal prosecutions of insider trading schemes.

The coordinated focus of the SEC and DOJ on large-scale insider trading cases achieved significant national attention in 2009, with the initiation of a series of cases centered on trading by hedge fund manager Raj Rajaratnam and his firm Galleon Management.106 The criminal case culminated in May 2011 when Rajaratnam was found guilty of all fourteen conspiracy and securities fraud charges brought against him.107 The criminal interest in the scheme was perhaps most noteworthy because it involved the government’s use of wiretaps to collect evidence, a tool not part of the SEC’s arsenal. In subsequent court rulings, the U.S. Court of Appeals for the Second Circuit upheld

103. SEC ENFORCEMENT MANUAL § 5.2.1.
the criminal prosecutors’ use of wiretaps, as well as the SEC’s ability to get access to the wiretaps from the defendant.

Over the past few years, the SEC has continued to file enforcement actions alleging large and highly lucrative insider schemes, including cases involving “expert networks” providing confidential information about clinical trials to hedge funds; cases alleging trading rings centered around investment bankers; and cases alleging long-running insider trading schemes involving corporate attorneys and Wall Street traders.

§ 15:4.1 “Classical Theory” of Insider Trading

Insider trading is prohibited by SEC Rules 10b-5 and 14e-3. Rule 10b-5, promulgated under section 10(b) of the Exchange Act, provides that

[i]t shall be unlawful for any person . . . [t]o employ any device, scheme, or artifice to defraud [or] . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

Rule 14e-3 prohibits similar activities in connection with a tender offer.

Insider trading liability under Rule 10b-5 originally required a fiduciary relationship between the insider and the person with whom the insider traded. This is because the fraud occurs not by virtue of the possession of material, nonpublic information alone, but rather by the trader’s failure to disclose such information where the

109. SEC v. Rajaratnam, 622 F.3d 159 (2d Cir. 2010). The court found, however, that the district court failed to properly balance the SEC’s right of access to the materials with the defendant’s privacy interests. Following remand, the lower court found the SEC’s right to the wiretaps to outweigh the defendant’s privacy interests and ordered the wiretaps to be produced. SEC v. Galleon Mgmt., LP, 274 F.R.D. 120 (S.D.N.Y. 2011).
trader has a duty to do so. Typically, a trader has no duty to disclose the information upon which he or she bases his or her stock transactions, and it is expected that investors trade on the basis of unequal (although equally available) information.

Instead, under the “classical theory” of insider trading, only certain persons—corporate executives and directors, as well as other persons associated with the corporation who have access to material, non-public information, such as certain key employees and the corporation’s accountants, lawyers, and investment bankers (and individuals who obtain information from any of these persons)—can be held liable for insider trading. It is the relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their relation to that corporation (or to a person who has such a relation) that gives rise to the duty to disclose the confidential information at the time of the trade or to abstain from trading. In short, the classical theory of insider trading holds that a corporate insider should not use corporate information to take unfair advantage of the corporation’s own shareholders in the securities markets.

§ 15:4.2 “Misappropriation Theory” of Insider Trading

In 1997, the U.S. Supreme Court, in United States v. O’Hagan, adopted the “misappropriation theory” of insider trading.113 Although the misappropriation theory had been adopted by five of the twelve U.S. courts of appeals, its validity had come into doubt because two other courts of appeals—the Fourth and the Eighth Circuits—had rejected misappropriation of material nonpublic information as a basis for insider trading liability.

In contrast to the classical theory of insider trading, the misappropriation theory holds that a person commits fraud “in connection with” a securities transaction for purposes of Rule 10b-5 when he misappropriates and trades on the basis of confidential information in a breach of a duty owed to the source of the information. As stated by the Supreme Court, “[i]n lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company’s stock, the misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”114 Thus, according to the Supreme Court, “[t]he two theories are complimentary” in that the original theory “targets a corporate insider’s breach of duty to shareholders with whom the insider transacts,” and the misappropriation theory “outlaws trading on the basis of nonpublic information by a

114. Id. at 652.
corporate ‘outsider’ in breach of a duty owed not to a trading party, but
to the source of the information.”

In practice, the O’Hagan case is used in training and educating
company employees not to divulge sensitive information to third
parties. Corporate compliance policies also should be clear that
employees are prohibited from trading on the basis of material,
nonpublic information obtained in the course of their duties as
employees, including information concerning companies with which
the employer conducts business or from which the company otherwise
receives confidential information.

One district court case has moved in the direction of limiting the
reach of the misappropriation theory of insider training, although it
was overruled on appeal. In July 2009, the district court granted a
defendant’s motion to dismiss allegations of insider trading on the
grounds that, absent a fiduciary relationship, an agreement to keep
information confidential did not itself create an obligation not to trade
based upon that information. In the case, the SEC’s complaint alleged
that the CEO of a corporation reached a verbal agreement with the
defendant that the defendant would keep the divulged information
confidential. The defendant thereafter used the information to sell his
stock in advance of the public announcement of the information. On
appeal, the Fifth Circuit held that the district court erred in that the
pledged misappropriation theory was sufficient to survive the motion
to dismiss and reinstated the charges against defendant.

Conversely, a recent Second Circuit case appears to have expanded
the reach of the misappropriation theory. In SEC v. Obus, the court
held that actual knowledge of the fiduciary breach is not required and
that tippee liability may be established where the tippee knew or
should have known that the information was improperly disclosed.

While the Circuit Courts appear willing to grant the SEC a wide
degree of latitude in prosecuting the misappropriation theory, this
attitude has not been shared by juries. In each of the above cases, the
Circuit Court’s ruling resulted in the case going to trial, and in both
instances the defendants were found not liable.

§ 15:4.3 “Use” Versus “Possession”

For many years, debate raged over whether an insider trading claim
could be based upon the fact that a person merely was in possession of
material nonpublic information at the time of a trade, regardless of
whether the person actually used such information as the basis for the

115. Id. at 652–53.
116. See SEC v. Cuban, 634 F. Supp. 2d 713 [N.D. Tex. 2009], vacated and
    remanded, 620 F.3d 551 [5th Cir. 2010].
117. SEC v. Obus, 693 F.3d 276 [2d Cir. 2012].
decision to trade. To provide the Enforcement Division with a more liberal standard upon which to base future insider trading cases, the SEC promulgated SEC Rule 10b5-1, which expressly states that a person trades “on the basis of” material nonpublic information when the person “was aware of” the material nonpublic information when the person made the purchase or sale. In other words, mere possession of the information—not just use of the information—suffices. The same rule, however, permits individuals to create so-called 10b5-1 plans that allow the person to buy or sell on a pre-established basis, pursuant to a written plan for the trading of such securities. The contract instruction or plan must specify the amount of securities to be sold, the formula for any such sales, or other indicia that the person has been divested of discretion to exercise any subsequent influence over how, when, or whether any securities were to be purchased or sold.

§ 15:5 Role of Directors

Outside directors have a critical role to play in preventing the adverse events that may lead to SEC investigations, mitigating the effects of any wrongdoing, and managing a company’s response to an SEC investigation to prevent it from going out of control. Plainly, outside directors cannot and should not try to micromanage an enterprise. On the other hand, by setting standards for corporate behavior, they may help a corporation prevent or ameliorate the effects of a government investigation. Several beneficial measures are discussed below.

§ 15:5.1 Corporate Codes of Conduct and Compliance Policies

Many corporations now have codes of conduct and compliance policies and procedures that set forth legal and ethical standards for officers and employees. Codes of conduct establish the corporation’s values and put employees on notice of behavior that may result in termination of employment even prior to the commencement of regulatory action. Codes of conduct enable a corporation to demonstrate to the government that misconduct by an employee was contrary to the interest of the corporation and may also provide a basis for terminating an errant employee who refuses to cooperate with an internal investigation.

Similarly, properly done compliance policies should help to prevent violations. Even when they are not fully effective, compliance policies demonstrate the corporation’s good faith.
§ 15:5.2  Internal Controls

Probably the most effective measure to prevent employee or officer misconduct is the presence of strong internal accounting and operational controls. The spate of high-profile financial reporting cases brought by the SEC (and the DOJ) in the early 2000s, including Enron, WorldCom, Adelphia, and HealthSouth, have been attributed in part to the lack of strong internal controls. Thus, outside directors can play a critical role in reviewing existing controls and insisting that they be enhanced where appropriate.

§ 15:5.3  Dealing with Potential Illegal Acts

Section 10A of the Private Securities Litigation Reform Act of 1995 requires that the auditor of a company whose stock is registered pursuant to section 12 of the Exchange Act include in its annual audit, among other things, procedures regarding the detection of illegal acts. Where material illegal acts are detected, section 10A requires the auditor to report its finding directly to the SEC if the issuer fails to do so.

Nothing in PSLRA section 10A or the regulations promulgated pursuant to it requires a company’s management or audit committee to undertake any additional duties or responsibilities to implement section 10A’s fraud detection and disclosure standards. But the potential for an auditor’s whistleblowing to the SEC in connection with the reporting of suspected illegal acts should provide added incentive for the audit committee and the board to strengthen their oversight of the company’s compliance programs, and to take appropriate remedial steps when illegal acts are suspected. Indeed, section 10A requires the auditor to seek to have appropriate remedial measures taken by the audit committee and the board, and to report violations to the SEC only when the auditor is not satisfied with the remedial actions taken. As well, the audit committee may be called upon to engage in more extensive oversight depending on the existence of fraud “risk factors” as specified in Statement of Auditing Standards No. 82.

In light of these standards, and as a minimum step toward monitoring accounting controls, the audit committee should consider the following:

• Evaluate, in conjunction with management, each of the risk factors identified in SAS 82 in order to judge whether any particular risk factors, alone or in combination with others,

indicate that the company’s current environment may foster fraud. The audit committee should recommend that appropriate actions be taken to mitigate these perceived risks, and expand the scope of the internal audit function to better detect fraud.

- Familiarize itself with the audit procedures to be implemented by the outside auditors, and understand to what extent the outside auditors believe that material fraud risk factors exist within the company.

- Consider, or reconsider, how the audit committee monitors corporate activities and what company-wide information and reporting systems exist for the detection of fraud and illegal acts.

Moreover, where fraud or other illegal acts are suspected, the audit committee’s counsel could independently investigate the suspected wrongdoing and advise the committee as to its obligations.

§ 15:5.4 Supervising Internal Investigations and Corporation’s Response to the SEC

Outside directors also should play a useful role in supervising internal investigations of potential misconduct and overseeing a corporation’s response to the government. Supervision of an internal investigation is helpful because it provides the corporation and third parties the assurance that evaluations of employee conduct have been independently made by persons who do not have as vested an interest in the outcome as does management. This independence is essential if the investigation implicates senior management, or if the effects of the misconduct are so severe as to warrant changes in senior management. Independence is just as important even if management changes are not warranted, as the independent determination by outside directors provides managers with the assurance that they will continue to be supported by the board during the investigation and may also enable the corporation to remove a political cloud over the managers at an early stage.

The board also should monitor pending government inquiries. Wishful thinking is an all-too-common human trait; thus, management may not fully appreciate the significance of a government investigation. The independent assessment that a board can provide allows a corporation to take appropriate remedial measures before it is too late.
§ 15:5.5  Audit Committee Oversight

Partly due to the enhanced duties imposed on audit committees under the Sarbanes-Oxley Act, the SEC has focused particular attention in recent years on the oversight responsibilities of audit committees, and in some cases the Enforcement Division staff has targeted audit committee members. In March 2014, the SEC initiated a pair of enforcement actions against the respective audit committee chairs of two companies headquartered in the United States with operations in China. In each case, the SEC alleged that the audit committee chair had actual knowledge of unreported fraud.120

In the first of these cases, the SEC permanently barred the former audit committee chair from signing public filings. According to the SEC, the company’s CEO falsely represented in SEC filings that a person served as the company’s acting CFO who in fact never did. The SEC alleged that when the former audit committee chair learned of this accusation, she merely inquired of the CEO, was told the accusation was false, and “contacted no one else, including anyone at the company or the company’s external auditors, to investigate.” The SEC further alleged that after the CEO later admitted the fraud to the audit committee chair, she nonetheless signed a false Sarbanes-Oxley certification.

In the second matter, the SEC alleged that when pervasive fraud was brought to the attention of the audit committee chair, he ignored advice to conduct an independent investigation under the guidance of legal counsel, and instead merely directed members of management and a consulting firm to investigate, and then largely ignored the results of those investigations. According to the SEC, when presented with evidence that the company systematically had reported fictitious revenues, maintained a second set of books, and engaged in extensive cover-up efforts, the audit committee chair failed to disclose the information to the company’s outside auditor or outside disclosure counsel and “failed to conduct further meaningful inquiries into the fraud even as additional red flags arose.”

In an earlier case, the SEC had filed a complaint against three former independent directors and audit committee members of DHB Industries, Inc.121 According to the SEC, from 2003 to 2006 the


directors permitted the company to report misleading financials, allowed the CEO to divert $10 million from the company, and oversaw payment of the CEO’s personal expenses. The SEC alleged that the directors “willfully ignored significant red flags,” including material weakness letters from and resignation of outside auditors, concerns raised by the company’s comptroller, and the resignation of outside counsel. The SEC alleged that the directors were not independent due to their business and decades-long personal relationships with the CEO, but also “made little or no effort even to understand their Audit Committee responsibilities.”

Another example is a 2006 enforcement action against the former audit committee chair of Spiegel, Inc.,122 in which the SEC alleged the director, through his position as audit committee chair, recommended that the Spiegel board withhold filing the company’s financial statements until the auditor provided an unqualified opinion after the audit firm first threatened a “going concern” qualification.123

It is still relatively rare for the SEC to pursue claims against audit committee members for a breach of their duty of oversight. Nevertheless, audit committee members should be mindful that, unlike the private securities litigation arena, where there is no private right of action for “aiding and abetting,” the SEC has plenary powers to pursue enforcement actions against aiders and abettors, including audit committee members. Thus, audit committee members should be mindful that some of the same principles that apply to them under state law fiduciary duty standards may apply to them under the federal securities laws.

§ 15:6 Role of Counsel

In recent years, the SEC has frequently spoken of the role of counsel in preventing fraud and has identified in-house and outside counsel as among the most important “gatekeepers” who are expected to play a role in guarding against misconduct.

In years past, in-house counsel were rarely sued in enforcement actions. That has changed over the past decade, with an increasing number of enforcement actions naming attorneys as defendants or respondents. In bringing such actions, SEC officials have often taken pains to point out that it was focusing on attorneys who engaged in


improper conduct, not who merely gave bad advice to clients.\textsuperscript{124} Similarly, in an SEC opinion involving charges against a broker-dealer’s general counsel, the Commission referenced “the Commission's traditional reluctance to bring an administrative action against a lawyer for the negligent rendering of non-public advice to his or her own client.”\textsuperscript{125} This is not to say that the SEC has not brought cases that sound in negligence and may appear to blur the lines between advice and conduct.\textsuperscript{126} However, most enforcement actions seem to identify significant conduct by counsel that went beyond the rendering of legal advice.

For example, in the mid 2000s, the Enforcement Division brought a number of cases against in-house general counsel for their alleged roles in connection with the improper backdating of stock options, including actions against the in-house counsel of Symbol Technologies, Comverse Technology, Apple Computer, McAfee, Mercury Interactive, CNET, Monster Worldwide and Boston Communications, KLA-Tencor, and Juniper Networks.\textsuperscript{127} In several of these cases, the DOJ also brought parallel criminal actions. In general, these cases turned on specific allegations that the in-house lawyers were active participants in knowing misconduct and, in most cases, were alleged to have personally benefited from the alleged misconduct.

Similarly, the SEC has filed multiple actions against counsel based on their alleged involvement in penny stock schemes. For example, in 2007 the SEC filed suit against two attorneys, David Stocker and Phillip Offill, for their respective roles in a “pump and dump” scheme, whereby they facilitated the issuance of millions of shares of stock to companies they controlled, then transferred the shares back to the company principals, who in turn dumped them into the market.\textsuperscript{128} The DOJ filed criminal charges against the pair; Offill was sentenced


\textsuperscript{127} An extensive review of these cases is found in Dickey, \textit{Litigation Against Accountants and Lawyers: The Year of Living Dangerously} (West Legal Works 17th Annual Litigation and Resolution of Complex Class Actions Workshop, Nov. 1–2, 2007).

to eight years in prison after a jury trial, and Stocker was sentenced to thirty-three months in prison after pleading guilty.\textsuperscript{129}

SEC enforcement actions have also been based on attorney conduct during SEC proceedings. In 2008, the general counsel of the SEC instituted Rule 102(e) proceedings against Steven Altman, alleging that he had called counsel for the respondents in an SEC administrative proceeding and offered to have his client provide false testimony to the SEC in exchange for certain financial consideration.\textsuperscript{130} Following a hearing at which the administrative law judge found in favor of the SEC, the Commission issued an opinion ordering Altman permanently barred from appearing before the agency as an attorney.\textsuperscript{131}

Not all such SEC actions have been as successful for the agency. In a highly publicized case, the SEC brought charges against the general counsel of a registered brokerage firm, claiming that he failed reasonably to supervise an individual stock broker who allegedly manipulated a publicly traded stock and who also allegedly engaged in sales practice violations with respect to the accounts of several of his customers.\textsuperscript{132} After years of heavy litigation, Chief Administrative Law Judge Brenda J. Murray issued an opinion recommending dismissal of the case, concluding that the general counsel acted reasonably. The Division of Enforcement appealed. The Commission dismissed the proceeding on a 1-1 vote (with other commissioners recusing themselves from the decision), leaving unresolved the legal issues presented—namely, when, if ever, a general counsel is a supervisor, and what constitutes a reasonable response to indicia of misconduct.\textsuperscript{133} Nevertheless, the recent history of enforcement actions against in-house counsel provides a sober reminder that counsel may be subject to SEC scrutiny.

\textbf{§ 15:7 Role of Auditors}

The other significant “gatekeepers” about which the Enforcement Division has frequently spoken in recent years are the outside audit


firms for public registrants. Over the past decade, a number of enforcement actions have been brought against major accounting firms and individual audit partners. In recent years, the SEC stepped up its enforcement efforts against individual audit partners. In addition to cases brought by the Division of Enforcement, proceedings may also be initiated by the Public Company Accounting Oversight Board (PCAOB) pursuant to its own independent enforcement powers over audit firms and audit partners. In 2003, the PCAOB, established by Congress as part of the Sarbanes-Oxley Act, adopted rules that govern its investigations and adjudications, and since then the PCAOB has slowly built up its enforcement resources. Today, the PCAOB is fully staffed to conduct inspections of audit firms and, where appropriate, initiate disciplinary proceedings.

With the combined oversight of the SEC and the PCAOB, auditors are acutely aware of their roles and responsibilities as gatekeepers and of their obligation to discharge their duties as independent auditors with ever-increasing vigilance. Even before passage of the Sarbanes-Oxley Act, federal statutes imposed significant obligations on audit firms to take prompt remedial actions in the event of detection of illegal acts. For example, Exchange Act section 10A sets forth detailed statutory requirements auditors must follow in the event they detect an illegal act, including the ultimate obligation to report to the SEC if, after detection of such an illegal act, the company’s management or board of directors fails to take “timely and appropriate remedial actions with respect to the illegal act.” The obligation to report to the SEC provides a powerful inducement to public companies to respond promptly and substantively to the audit firm’s concerns during the course of an audit. In practice, the duty to report has resulted in significant cooperation between companies and auditors to address suspected wrongdoing in a prompt and decisive fashion.

The Sarbanes-Oxley Act further enhanced the standards applicable to audit firms in the performance of their audit duties, including new independence standards and new obligations imposed on public companies with regard to their financial statements, including the requirement that the chief executive officer and chief financial officer sign “certifications” of the financial statements, that the company certify as to the sufficiency of its internal controls, and that the company’s management avoid any improper influence on the conduct of the external audit. All of these provisions have caused audit firms to perform more rigorous annual audit and quarterly reviews, and management to implement more rigorous internal policies and practices associated with the preparation and disclosure of the company’s financial statements.
The auditor’s role continues to be critical to the effective implementation of all these systems. While the fair presentation of the company’s financial statements is the responsibility of management, auditors nevertheless have generally taken proactive steps in recent years in at least the following areas:

- ensuring their own independence, consistent with independence standards promulgated by the FASB, the PCAOB, and other standards-setting organizations;
- designing audit procedures that are reasonably likely to detect fraud;
- evaluating the company’s business risks, credit risks, and financial statement risks, and incorporating those risks into the development of the audit plan;
- regularly and effectively communicating with the audit committee; and
- evaluating the integrity of management and the effectiveness of the company’s system of internal controls.

These and other steps have become “best practice” for most public company audits and are key areas that the SEC Enforcement Division staff will focus on in the event that it decides to investigate a possible fraud. The SEC will expect to find documentation showing that the audit firm carefully designed its audit and that, if a fraud occurred, it was not for lack of audit procedures that were reasonably designed to detect fraud. In that respect, and in light of the major financial frauds of the last decade, more is expected of audit firms by the SEC than ever before.134

One of the larger emerging issues facing auditors and the SEC relates to the discoverability of work papers from foreign accounting firms performing audits of companies trading in the U.S. markets. With the increased globalization of U.S.-listed companies, conflicts have arisen between the SEC’s requests for offshore audit work and limitations on the ability of these firms to produce the materials under the law of the foreign jurisdiction. Section 106 of the Sarbanes-Oxley

134. Partly as a result of the heightened level of SEC enforcement activity, and also the sheer magnitude of the damages exposures represented by parallel private civil actions against accounting firms, the risk of catastrophic loss to the remaining “Big Four” accounting firms has led to a number of recent proposals to reform the liability standards applicable to auditors. For a discussion of recent reform proposals, see Jonathan Dickey, Aric Wu & Ross Wallin, 2008 Securities Litigation Reform Forecast: Cloudy, Chance of Rain, 5 SEC. LITIG. REP. 2 (Feb. 2008).
Act expressly requires foreign firms issuing opinions relied upon by domestic firms registered with the PCAOB to produce work papers to the SEC or PCAOB. This statute was put to the test in a series of recent actions by the SEC. In May 2012, the SEC filed administrative proceedings against Deloitte’s Shanghai affiliate for failure to comply with section 106. This action remains pending.

In late 2012, the SEC filed administrative proceedings against foreign affiliates of five accounting firms (including all of the “Big Four”) for their failure to produce documents prepared in connection with their audits of ten China-based companies. In January 2014, Administrative Law Judge Cameron Elliot issued an initial decision barring each Big Four affiliate from SEC practice for six months, finding that the firms had “willfully refused to comply” with section 106 because they had “chose[n] not to comply with at least one Sarbanes-Oxley 106 request after receiving at least constructive notice of it.” Notably, the ALJ found the firms’ argument that they “were ready, willing, and able to produce documents, but were unable to do so because Chinese law prevented it” was irrelevant to determining liability under section 106’s “willful refusal” standard, and that a “willful refusal” under section 106 does not require conscious wrongdoing or a lack of good faith, as the firms argued. The ALJ did note that the firms “did not act with scienter”—they “obviously had no intent to defraud, nor were they reckless”—that is, their conduct was not “an ‘extreme departure’ from the standards of care.”

The auditing firms appealed the decision to the Commission in February 2014, where it remains pending. Sanctions will not take effect during the pendency of any appeals.

§ 15:8 The Janus Decision

The Supreme Court in Janus Capital Group, Inc. v. First Derivative Traders held that an individual or corporation cannot be held primarily liable under Rule 10b-5 for “making” a false or misleading statement


unless the person or corporation had “ultimate authority over the statement, including its content and whether and how to communicate it.”\textsuperscript{138} “One who prepares or publishes a statement on behalf of another,” wrote Justice Thomas, “is not its maker. . . . Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it.”\textsuperscript{139}

\textit{Janus} only explicitly purported to limit private causes of action and did not appear necessarily to limit actions brought by the SEC. At least one court has suggested that \textit{Janus} is not applicable to SEC enforcement actions.\textsuperscript{140} Yet the majority of courts, often without much discussion, apply \textit{Janus} to SEC actions.\textsuperscript{141} The SEC itself apparently concedes that its suits under Rule 10b-5(b) are governed by \textit{Janus}.\textsuperscript{142} Other courts consider the question open.\textsuperscript{143}

The trend seems to be toward a rule that \textit{Janus} applies to SEC actions under Rule 10b-5(b), but not (as some defendants claim) to SEC actions under Rules 10b-5(a) and (c), which do not require a defendant to “make” any untrue statement.\textsuperscript{144} Nor does \textit{Janus} appear to apply to SEC actions under section 17(a), the 1933 Act’s antifraud provision, which does not provide a private cause of action.\textsuperscript{145}

\begin{itemize}
\item \textsuperscript{138} Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011).
\item \textsuperscript{139} Id.
\item \textsuperscript{140} SEC v. Pentagon Capital Mgmt. PLC, 844 F. Supp. 2d 377, 421–22 [S.D.N.Y. 2012], as amended [Aug. 22, 2012] (stating that the Supreme Court limited its holding in \textit{Janus} to “accord [ ] with the narrow scope” of Rule 10b-5 as applied to private plaintiffs in contrast with the Commission, and that “[t]here is no indication that the Court or Congress intended for actions brought by the SEC to be so limited”) (internal quotations omitted).
\item \textsuperscript{142} See, e.g., SEC v. Brown, 878 F. Supp. 2d 109, 121–22 [D.D.C. 2012] (SEC concedes that after \textit{Janus}, a claim against an officer who only “prepared” documents cannot rest on Rule 10b-5(b]).
\item \textsuperscript{143} SEC v. True N. Fin. Corp., 909 F. Supp. 2d 1073, 1119 [D. Minn. 2012] (noting division among district courts as to “whether \textit{Janus} applies to a public securities fraud action”).
\item \textsuperscript{144} SEC v. Sells, 2012 WL 3242551, at *7 [N.D. Cal. Aug. 10, 2012] (\textit{Janus} “did not address” Rules 10b-5[a] and [c]).
\item \textsuperscript{145} See, e.g., id. \textit{Janus} does “not apply to claims premised on § 17[a]”; SEC v. Daifotis, 874 F. Supp. 2d 870, 878 [N.D. Cal. 2012] (“\textit{Janus} only applies to Section 10[b] and Rule 10b-5”). Courts generally point to the different language in sections 10(b) and 17(a); SEC v. Sentinel Mgmt. Grp., Inc., 2012 WL 1079961, at *15 [N.D. Ill. Mar. 30, 2012] (\textit{Janus} is inapplicable to section 17[a] claims for both textual and policy reasons); SEC v. Big Apple Consulting USA, Inc., 2012 WL 3264512, at *3 [M.D. Fla. Aug. 9, 2012] (\textit{Janus} does not apply to section 17[a] because \textit{Janus} interpreted the “to make” language that only appears in 10b-5).