Chapter 15

SEC Investigations and Enforcement Actions

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§ 15:1 Introduction

The U.S. Securities and Exchange Commission (SEC) is the federal government’s principal investigative and enforcement arm with respect to the securities activities of corporate America. This chapter provides an overview of SEC investigative and enforcement authority as commonly applied to public companies and their officers, directors, and employees, and suggests how public companies and their directors may most effectively deal with SEC investigations and enforcement actions.1

Investigations by the SEC are both a major cause and a symptom of a 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. Even if the investigation is concluded without an enforcement action, the pendency of an investigation places a cloud over the corporation that may inhibit its access to capital markets, chill

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relationships with vendors and customers, and distract and demoralize management.

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; and it may ultimately require significant changes in key management, not to mention that it raises the spectre of individual liability for the corporation’s officers, directors, or employees.

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 Department of Justice (DOJ), such conduct may not 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.2

Nearly two decades ago, the SEC stated that it “considers it essential for board members to move aggressively to fulfill their responsibilities to oversee the conduct and performance of management.”3 The Cooper case arose out of three alleged schemes, involving the company’s CEO and co-chairman, to engage in frontrunning, insider dealings of corporate assets, and securities manipulation. The allegations ultimately led to criminal convictions of the CEO and the company. The SEC asserted that the company’s board was aware of an initial investigation by the SEC, a subsequent parallel investigation by the DOJ, and then undisclosed affiliated transactions between the company and its CEO that resulted in a transfer of $560,000 in potential profits from the company to the CEO and his family.

2. The Federal Sentencing Guidelines for Organizations consider the presence of effective programs to prevent and detect violations, and acts of self-reporting and cooperation with the government, as mitigating factors in determining the sentence to be imposed on a corporation found guilty of a violation of law. In practice, such measures may even prevent a corporation from being charged in the first place. Although the Sentencing Guidelines are not binding on the SEC in connection with its civil enforcement efforts, they are consistent with the SEC’s own views.

The SEC further asserted that the board had permitted the CEO to remain in place, promoted his brother to chief operating officer, and permitted the company to make misleading protestations of innocence even though the board knew that the CEO and COO had asserted Fifth Amendment privileges in response to government inquiries and had refused to respond to questions posed during the company’s internal investigation. Finally, the SEC asserted that the “Board failed to satisfy its obligations when confronted with serious indications of management fraud.” While the failure was couched in terms of preventing further violations of the disclosure provisions of the federal securities laws, the criticism was plainly directed at the board’s alleged failure to demand additional information regarding the underlying conduct and to impose, at a minimum, added supervision on the suspected employees.

Since Cooper, the SEC has continued to bring enforcement actions in which the Staff has questioned the adequacy of a corporation’s response to suspected wrongdoing. In recent years, the SEC has imposed harsh penalties in cases where it believed that a company’s self-policing efforts were less than thorough, or lacking in independence. In addition, the Staff has publicly stated that it views the board and in-house counsel as critical gatekeepers charged with responsibility to monitor and oversee the company’s securities law compliance. The Staff also has declared that it will bring enforcement action against such gatekeepers in appropriate circumstances.

The overall question of how to coordinate the defense and resolution of parallel civil and regulatory proceedings is beyond the scope of this treatise and indeed may require a treatise itself. That said, it is critical that defense counsel be familiar with the general approaches that the SEC takes in investigating possible securities law violations, how it expects companies to behave in connection with an investigation, and some of the potential pitfalls in dealing with the Staff. The SEC recently provided written guidance in all of these areas in its Enforcement Manual.4

§ 15:2 SEC Investigations

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 before SEC Administrative Law Judges and in federal court.

§ 15:2.1 Triggering Events

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 registrations statements by the Division of Corporation Finance.
2. Review of Forms 8-K. The SEC reviews every Form 8-K dealing with adverse events and with changes in auditors.
3. Review of trading data and market surveillance reviews.
4. Referrals from self-regulatory organizations such as the NASD [now FINRA—the Financial Industry Regulatory Authority].
5. DOJ referrals under the Foreign Corrupt Practices Act [FCPA].
6. Newspaper and other media reports.
7. Complaints from disgruntled investors. Investors frequently complain to the SEC. Sometimes these complaints come from professional short-sellers.
8. Complaints from issuers that believe their stock is subject to illegal short selling or manipulation.
9. Tips from anonymous informants—frequently an employee of the company who is dissatisfied with the manner in which management is accounting for its assets.
10. Complaints from competitors. On occasion, corporations believe that they are competing against a company that has been falsely stating its performance.
11. Complaints from plaintiffs and their lawyers. It is not unusual for the plaintiffs in private civil actions to assert that the SEC should get involved in the same matters that are the subject of the private lawsuits.

While the SEC Staff has endeavored to evaluate such complaints with a critical eye, some complaints have proven to be well founded, and the Staff has taken appropriate action. Some complaints, however, may not receive the scrutiny they deserve. In early 2009, the SEC received a torrent of criticism when it was disclosed to the public that
Harry Markopolous, an independent financial fraud investigator and former securities industry executive, for nine years had attempted repeatedly, in vain, to persuade the SEC to investigate Bernard Madoff.

Since becoming Chairman of the SEC, Mary Schapiro has worked to address the “important questions” raised by the Markopolous affair concerning the SEC’s handling of tips and whistleblower information. As part of an ongoing initiative to review and improve the SEC’s internal procedures in evaluating tips, complaints, and referrals, the Enforcement Division established the Office of Market Intelligence, which will serve as a central office for handling all such information.

In addition, the SEC has completed the first phase of system improvements for reviewing and tracking tips; this phase consisted of centralizing all existing tips and complaints into a single database. A new intake system, which will possess greater search and workflow capabilities, is expected to launch in 2010, and steps are underway to design additional system capabilities adding risk analytics tools.

Not only has Chairman Schapiro undertaken to improve the SEC’s ability to evaluate and act upon whistleblower information, but she also has promised to implement programs designed to encourage whistleblower and investor tips. In March 2009, Chairman Schapiro told the Senate Committee on Banking, Housing, and Urban Affairs that she expected in the near future to present a proposal that Congress grant the SEC “authority to compensate whistleblowers who bring us well-documented evidence of fraudulent activity.”

Such a provision is included in the recently passed Dodd-Frank financial reform bill. The new provision would reward whistleblowers who voluntarily provide original information that leads to a successful enforcement action and imposition of monetary sanctions of over $1 million. The whistleblower in such cases would be entitled to between 10% and 30% of the total monetary sanctions imposed.

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6. Id.
7. Id.
8. Id.
11. Id. § 922.
§ 15:2.2 Types of SEC Enforcement Activities

[A] Informal Investigations

Frequently, SEC investigations begin with a request for the corporation’s voluntary cooperation in providing information to the SEC Staff. While 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 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 and may possibly reduce the company’s requirement to disclose the informal inquiry in its periodic filings. 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 is obligated to preserve relevant documents. The destruction of relevant documents in these circumstances could lead to charges of obstruction of justice.\(^{12}\) 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.\(^{13}\)

[B] Formal Investigations

The federal securities laws permit the SEC to issue subpoenas to compel the production of documents by company or by individuals and to compel witnesses to appear and to testify under oath in connection with investigations of possible violations of the securities laws. The commissioners do not, of course, conduct these investigations themselves. They delegate their authority to members of the Staff. This delegation is accomplished by the issuance of a “formal order of private investigation,” which recites the factual predicate for issuing the order and the statutory sections that may have been

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12. See, e.g., United States v. Fruchtman, 421 F.2d 1019, 1021 (6th Cir. 1970) (holding that the obstruction of justice statute applies to an FTC inquiry and is not limited to matters “before a federal agency which are juridical or administrative in nature”; a “proceeding” within the meaning of the obstruction of justice statute “is a term of broad scope, encompassing both the investigative and adjudicative functions of a department or agency”).

13. For a more detailed discussion of the benefits of cooperation, see section 15:3.1, infra.
violated, and which authorizes designated Commission employees to issue subpoenas and compel witnesses to appear under oath.

A formal order is not a finding of a fact or a form of adjudication. It is akin to a corporate board resolution. Nevertheless, it asserts the possibility of a violation of law by the company, and it may include within its scope a wide variety of persons.\(^\text{14}\)

In an effort to bolster the SEC’s enforcement program, SEC Chairman Mary Schapiro provided for a more rapid initiation of investigation.\(^\text{15}\) Formal orders had previously been subject to full review at a meeting of all the Commissioners.\(^\text{16}\) This required several weeks advance notice in order to have the formal order request placed on the Commission’s meeting agenda.\(^\text{17}\) Under Chairman Schapiro, the SEC has delegated the authority to issue subpoenas directly to senior staff of the Enforcement Division “so investigations can be launched without the prior—and time-consuming—approval of the Commission.”\(^\text{18}\)

Typically, SEC investigations commence with a broad request to the company for the production of documents covering a specified time period, as well as possible subpoenas. Such document requests and subpoenas can be narrowed by negotiation in order to prevent an undue burden and the production of irrelevant documents.

Once documents are collected, if the SEC Staff continues to have questions, it will frequently call witnesses to testify regarding the matter. In a financial disclosure case, witnesses from the company usually include its controller, its chief financial officer, and other accounting and finance personnel.

Because financial disclosure investigations frequently turn on the treatment of transactions between the company and third parties, the SEC may issue subpoenas for testimony to other relevant persons. Depending upon the nature of the case, these may include

\begin{enumerate}
\item the company’s independent auditors;\end{enumerate}

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\(^\text{17}\) Id.

counterparts, such as customers, vendors, lenders, and banks; and

business partners.

The SEC takes the position that it is not required to give the company notice of the persons to whom the subpoenas are issued. Thus, one of the frequent side effects of an SEC investigation is the fact that it will cause persons with whom the company does business to receive a subpoena in the investigation, with concomitant effects upon the company’s reputation and business relationships.

The Enforcement Division has also formed five specialized units, each with a specific enforcement focus, in order to increase enforcement efficiency. These five units address high-priority areas of enforcement, specifically: Asset Management, Market Abuse, Structured and New Products, the Foreign Corrupt Practices Act, and Municipal Securities and Public Pensions. The Division has additionally made efforts to streamline internal operations by reducing the number of managers, reassigning those individuals to the front lines of investigations, and delegating authority to start formal investigations and issue subpoenas to senior officers in the Division.¹⁹

[C] “Wells” Notices

After gathering documents and taking testimony, the Staff typically makes a collaborative decision as to whether it will recommend 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 and legal arguments why an enforcement action may not be appropriate. Before making the Wells submission, the prospective defendant and counsel 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

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investigative file. Viewing such information may allow counsel to more intelligently assess the risks of possible enforcement action.

The ultimate decision whether to institute an enforcement proceeding is the Commission’s, based upon the Staff’s recommendation. That recommendation usually is a collaborative one. Thus, in a financial disclosure case, attorneys from the SEC’s Division of Enforcement typically solicit the views of the Office of the Chief Accountant and the Division of Corporation Finance, and all recommendations are reviewed for consistency and for compliance with Commission policy and statute by the Office of the General Counsel.

Meetings with and Wells submissions to the Staff sometimes are fruitful. Often counsel or the company can inform the Staff of significant facts that may change its recommendation. Moreover, even if the recommendation itself is not ultimately changed, 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 future litigation 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 pursuant to an information request 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.

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22. See SEC Enforcement Manual § 2.4, at 24 [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. at 25 [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”].
If the prospective defendant is unsuccessful in persuading the Staff, the Staff sends its recommendation in the form of a memorandum together with the Wells submission, to the Commissioners. In a meeting open to the Staff but not to the public or to the prospective defendants, the Commissioners decide whether an enforcement action should be commenced. Once that decision is made, counsel is usually advised of it and afforded a brief opportunity to determine whether to negotiate a resolution of the case or to contest it.

The receipt of a Wells notice may create disclosure obligations. For example, a registered broker who receives a Wells notice is required to report that event on his or her Form U4.23 In addition, the receipt of a Wells notice may trigger reporting obligations for a public company. Wells notices are also commonly sought in private civil litigation discovery. On occasion, the Staff will invite a “pre-Wells” submission and dialogue which can alleviate this discovery issue.24

[D] Closing Investigations

In 2007, the Government Accountability Office issued a report criticizing the SEC for failing to close investigations in a timely manner.25 The SEC responded to that criticism by encouraging the Staff to close an investigation as soon as it becomes apparent that no enforcement action will be recommended so that resources can be directed to investigations that will be more productive.26 The SEC closed 1,355 cases in fiscal year 2008, compared to 374 in fiscal year 2007—a 262% increase.27

The SEC also has made it its policy to send termination letters to the individuals, entities, or their counsel “at the earliest opportunity” when the Staff has determined not to recommend an enforcement action against them.28 The SEC’s policy is to send termination letters regardless of whether the investigation was pursuant to a formal order.29 The SEC Enforcement Manual provides that a termination letter

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24. See SEC Enforcement Manual § 2.4, at 22 (“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.”).
28. See SEC Enforcement Manual § 2.6.1, at 34.
29. Id.
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. All that such a communication means is that the staff has completed its investigation and that at that time no enforcement action has been recommended to the Commission.  

§ 15:2.3 SEC Enforcement Trends

The recent turmoil in the economy and in the financial markets has underscored the importance of SEC enforcement and spurred a period of significant review and change in its enforcement program. In January 2009, Mary Schapiro became the twenty-ninth Chairman of the SEC. Schapiro has stated that she intends to reinvigorate the SEC’s enforcement program and protect investors through a variety of new measures and proposals to bring transparency and accountability to the marketplace. The implications are likely to be significant for companies facing SEC investigations in the coming months.

Over the last few years, the SEC Enforcement Division has brought hundreds of enforcement actions annually, ranging from 484 actions in 2001 to 725 in 2009. The number of insider trading and market manipulation cases increased 25% and 45% respectively from 2007 to 2008. This included twenty-seven cases involving stock option backdating. Compared to the prior year, during the first twelve months under Chairman Schapiro, the SEC filed nearly 10% more actions overall (including nearly twice as many actions involving Ponzi-like schemes), issued more than two times the number of formal orders of investigation, and sought more than twice as many temporary restraining orders and asset freezes.

In 2009, the SEC obtained roughly $540 million more in disgorgement orders (for a total of $1.73 billion) than in 2008, and penalty orders increased from $193 million to $410 million. One of Ms. Schapiro’s first acts as Chairman was to end the SEC’s “penalty-pilot” program, which required approvals from the Commissioners before seeking monetary penalties against public companies in civil fraud actions. That policy was heavily criticized for discouraging the

30. Id. at 35.
33. Id.
34. Id.
35. Id.
Staff from either seeking a penalty or seeking what was considered to be a disproportionately high penalty.\(^{36}\)

Year in and year out, financial reporting and disclosure cases represent the single biggest percentage of the Enforcement Division’s caseload. Indeed, in every year between 2001 and 2007, the Enforcement Division brought at least one hundred such cases. This trend somewhat parallels the trend in restatements by public companies, which reached record levels during this same time period, spurred in part by the reforms adopted by many companies as a result of the passage of the Sarbanes-Oxley Act.

The Enforcement Division has also dramatically increased the number of actions brought under the FCPA. For decades, the SEC seldom used its authority, shared with the DOJ, to enforce this thirty-year-old statute. But in recent years the number of FCPA cases—which are very often very large and can involve fines in the hundreds of millions—has increased dramatically, rising from zero cases in 2003 to fourteen in 2009.\(^{37}\) In December 2008, the SEC reached a $350 million settlement with Siemens AG in an FCPA case, the largest FCPA settlement in the SEC’s history. Two months later, the SEC concluded a $177 million settlement with Halliburton Co. and its former subsidiary, KBR, Inc. In March 2010, Daimler AG agreed to pay $91.4 million to settle SEC charges for FCPA violations.

\section*{§ 15:3 SEC Enforcement Actions}

\subsection*{§ 15:3.1 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,\(^{38}\) in which the SEC laid out the factors that are considered in determining whether a company

\begin{itemize}
\item \(^{36}\) Luis A. Aguilar, SEC Commissioner, Speech at Third Annual Fraud and Forensic Accounting Education Conference, Atlanta, Georgia, “Combating Securities Fraud at Home and Abroad” (May 28, 2009), \textit{available at} \url{www.sec.gov/news/speech/2009/spch052809laa.htm}.
\end{itemize}
should receive credit for good cooperation. The release stressed four key concepts—self-policing, self-reporting, cooperation, and remediation—and listed a detailed set of factors the SEC may consider when bringing an enforcement action. The Seaboard Report notes that public companies should institute effective compliance procedures before the discovery of alleged wrongdoing—and be prepared to answer questions such as “What compliance procedures were in place to prevent the misconduct now uncovered?” and “Why did these procedures fail to stop or inhibit the wrongful conduct?” Companies need to be aware of these concerns and should probe their own compliance structure and conduct with these questions in mind.

While an effective compliance program and self-policing are important factors, the Seaboard Report also devoted considerable time to a discussion of the role of cooperation. In the Seaboard investigation itself, the Staff noted that the company had provided the SEC with all information relevant to the alleged misconduct, including the details of its internal investigation. That included notes and transcripts of interviews of the former controller and others. Also, the company “did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.”

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.39

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 new enforcement manual provides the Division and the Commission with a nonexclusive list of tools to encourage and facilitate such cooperation.

Cooperation agreements: The Enforcement Division may agree to recommend to the Commission that the individual or company receives credit for giving substantial assistance. The 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.

Deferred prosecution agreements: The Commission may forego an enforcement action against an individual if the individual agrees to cooperate fully and truthfully, to waive applicable 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.

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.

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.

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.

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

It remains to be seen whether these initiatives will result in meaningful credit for cooperation by individuals.
[B] 2006 Statement on Penalties

Following criticism from the issuer community about the Enforcement Division’s pattern of imposing ever-increasing civil penalties against corporations for alleged noncooperation, and in light of the lack of definitive guidance as to the circumstances under which the SEC would impose penalties against a corporate issuer, the SEC issued important guidance in 2006, setting forth specific criteria that the Staff will utilize in evaluating the question of civil penalties. Specifically, the SEC issued its “Statement Concerning Financial Penalties” on January 4, 2006, in which it said that the appropriateness of penalties on 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 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.” The stated purpose of the guidelines was to provide “clarity, consistency, and predictability.” Upon recommendation by the Government Accountability Office, current Enforcement Director Robert Khuzami intends to undertake an examination to see whether the 2006 corporate penalty policy is actually achieving its intended goals. As stated by Mr. Khuzami, the “focus of any penalty policy should be assurance that malefactors get appropriately severe sanctions to sufficiently deter them and others from engaging in similar misconduct in the future.”

In 2007, then-Chairman Christopher Cox announced a new policy with respect to the imposition of civil penalties against corporate entities. Under the new policy, called the “penalty-pilot” program, the Enforcement Division was required to seek Commission “pre-approval” for civil penalties that it intended to seek against a corporate issuer. A 2008 study of the pilot program by the Government Accountability Office found, however, that the program actually had the effect

41. Id.
42. Id.
of delaying cases and producing fewer and smaller corporate penalties. As discussed above, one of Chairman Schapiro’s first acts was to terminate the penalty pilot program. However, the SEC’s struggles with the issue of corporate penalties continues, as illustrated by the SEC’s settlement with Bank of America over its failure to disclose an agreement to pay $5.8 million in bonuses to Merrill Lynch executives prior to Bank of America’s acquisition of Merrill. After rejecting the SEC’s initial proposed fine of $33 million, Judge Rakoff reluctantly approved a $150 million settlement with Bank of America. Judge Rakoff noted that the fine penalized shareholders without holding individual executives accountable, and suggested that sanctions against the culpable employees would have been more appropriate.44

[C] Privilege Waivers As Element of Cooperation

In light of the Seaboard Report and subsequent 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. In the wake of Seaboard, although the Enforcement Staff publicly stated that it did not require companies to waive privilege, the Staff has consistently asked companies to produce their privileged materials. As a result, companies 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.45

This practice met with considerable criticism from a wide range of commentators and practitioners, including one SEC Commissioner. In one article, former Commissioner Paul Atkins and a co-author wrote that “the Enforcement Division and the Commission . . . often have misinterpreted the Seaboard Report as a basis for rewarding

44. Id. at *5 (“Where management deceives its own shareholders, a fine most directly serves its deterrent purposes if it is assessed against the persons responsible for the deception.”).
companies for waiving privilege." The authors noted that, "[a]s a practical matter, rewarding companies for cooperating by waiving privilege has the same effect as punishing them for not waiving privilege—both effectively strip the attorney-client privilege, which is a fundamental component of our legal system." Widespread concerns over the "culture of waiver" led to congressional inquiries and proposed legislation to forestall future efforts by the SEC to penalize companies that refuse to waive attorney-client privileges in connection with SEC investigations. The DOJ addressed the issue head-on in the McNulty Memorandum, issued in December 2006. The McNulty Memorandum stated that "waiver of attorney-client and work product protections is not a prerequisite to a finding that the company has cooperated in the government’s investigation." The McNulty Memorandum went on to recite, however, that prosecutors may legitimately request waivers when in their view there is a "legitimate need for the privileged information to fulfill their law enforcement duties." If those conditions exist and a request for waiver is made, "a corporation's response to the government's request for waiver of privilege [of purely factual information relating to the underlying misconduct] may be considered in determining whether a corporation has cooperated in the government’s investigation." By contrast, a prosecutor’s request for privileged information that may include overt attorney-client communications or non-factual attorney work product, if refused, may not be considered against the corporation in making a charging decision.

In August 2008, in the face of the many challenges to the McNulty Memorandum’s position on privilege waivers in connection with DOJ criminal investigations, the DOJ announced that it was once again revising its guidelines, effectively superseding the McNulty Memorandum. In the revised guidelines, known as the Filip Memorandum, the DOJ 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

47. Id. at 404–05.
48. See Principles of Federal Prosecution of Business Organizations, a memorandum from Deputy Attorney General Paul J. McNulty to all United States Attorneys [hereinafter McNulty Memorandum].
49. The McNulty Memorandum also sets forth various other factors that may influence the charging decision, including whether the company may be viewed as trying to protect culpable employees from the government. This factor in turn may implicate such common practices as the advancement of defense costs, indemnification policies and practices, and the like. For a discussion of this aspect of the McNulty Memorandum, see section 14:1.6.
be based on disclosure of relevant facts not necessarily embodied in privileged communications. The Filip Memorandum is already the target of criticism for not going far enough to protect the attorney-client privilege. As former Deputy Attorney General McNulty stated, “there is still a pressure to waive attorney-client privilege if you have ‘relevant factual information’ covered by attorney-client privilege . . . and quite a bit of ‘relevant factual information’ is subject to privilege claims.”

In November 2008, the Enforcement Division issued its first-ever Enforcement Manual, which sets forth the SEC’s approach to privilege waivers. Like the Filip Memorandum, the 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.

§ 15:3.2 Civil Remedies

[A] Civil Injunctions

The SEC may obtain a civil injunction prohibiting any person or corporation 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 and a trial pursuant to the Federal Rules of Civil Procedure. The standard for issuing an injunction requires that the SEC show a reasonable likelihood of future violations. Courts usually look to four factors:

(1) The nature of the conduct;
(2) The degree of scienter (bad intent) involved;
(3) The defendant’s ability to violate the law in the future; and
(4) The degree to which the defendant has recognized the wrongfulness of his conduct.

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 significant reason to believe that a defendant might destroy evidence or move assets outside

52. Id.
§ 15:3.2  SECURITIES LITIGATION

the SEC’s jurisdiction. Recently, the SEC even went so far as to obtain an asset freeze in the United Kingdom, which required convincing the High Court of Justice in London that the SEC constituted a public law enforcement agency for the purposes of U.K. law.53

[B] Ancillary Relief

Even if a court does not issue an injunction prohibiting future violations of the law, it may award the SEC ancillary relief. Common forms include the following.

[B][1] Disgorgement

The SEC will frequently 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 illegal securities distributions; bonuses based upon improperly recognized revenues; and assets that were misappropriated. The SEC will seek prejudgment interest on these sums.

In addition to traditional disgorgement remedies, the SEC also was granted new authority by the Sarbanes-Oxley Act of 2002, permitting it 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 SEC succeeded in distributing approximately $1 billion to injured investors in 2008, bringing the total distributions since the passage of Sarbanes-Oxley to over $4.6 billion.54 In 2007, the SEC created the Office of Collections, Distributions and Financial Management to manage the collection of penalties and disgorgements and speed the process of returning funds back to harmed investors.55

Finally, 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. Specifically, section 1103 allows such an

53. See SEC Obtains Asset Freeze in the United Kingdom Against Hedge Fund Principal [June 25, 2008], available at www.gibsondunn.com/Publications/Pages/SECAssetFreezeInUKAgainstHedgeFundPrincipal.aspx.


55. Id.
asset freeze if 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. In practice, this statute would typically be used in the context of a severance deal with a wrongdoing officer, particularly if there is a flight risk.

[B][2] 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 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.\(^{56}\) The statute does not specify whose “misconduct” is required in order to trigger the remedy. Until recently, 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 who participated in option backdating and received backdated options.\(^{57}\) Another case involved an officer who allegedly participated in a fraud and misappropriated company funds.\(^{58}\)

Recently, the SEC for the first time used section 304 in an action seeking to “claw back” bonuses and proceeds of stock sales from a CEO who was not accused of any securities law violation.\(^{59}\) The SEC’s complaint bases the claim on the company’s misconduct.\(^{60}\)

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60. The SEC had previously filed a settled enforcement action against the company alleging improper accounting that led to financial restatements. See In the Matter of CSK Auto Corp., Securities Act Rel. No. 9,032 [May 26, 2009], available at www.sec.gov/litigation/admin/2009/33-9032.pdf. The SEC had also filed an unsettled enforcement action against several former senior executives of the company, other than the
district court in the case recently denied the CEO’s motion to dismiss, finding that section 304 does not require personal misconduct. The SEC’s application of section 304 to executives not accused of personally violating the securities laws or other misconduct raises significant legal and policy questions that will continue to be addressed in this litigation. In another recent matter, the SEC reached a settlement with a CEO whereby the CEO consented to a final order for him to reimburse cash bonuses, stock, and stock options, despite the fact that the SEC did not allege the CEO was involved in the corporation’s alleged fraud.

[B][3] Corrective Disclosure

The SEC may also seek an order requiring that the issuer restate previously issued annual or quarterly financial statements to correct alleged accounting errors or to correct other previously filed 10Ks, 10Qs, or disclosure documents.

[B][4] 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.

[B][5] Civil Money Penalties

As a result of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act), 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.

[B][6] “Improper Influence”

Section 303 of the Sarbanes-Oxley Act of 2002 added a new potential cause of action, giving the SEC exclusive authority to sue an officer or director of a corporation who had taken any actions to “fraudulently influence, coerce, manipulate or mislead” the company’s

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outside auditors. As of the time this book went to press, no reported decision has been found in which an enforcement action under section 303 has been litigated.

[C] Bar Upon Service As Officer or Director

The Remedies Act also 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 require a showing of a violation of a scienter-based anti-fraud provision applicable to public companies—section 10(b) of the Securities Exchange Act or section 17(a)(1) of the Securities Act.63

In addition, the Sarbanes-Oxley Act of 2002 amended the standard under which a court or administrative law judge can determine whether an officer or director meets the test of “unfitness” that would support the imposition of a bar order. Specifically, section 305(a) modified the existing standard that used the phrase “substantial unfitness,” and substituted the less rigorous standard of mere “unfitness.” Commentators believe that the lower standard will enable the SEC to obtain bar orders based on a single act or transgression of a director or officer.

§ 15:3.3 Administrative Remedies

[A] Cease-and-Desist Orders

Before 1990, the SEC had relatively little jurisdiction in administrative proceedings over public companies and their officers. 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 authorizes 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 state its financial reports in accordance with GAAP 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 Court of Appeals held that the SEC could use a negligence standard as the basis for issuing a cease-and-desist order.64

63. The Sarbanes-Oxley Act of 2002, section 1105, extended the SEC’s authority to obtain bar orders in administrative cease-and-desist proceedings as well as in district court actions.

64. KPMG, LLP v. SEC, 289 F.3d 109, 118–20 (D.C. Cir. 2002).
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 the U.S. Court of Appeals. Thus, the trial is entirely an in-house proceeding with far more restricted rights of discovery and of appeal than in a standard civil trial.

The SEC may also issue orders compelling disgorgement of ill-gotten gains and ancillary relief in administrative proceedings. It may not, however, obtain a civil order in an administrative proceeding requiring the payment of a civil money penalty from an issuer or person affiliated with an issuer. The Dodd-Frank financial reform legislation proposes to change this by granting the SEC the authority in cease-and-desist proceedings to impose fines ranging from $7,500 to $150,000 for individuals and $75,000 to $725,000 for companies and other entities. 65

[B] Suspension and Deregistration

Under section 15(b) of the Exchange Act, the SEC can suspend or revoke the registration of any individual or entity that willfully violates or aids and abets a violation of any of the federal securities laws. Because issuers, broker-dealers, investment advisers must be registered with the SEC in order to do business, revoking the registration of such an entity has been referred to as the “death penalty” of the securities laws.

[C] 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 amendments to the Exchange Act codified Rule 102(e) of the SEC’s Rules of Practice. 66

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

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. According to Section 307, 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. 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.

§ 15:3.4 Parallel Criminal Cases

The SEC does not have independent authority to prosecute criminal cases. On the other hand, any willful violation of the federal securities laws can be prosecuted as a crime. Because of the large amounts of money often involved, securities offenses are popular among federal criminal prosecutors. Thus, the SEC has a close working relationship with federal prosecutors and frequently refers more egregious violations of the federal securities laws to them.

68. 17 C.F.R. § 205 et seq.
[A] Common Grounds for Prosecution

The securities laws violations most commonly prosecuted are insider trading, financial fraud, and unregistered securities offerings. While not always pursued for garden-variety financial disclosure cases, criminal prosecutions are frequent where there has been widespread misappropriation of assets or the sale of stock by insiders who know that the financial statements are false.

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

1. mail and wire fraud;
2. false statements to the government, such as those contained in SEC filings, under 18 U.S.C. § 1001;
3. money laundering; and
4. RICO violations.

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 subjects 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.
- Finally, 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**

Testifying before the Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment, Robert Khuzami, the SEC’s new Director of the Division of Enforcement, identified “cooperation and coordination with criminal and other authorities” as vital for “yield[ing] even better results.” Director Khuzami’s testimony underscores a strategy that has now become commonplace. In recent years, the SEC and the DOJ have organized joint task forces that allow for more robust investigations into alleged misconduct, including the use of expanded investigatory tools and resources. The Corporate Fraud Task Force and the Subprime Working Group are two such examples.

Coordinated law enforcement efforts have not gone unchallenged, however. In a recent challenge to a joint investigation by the DOJ and SEC, *United States v. Stringer,* the Ninth Circuit rejected claims of due process violations stemming from the joint investigation. The defendant in *Stringer* claimed that after the SEC commenced an investigation of FLIR Systems, Inc., the SEC did not tell Stringer (a former officer of FLIR) that it was meeting with and sharing information with the FBI and the DOJ. The facts showed, however, that Stringer had been supplied with a form when he was subpoenaed disclosing that the SEC “often makes its files available to other government agencies, particularly the United States Attorneys and state prosecutors.” Placing significant weight upon the form notice provided with the subpoena to Stringer, the Ninth Circuit rejected the district court’s finding that nondisclosure of the criminal investigation violated Stringer’s due process rights. According to the Ninth Circuit, the SEC has no legal duty to otherwise disclose the existence of a criminal investigation.

The SEC Enforcement Manual provides direct guidance to the Staff in the area of parallel proceedings, which largely follows the prescription for proper coordinated law enforcement investigations set forth by


73. *United States v. Stringer,* 535 F.3d 929 (9th Cir. 2008).
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.\textsuperscript{74} 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.\textsuperscript{75} 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 files available to other government agencies, particularly the United States Attorneys and state prosecutors.”\textsuperscript{76} Fourth, the Staff is directed to have supervisors involved “in all significant discussions and written communications with criminal authorities.”\textsuperscript{77} 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.\textsuperscript{78}

[C] Parallel Proceedings by the SEC and Private Entities

The manual also provides guidance for parallel investigations by the SEC and private entities.\textsuperscript{79} Under the “state actor doctrine,” an action by a private party may be attributed to a government entity “if there is a sufficiently close nexus between the state, or government entity, and the challenged action of a private entity.”\textsuperscript{80} Thus, the manual provides that, when the Staff is aware that a private entity is investigating conduct that is also the focus of an investigation by the Staff, “the SEC and the private entity’s investigations should be parallel and should not be conducted jointly.”\textsuperscript{81} To this end, the manual directs the Staff to:

1. make independent investigative decisions;
2. not take investigative steps principally for the benefit of a private entity’s investigation;

\textsuperscript{74} SEC Enforcement Manual § 5.2.1.
\textsuperscript{75} Id.
\textsuperscript{76} Id., n.2.
\textsuperscript{77} Id. § 5:2.1.
\textsuperscript{78} Id.
\textsuperscript{79} Id. § 3:1.4.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
not suggest investigative steps to a private entity; and

where a witness in an SEC investigation has indicated an
intention to assert his or her Fifth Amendment right not to
testify, not suggest to the private entity any line of questioning,
nor to provide “any document or other evidence . . . other than
pursuant to an approved access request.”

§ 15:4 Insider Trading Cases

“[I]nsider trading has a unique hold on the American popular
imagination.” And recent trends suggest that insider trading enforce-
ment is making a comeback. In fact, during the 2008 fiscal year, the
Enforcement Division brought the highest number of insider trading
cases in the SEC’s history. In one of the most significant insider
trading cases brought in 2008, the SEC charged the former chairman
and CEO of Enron Energy Services, Lou Pai, with selling Enron stock
on the basis of material, nonpublic information. In another high-
profile case brought in 2008, the SEC reached a $24 million settlement
with four Hong Kong residents, one of whom was a former Dow Jones
board member, for allegedly engaging in insider trading and illegal
tipping prior to the public disclosure of an unsolicited buyout offer
from News Corporation that caused Dow Jones shares to increase
dramatically. By obtaining an emergency order to freeze the defend-
ants’ accounts within days of News Corporation’s offer, the SEC
prevented them from realizing approximately $8 million in illicit
profits.

In June 2009, the SEC filed insider trading charges, among others,
against Angelo R. Mozilo, the co-founder of Countrywide Financial
Corp. The insider trading charges allege that the former chief
executive officer realized $140 million in profits by accelerating
planned stock sales in the company in late 2006 and the first half of

82. Id.
83. Linda Chatman Thomsen, SEC Dir. of Enforcement, Remarks Before the
Australian Securities and Investments Commission 2008 Summer School:
U.S. Experience of Insider Trading Enforcement (Feb. 19, 2008), available
84. SEC, 2008 PERFORMANCE AND ACCOUNTABILITY REPORT 2, available at
87. SEC, 2008 PERFORMANCE AND ACCOUNTABILITY REPORT 112, available at
88. See SEC v. Mozilo, SEC Litig. Rel. No. 21,068 (June 4, 2009), available at
2007, just before the subprime market began its downward spiral. In November 2009, the district court denied Mozilo’s motion to dismiss.

In October 2009, the SEC filed what it described as the largest hedge fund insider trading case it had ever brought, *SEC v. Galleon Management*. The insider trading scheme alleged in the case is estimated to have generated approximately $45 million in profits. The *Galleon* case is the first time, in the parallel criminal investigation, that the government used wiretaps to collect evidence. The propriety of the wiretaps to collect evidence, as well as the SEC’s access to such evidence, is being litigated in that case.

The SEC has recently extended its jurisdiction to reach insider trading in credit default swaps. In *SEC v. Rorech*, the court held that credit default swaps are subject to section 10(b) of the Securities Exchange Act of 1934 as “securities-based swap agreements” under the Graham-Leach-Bliley Act. However, the court ruled against the SEC on whether the defendants had committed insider trading.

### § 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 Securities Exchange Act of 1934, 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 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,

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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,94 adopted the “misappropriation theory” of insider trading. Although the misappropriation theory had been adopted by five of the eleven 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.”95 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 corporate

95. Id. at 652.

(Securities Litig., Rel. #4, 9/10) 15–31
‘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 recent case has moved in the direction of limiting the reach of the misappropriation theory of insider trading. In July 2009, a 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. The case is currently on appeal to the Fifth Circuit.

§ 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 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 preestablished 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.

96. Id. at 652–53.
§ 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. Several recent debacles, such as the collapse of 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 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 towards 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 the 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 Staff has targeted audit committee members. One example is the 2006 enforcement action against the former chair of the audit committee of Spiegel, Inc.,98 in which the Staff initiated a cease-and-desist proceeding where it is alleged that Hansen, 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.99

It is still relatively rare for the SEC to pursue claims against audit committee members for a breach of 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


(Securities Litig., Rel. #4, 9/10) 15–35
members. Underscoring the point, in a 2006 speech former Commissioner Campos stated that “directors cannot have a good-faith belief that an audit committee of a multi-billion-dollar corporation that meets for an hour quarterly (with some participating by phone) devoted enough time and attention to oversight.” 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, it was infrequently the case that in-house counsel was ever sued in an enforcement action. In several important cases beginning in Fall 2004, however, the SEC announced that it was taking a harder look at the role of lawyers in alleged frauds, and it soon began to assert claims against lawyers with greater frequency. Among the higher-profile cases were the SEC’s actions against an in-house counsel at Google and at an outside counsel for a Pennsylvania school district. In the latter case, the SEC had found that the lawyer had been “at least negligent” in his work as bond counsel for the school district and had failed to exercise “reasonable prudence,” which to most observers were indicative that the Staff was effectively suing the lawyer for negligence under section 17(a) of the Securities Act—a concept that immediately stirred controversy within the legal community. In 2006, the SEC decision was affirmed by the court of appeals in language that tended to describe the lawyer’s conduct as “negligence plus.” The SEC, however, does not use a professional conduct standard when evaluating a claim against a lawyer. It will not take action against a lawyer for “giving bad advice” or “negligent acts . . . they may have committed in providing non-public legal advice to clients.” The Commission instead looks to see if a lawyer engaged

100. Remarks of Commissioner Roel Campos, How to Be an Effective Board Member, HACR Program on Corporate Responsibility, Boston, Mass. (Aug. 15, 2006).
103. Weiss v. SEC, 468 F.3d 849 [D.C. Cir. 2006].
104. Christopher Cox, Chairman, SEC, Address to the 2007 Corporate Counsel Institute (Mar. 8, 2007).
in conduct such as intentional violation of securities laws, causing
false statements to be filed with the SEC, or conduct that would have
made a non-lawyer liable in similar circumstances.\textsuperscript{106}

In a case involving outside counsel, Joseph Collins, a former
partner and head of a large law firm’s derivative practice, was charged
for his role in the financial demise of Refco, a now-defunct New York
financial services firm.\textsuperscript{107} As the long-time primary outside counsel for
Refco, Collins was alleged to have substantially assisted Refco in its
failure to disclose millions of dollars in related party transactions and
related party indebtedness.\textsuperscript{108} A district judge dismissed a share-
holders’ suit against Collins and his law firm, citing the Supreme
Court’s decision in \textit{Stoneridge v. Scientific-Atlanta},\textsuperscript{109} which held that
third parties could not be liable to shareholders unless the share-
holders directly relied on actions by the third parties in making
investment decisions.\textsuperscript{110} \textit{Stoneridge} did not save Collins from criminal
liability, however, as the U.S. Attorney’s Office for the Southern
District of New York brought criminal charges against Collins for
his role in helping perpetrate the Refco fraud.\textsuperscript{111} In July 2009, follow-
ing a trial on the criminal charges, a jury found Collins guilty of
securities fraud, wire fraud, and conspiracy. He is currently serving a
seven-year prison sentence. Following his conviction, the SEC, which
had charged Collins with fraud stemming from his acts to aid and abet
Refco file a false IPO, reached a settlement with Collins enjoining him
from future violations of section 10(b) of the Securities Exchange
Act.\textsuperscript{112}

In another recent criminal case, attorney Phillip Offill was found
guilty of securities fraud for his role in advising several companies
on evading registration requirements under the securities laws as part
of a “pump-and-dump” share-price manipulation scheme.\textsuperscript{113} He was
sentenced to eight years imprisonment.

In recent years, the Enforcement Division has also brought a number
of cases against in-house general counsel. Many of these cases arose
from the stock option backdating scandal and include enforcement
actions against in-house counsel of Symbol Technologies, Comverse

\begin{footnotes}
\item[106.] Id.
\item[107.] See SEC v. Collins, SEC Litig. Rel. 20,402 (Dec. 18, 2007), available at
\item[108.] Id.
\item[109.] Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148
(2008).
\item[110.] In re Refco, Inc. Sec. Litig., 609 F. Supp. 2d 304 (S.D.N.Y. 2009) [Lynch, J.].
\item[111.] See SEC v. Collins, SEC Litigation Rel. No. 20,402 (Dec. 18, 2007),
\item[112.] Id.
\item[113.] SEC v. Offill, SEC Litigation Rel. No. 21,508 (Apr. 28, 2010), available at
\end{footnotes}
Technology, Apple Computer, McAfee, Mercury Interactive, CNET, Monster Worldwide and Boston Communications, KLA-Tencor, and Juniper Networks.\textsuperscript{114} In several of these cases, the DOJ also brought parallel criminal actions. In general, these cases turn on specific allegations that the in-house lawyers were active participants in knowing misconduct and, in most cases, are alleged to have personally benefited from the alleged misconduct. In that respect, it can be concluded that the SEC is not simply targeting in-house counsel who commit negligent acts, but rather is targeting lawyers who allegedly engage in deliberate and intentional acts. Nevertheless, the recent history of enforcement actions against in-house counsel provides a sober reminder that counsel are not immune from SEC scrutiny, that they must be mindful of their crucial roles as gatekeepers, and that they must rigorously carry out their duties under the Sarbanes-Oxley Act to report “up the ladder” in the event of suspected law violations.

\textbf{§ 15:7 \hspace{1em} 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 2006, for example, the number of such actions was twenty-seven, up from the prior four-year average of about twenty-one cases a year. Similarly, the number of two- to four-year suspensions of audit partners jumped in 2006 from an average of about nine per year to fourteen. These statistics do not include any proceedings initiated by the Public Company Accounting Oversight Board (PCAOB) (discussed below) pursuant to its own independent enforcement powers over audit firms and audit partners. A representative summary of recent SEC enforcement proceedings against audit firms and audit partners is found in Appendix 15A at the end of this chapter.

In addition to the SEC, audit firms also are subject to oversight and enforcement from the PCAOB, established by Congress as part of the Sarbanes-Oxley Act. In 2003, the PCAOB 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.

\footnote{114. An extensive review of these cases is found in Dickey, \textit{Litigation Against Accountants and Lawyers: The Year of Living Dangerously}, \textsc{West Legal Works} (Nov. 2007).}
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 Sarbanes-Oxley, federal statutes imposed significant obligations on audit firms to take prompt remedial actions in the event of the detection of illegal acts. For example, section 10A of the Securities Exchange Act sets forth detailed statutory requirements that auditors must follow in the event it detects 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:

- Insuring 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 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.115

115. 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 J. Dickey, et al., 2008 Securities Litigation Reform Forecast: Cloudy, Chance of Rain, 5 SEC. LITIG. REP. 2 (Feb. 2008).