INSIGHTS

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2013 Year-End Securities Enforcement Update

The SEC continued its aggressive enforcement program in 2013. It saw not only changes in leadership, but also revision to its settlement policies to require admissions in certain cases. Expectations for 2014 include ramping up of the new accounting fraud task force, continued actions against investment advisers, and brokers and more admissions of liability.

By Marc J. Fagel

2013 proved to be a year of major change for SEC enforcement. Chair Mary Jo White came on board in April 2013, and shortly thereafter named Andrew Ceresney and George Canellos as Co-Directors of the Division of Enforcement. All three are former criminal prosecutors—Chair White served as United States Attorney in Manhattan under President Clinton, and both Ceresney and Canellos were Assistant U.S. Attorneys in her office—and all immediately took steps to embrace an aggressive enforcement program, both in terms of policy and public pronouncements. (Canellos announced his departure from the agency at the beginning of 2014, leaving Ceresney as sole Director.)

The year also has seen a significant number of new appointments at senior levels of the agency. The Chicago, San Francisco, Boston, Denver and Salt Lake City Regional Offices all have new regional directors, over half of whom similarly have experience as federal criminal prosecutors. In addition, new leaders were appointed to several of the Enforcement Division's specialized units.

With so many senior-level changes, it is little surprise that we have seen shifts not just in enforcement policy and priorities, but also in the handling of ongoing investigations. Anecdotally, there is talk in the securities enforcement bar about long-running investigations that were heading for settlement or termination being revisited by the staff; a tentative settlement with the staff appeared to have been scuttled and new, harsher settlement terms proposed (including an admission of liability under the SEC's new policy of demanding admissions in certain cases).

Recognizing that demanding admissions (and tougher sanctions generally) may lead more

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defendants to take cases to trial, Chair White and others at the agency have embraced a larger litigation docket. In a November 2013 speech, Chair White emphasized the SEC's willingness to try more cases, hailing the importance of trials in fostering legal developments and creating public accountability. That said, the agency's trial record over the past six months has been a mixed bag.

In terms of which cases will draw the attention of an energized Enforcement Division, it is still too soon to tell. 2013 enforcement actions remained consistent with recent years, with a significant number of cases involving investment advisers, fund managers and brokers, and a seemingly endless flow of insider trading cases. The SEC filed a number of cases arising out of the financial crisis, perhaps signaling that the end of the pipeline is approaching. And the Division appears poised to refocus its attention on financial reporting by public companies, an area that continued to see a marked decline in enforcement actions, with few meaningful new cases filed in recent months (and almost all of those involving Chinese issuers).

2013 Enforcement Trends: Statistical Overview

While the SEC is taking (and certainly talking) a tougher enforcement approach, the actual number of new cases filed this year showed a noticeable decline. The SEC brought 686 new cases in the fiscal year ended September 30, 2013, down seven percent from last year.[1] After excluding the 132 delinquent filing cases (which actually constituted the highest proportion of the overall enforcement docket since the agency began tracking them), FY2013 turned out to be the slowest year for new cases since 2006.

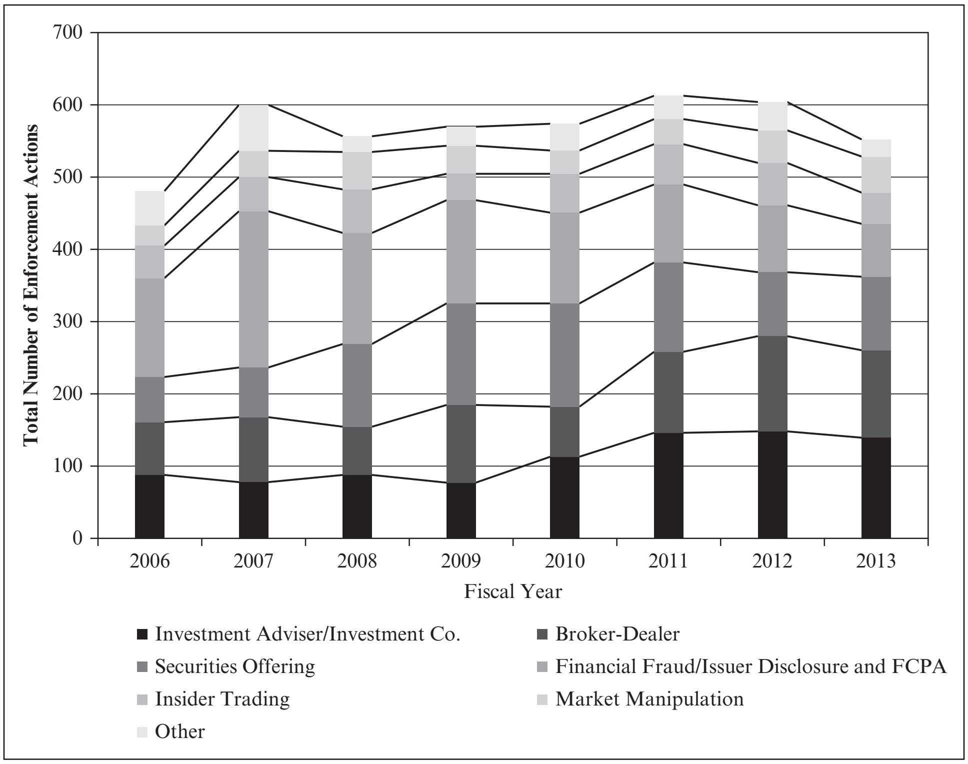
In addition, according to data released by the SEC to the *Wall Street Journal*, the number of new inquiries opened by the Enforcement Division is also in decline, though the Division attributed some of this to improved triage of incoming tips and complaints.[2] One growth area for the Division was the number of formal orders, which rose 20 percent over 2012.[3] This suggests a continuing trend towards investigations becoming formal (and thus allowing the staff to issue subpoenas compelling witnesses to testify and produce records) on a more routine basis, instigated by the SEC's policy change several years ago delegating formal order authority to senior Enforcement officials. While the increase in formal orders may lead to enhanced discovery burdens for companies and individuals, the issuance of a formal order is arguably no longer symptomatic of an investigation becoming somehow more serious in the eyes of the SEC, but rather just a routine part of any investigative inquiry by the staff.

More telling than the overall number of new cases, however, is how those actions were allocated across subject matter areas. In this regard, the Enforcement program was relatively unchanged from the past few years, with the bulk of cases coming in the investment adviser/investment company and broker-dealer space, while the number of financial fraud/issuer disclosure cases (as well as FCPA matters) continued to decline. Indeed, the SEC filed a strikingly low 68 public company reporting cases, and a mere 5 new FCPA cases. Combined, these cases represented only 13 percent of the enforcement caseload (excluding delinquent filings matters), as compared to the high of 36 percent in 2007. At the same time, cases involving brokers or advisers represented over 47 percent of the docket (versus 28 percent in 2007). Meanwhile, insider trading remains relatively consistent, comprising about eight percent of new enforcement filings in 2013.

The Return of Financial Fraud (Investigations)

The SEC announced the formation of a Financial Reporting and Audit Task Force in July

Figure 1: Enforcement Actions Filed by Fiscal Year, 2006–2013[4]



2013.[5] 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. Obviously, given the typical length of a public company reporting investigation, it will be some time before we see whether this initiative is successful in proactively ferreting out financial fraud cases.

More parties will be incentivized to take their chances at trial.

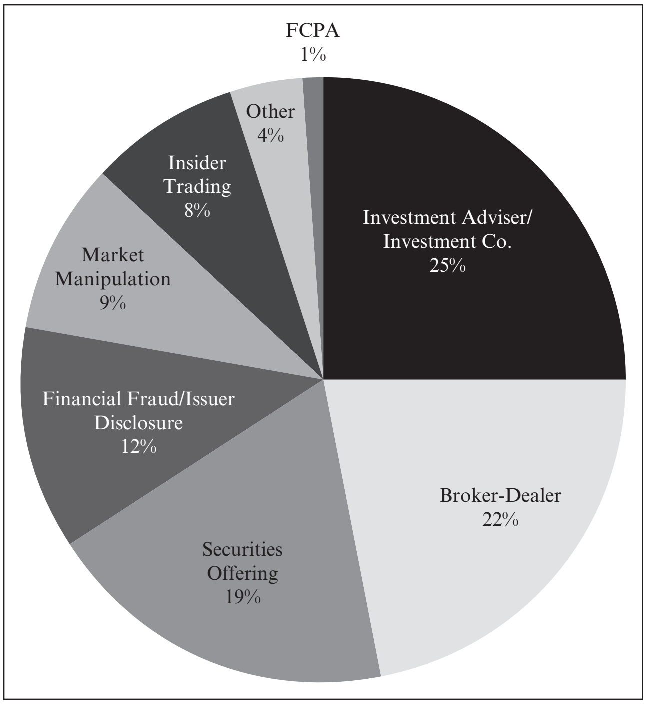
In light of the continued decline in the number of SEC financial fraud cases illustrated above, it is an open question whether this trend reflects an absence of improprieties, or simply the agency's lack of focus on the area. While the Division has reallocated significant investigative resources to financial crisis-related investigations, and to its enhanced focus on investment adviser cases, it does not necessarily mean that the agency is "missing" a groundswell of fraudulent reporting—the decline in these cases may very well be the result of improved internal controls and reporting quality post-Sarbanes-Oxley, or market trends diminishing the incentives or opportunities to commit financial fraud (such as a smaller IPO pipeline). Nonetheless, we anticipate that the SEC's public proclamations about enhancing its public company presence, and the freeing up of resources as financial crisis investigations wind down, will lead to the opening of significant financial reporting investigations this year based simply on anomalous metrics in corporate financial statements. A rising number of investigations in this realm is likely to be further exacerbated by the growing visibility of the SEC's whistleblower program, as discussed below.

The SEC Begins Requiring Party Admissions

After growing judicial and public criticism of the SEC's longstanding policy of allowing parties to settle enforcement cases without admitting or denying the allegations, the SEC announced a new policy in June 2013 requiring party admissions as a condition of settlement in certain cases. While the agency emphasized that most cases would continue to be settled with parties neither admitting nor denying the SEC's allegations, the SEC would break from this practice in cases which involved "egregious intentional misconduct," where the misconduct "harmed large numbers of investors," or where the defendant obstructed the investigation.[6] Chair White reaffirmed the policy in her first public statement of 2014, explaining, "What we are focused on is the enhanced public accountability and the admission of the conduct, the wrongdoing… An apology is easy. We want you to admit what you did."[7]

In the intervening months since announcing the policy, the SEC has only reached two settlements that required admissions. First, in August, the SEC announced a settlement with hedge fund adviser Harbinger Capital Partners and its principal Philip Falcone, in which the defendants admitted to a statement of facts concluding that they acted "recklessly," that Falcone "improperly borrowed" funds from a fund to pay personal tax obligations, and that they selectively agreed to redemption requests by favored customers.[8] The settlement further provided for the payment of $18 million in penalties and disgorgement, as well as a five-year industry bar for Falcone. Notably, despite early assurances that the SEC would not be applying the new policy to cases already in settlement talks,[9] news reports suggest that a tentative agreement (without admissions) had

Figure 2: Breakdown of Enforcement Cases Filed in FY 2013[10]



already been in the works, but was viewed by the Commission as too lax.[11]

The second settlement under the new policy came a month later, when the SEC settled with JPMorgan Chase over the bank's multi-billion dollar "London Whale" trading loss.[12] As part of the settlement, JPMorgan admitted that the bank misstated financial results, lacked effective internal controls, and misled senior management.[13] A month later, the Commodity Futures Trading Commission announced a settlement with JPMorgan Chase Bank in which the regulator appeared to follow the SEC's lead and required admissions that JPMorgan traders acted recklessly. However, JPMorgan "neither admitted nor denied the CFTC's legal conclusion that there was a violation" of the law.[14] It is unclear to date whether the CFTC will adopt the SEC's admissions policy more broadly or how often the regulator will require admissions as part of a settlement.

Given the paucity of SEC settlements so far including party admissions, it is still too soon to tell how often the agency will invoke the policy, or what fact scenarios are likely to trigger an admission demand by the Enforcement Division. Most practitioners agree that admissions are most likely to be found in high-visibility, publicly scrutinized matters, but the SEC brought a number of high profile cases in recent months (including several stemming from the financial crisis) which continued to be settled on a neither-admit-nor-deny basis. This will be a closely watched area in the months ahead.

The SEC's Mixed Record at Trial

One clear implication of the SEC's move towards requiring some settling parties to admit misconduct, as well as the general trend towards tougher settlements, is that more parties will be incentivized to take their chances at trial. Indeed, the SEC has recognized this likelihood and publicly embraced it. In a November 2013 speech entitled "The Importance of Trials to the Law and Public Accountability," Chair White stated:

> [I]n this age of diminishing trials, we at the SEC may be about to reverse the trend a bit… If, in fact, a result of our change in settlement policy results in more trials, one clear winner will be the administration of justice, which will always fare best in the open for the public to see and to take stock of what a defendant did and what its government is doing.[15]

She called the SEC's 80 percent success rate in trials over the past three years "impressive," especially given the limited trial tools available to the SEC relative to the criminal authorities.

The latter half of 2013 saw a number of significant trial setbacks for the SEC.

Notwithstanding this show of confidence, the latter half of 2013 saw a number of significant trial setbacks for the SEC. The agency got off to a solid start in August, when a federal jury found former Goldman Sachs trader Fabrice Tourre liable on six of seven counts in the closely watched case involving the sale of a collateralized debt obligation.[16] But any celebrating at the SEC was presumably cut short two months later, when, on October 16, a jury found against the agency on all counts in the highly publicized insider trading trial of Mark Cuban.[17] The case may not offer any broader lessons on the SEC's insider trading strategy—the SEC tried the case without its key witness appearing to testify, against a celebrity before a home-town jury, on a legal theory shaky enough that the trial judge had initially dismissed it on the pleadings.[18] But a clear-cut loss in such a high-profile matter may embolden more defendants to roll the dice and litigate against the SEC.

The Cuban trial was followed by back-to-back defeats in financial fraud cases. In early

December, in a case alleging that website design company NIC, Inc. had failed to disclose $1.18 million in perquisites paid to its CEO, a Kansas jury found CFO Stephen Kovzan not liable on all counts.[19] And two weeks later, in a case alleging that water purification company Basin Water Inc. had engaged in sham transactions to boost reported revenue, the court dismissed all claims against the CEO and CFO following an eight-day bench trial. The court held that the SEC had failed to present evidence that the defendants had misled anybody, or that they had acted with scienter.[20] (And, in the first week of 2014, a federal trial judge in Georgia handed another defeat to the SEC in an insider trading bench trial.[21])

It seems unlikely that these recent losses will lead the SEC to soften its settlement posture or refrain from bringing difficult cases. However, the recent trial record may result in the SEC filing more cases as administrative proceedings before an administrative law judge, where the Enforcement Division is perceived to face an easier battle. Dodd-Frank includes provisions allowing the SEC to secure essentially the same relief in an administrative proceeding that it can obtain in a civil court case.[22] The implications of more administrative proceedings—which permit limited (if any) discovery, no jury, a much shorter path to trial, and a more challenging appeal path for respondents—may be significant for parties in the SEC's sights.

The Continuing Ascendance of Whistleblowers

The SEC's whistleblower program, created pursuant to Dodd-Frank and in effect for just over two years, continued to make headlines. After a seemingly slow start, with just two relatively small awards handed out to whistleblowers, the Commission announced on October 1, 2013, that a confidential whistleblower was designated to receive over $14 million after providing tips that helped the SEC quickly investigate and file an enforcement action.[23] Because of the requirement that the SEC maintain the confidentiality of the whistleblower's identity, the agency's announcement provided minimal insight into the underlying case, though it appears likely to have been (like the two earlier cases) a fraud in connection with a securities offering. As whistleblowers are eligible to receive between 10 to 30 percent of the money collected from a successful case, this particular case may involve over $140 million.

Less than a month later, the SEC announced a fourth case in which a whistleblower award had been authorized, this time for $150,000.[24] Once again, the facts were scant, but it appeared to be yet another offering fraud.

In November, the SEC released its second annual report on the Dodd-Frank Whistleblower Program.[25] The report showed a slight increase in the overall number of whistleblower tips, from 3,001 in the 2012 fiscal year to 3,238 in 2013. For the second straight year, "Corporate Disclosures and Financials" was the single largest category of complaints (followed closely by offering fraud and market manipulation claims). Nonetheless, we have yet to see whether the program will lead to enforcement actions involving public companies, or regulated entities such as hedge funds, mutual funds or brokers. Of course, such cases typically take longer than offering frauds to investigate, so there could be cases on the way. And a $14 million payout undoubtedly will generate attention among potential whistleblowers (including corporate insiders who might otherwise be reluctant to come forward), not to mention the plaintiffs' bar.

First Deferred Prosecution Agreement with an Individual

The Enforcement Division has been gradually rolling out its cooperation tools since then-Director Robert Khuzami first began adapting criminal tools for the SEC's civil program several years ago. The program took another step forward in November 2013, when the SEC entered into its first deferred prosecution agreement

(DPA) with an individual. (The SEC has previously reported several DPAs with companies.) The SEC announced it had entered an agreement with Scott Herckis, a former hedge fund administrator whose "voluntary and significant cooperation" enabled the SEC to file an emergency enforcement action alleging that the Heppelwhite Fund's founder and manager had misappropriated more than $1.5 million from the hedge fund and overstated its performance to investors.[26] As a part of the DPA, Herckis 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 company for a period of five years, and must disgorge approximately $50,000 in fees that he received for serving as the fund administrator.

Given that Director Ceresney, like Khuzami, has background as a criminal prosecutor (as does Chair White), we anticipate that the SEC's use of various quasi-criminal cooperation agreements will continue to expand under the new administration.

JOBS Act Rulemaking

Finally, one additional area to watch in the months ahead will be investigations arising out of securities offerings taking advantage of the 2012 Jumpstart Our Business Startups Act (JOBS Act). In September 2013, certain key provisions of the JOBS Act went into effect, including broadened availability of general solicitations for companies seeking access to the capital markets. The SEC finalized rules addressing reasonable steps issuers must take to ensure that all investors qualify as accredited investors, as well as governing the involvement of certain "bad actors" associated with issuers whose regulatory or criminal history either precludes the company from using general solicitations or requires disclosure to investors.[27] The SEC also proposed rules calling for additional disclosure requirements for companies using general solicitation, as well as initial rule proposals for companies seeking to raise up to $1 million using crowdfunding platforms.[28]

While the JOBS Act provisions are too new to gauge how widely they will be used, the SEC wasted no time in signaling that they will be vigilant in policing potential abuses. In September, shortly before the general solicitation rules became effective, Director Ceresney stated, "We're focused on making sure that we're poised to address any fraud that may occur" under the Act.[29] And in an October speech, Chair White emphasized:

> Contemporaneously with lifting the ban on general solicitation, the SEC staff has undertaken an interdivisional effort designed to monitor how the ability to advertise and "generally solicit" is actually occurring—how companies and hedge funds are taking advantage of the new rule. It includes assessing the impact of general solicitation on the market for private securities and—importantly—on identifying fraud if it is occurring. If it is, we can seek to stop those in their tracks, who would inappropriately take advantage of this new more open environment.[30]

As issuers and funds begin testing the waters of the JOBS Act, we expect the Enforcement Division to be proactive in opening investigations and, down the road, bringing enforcement actions designed to deter abuse of the new rules.

Expectations for 2014

The SEC begins 2014 in a dramatically different place than it began 2013. A new Chair (plus two other new Commissioners), a new Enforcement Director, the majority of regional offices, and Enforcement units under new leadership—with so many new faces presumably eager to put their imprint on the Enforcement program, it would be a mistake to take too much comfort in the apparent slowdown in new cases last year. Here, then, a few final words on the year ahead:

- The ramping up of the Enforcement Division's accounting fraud task force, coupled with continuing pressure from whistleblowers and the freeing up of resources as the remaining financial crisis investigations wind down, will lead to an expanding number of public company financial reporting investigations. However, with recent statistics suggesting a continuing absence of major fraud on this front, companies could wind up expending significant resources on internal investigations that do not result in actual enforcement actions (or that uncover lesser books and records or internal controls cases that create headaches for companies but do not give the Division major trophies for its efforts).

- The large number of enforcement actions brought against investment advisers and brokers shows no signs of abating. To the contrary, as the SEC's examination program expands its review of hedge funds and private equity funds newly-registered under Dodd-Frank, the enforcement focus on advisers is likely to continue to dominate the docket.

- The SEC will continue to feel pressure to seek more admissions of liability (and to ratchet up settlement terms generally), inevitably leading more defendants to opt to litigate. However, the difficulty in winning complex securities fraud trials, as well as the resource cost to the Enforcement Division of litigating more cases (at the expense of opening new investigations) may ultimately impose a check on the SEC's ability to expand its aggressive settlement strategy.

Notes

1. Year-by-Year SEC Enforcement Statistics, available at *http://www.sec.gov/news/newsroom/images/enfstats.pdf.*

2. Jean Eaglesham, SEC Brings Fewer Enforcement Actions, Slows Early-Stage Probes, Wall St. J., Dec. 17, 2013.

3. SEC Press Release, *SEC Announces Enforcement Results for FY 2013*, available at *http://www.sec.gov/servlet/Satellite/News/PressRelease/Detail/PressRelease/1370540503617.*

4. Note: Data used in chart exclude Delinquent Filings cases.

5. For a more in-depth discussion, *see* Marc Fagel & Leslie Wulff, *Public Companies: Back in the SEC Hot Seat?* Wall St. Lawyer (Sept. 2013), available at *http://www.gibsondunn.com/publications/Documents/FagelWulff-PublicCompanies.pdf.*

6. For a more expansive analysis of the policy change and its implications, *see* Marc Fagel, *The SEC's Troubling New Policy Requiring Admissions*, Bloomberg BNA Securities Regulation & Law Report (June 24, 2013), available at *http://www.gibsondunn.com/publications/Documents/Fagel-SECs-Troubling-New-Policy-Requiring-Admissions.pdf.*

7. Andrew Tangel and Jim Puzzanghera, *SEC's Mary Jo White Wants Companies To Fess Up*, LA Times (Jan. 1, 2014).

8. SEC Press Release, *Philip Falcone and Harbinger Capital Agree to Settlement* (Aug. 19, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222.*

9. Dave Michaels, *SEC Says It Will Seek Admission of Wrongdoing More Often*, Bloomberg Businessweek (June 19, 2013).

10. Note: Data used in chart exclude Delinquent Filings cases.

11. Alexandra Stevenson, An Admission of Wrongdoing As S.E.C. Takes A Harder Line, N.Y. Times (August 20, 2013).

12. SEC Press Release, *JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges* (Sept. 19, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965.*

13. The SEC also filed a litigated case against two JP Morgan traders in connection with the losses. SEC Press Release, *SEC Charges Two J.P. Morgan Traders with Fraudulently Overvaluing Investments to Conceal Losses* (Aug. 14, 2013), available at *www.sec.gov/News/PressRelease/Detail/PressRelease/1370539776091.* The two were subsequently indicted by the U.S. Attorney's Office in the Southern District of New York. Reed Albergotti, *Two Former J.P. Morgan Traders Indicted for 'London Whale' Trading Loss*, Wall St. J. (Sept. 16, 2013).

14. CFTC Press Release, CFTC Files and Settles Charges Against JPMorgan Chase Bank, N.A., for Violating Prohibition on Manipulative Conduct In Connection with "London Whale" Swaps Trades (October 19, 2013), available at *http://www.cftc.gov/PressRoom/PressReleases/pr6737-13;* Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions (Oct. 16, 2013), available at *http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfjpmorganorder101613.pdf.*

15. SEC Speech, Chair Mary Jo White, *The Importance of Trials to the Law and Public Accountability* (Nov. 14, 2013), available at *http://www.sec.gov/News/Speech/Detail/Speech/1370540374908.*

16. Susanne Craig and Ben Protess, *Former Trader Is Found Liable in Fraud Case*, NY Times (Aug. 1, 2013). Post-trial motions are pending, including the SEC's motion for more than $1 million in penalties, disgorgement, and interest.

17. Ben Protess and Lauren D'Avolio, *Jury Rules for Mark Cuban in Setback for S.E.C.*, NY Times (Oct. 16, 2013).

18. *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), vacated and remanded, 2010 U.S. App. LEXIS 19563 (5th Cir. 2010).

19. Mark Davis, Jury Clears NIC Executive Stephen Kovzan After 18-Day Trial, Kansas City Star (Dec. 4, 2013).

20. Stephanie Russell-Kraft, SEC Loses Fraud Claims Against Water Purifier Co. Execs, Law360 (Dec. 12, 2013).

21. SEC V. Schvacho, 1:12-CV-2557-WSD (N.D. Ga. Jan. 7, 2014).

22. For example, Dodd-Frank allows the SEC to seek civil monetary penalties in an administrative cease and desist proceeding. Prior to 2010, with the exception of registered persons such as brokers and investment advisers, penalties could only be obtained in federal court.

23. SEC Press Release, *SEC Awards More than $14 Million to Whistleblower* (October 1, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258; see also* Gregory Wallace, *Whistleblower Awarded $14 million—SEC's Largest Ever*, CNN Money (October 1, 2013), available at *http://money.cnn.com/2013/10/01/news/sec-whistleblower/.*

24. SEC Press Release, *SEC Rewards Whistleblower With $150,000 Payout* (Oct. 30, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540158194.*

25. 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program, available at *http://www.sec.gov/about/offices/owb/annual-report-2013.pdf.*

26. SEC Press Release, *SEC Announces First Deferred Prosecution Agreement with Individual* (November 12, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540345373.*

27. SEC Press Release, SEC Approves JOBS Act Requirement to Lift General Solicitations Ban, available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782.*

28. *See* Gibson Dunn, SEC Proposes Rules to Implement Crowdfunding Exemption: What Factors Will Affect Its Success?, available at *http://www.gibsondunn.com/publications/Pages/SEC-Proposes-Rules-to-Implement-Crowdfunding-Exemption-What-Factors-Will-Affect-Its-Success.aspx.*

29. Emily Chasan, *SEC's Enforcement Unit Changes Tack*, Wall. St. J. (Sept. 11, 2013).

30. SEC Speech, Chair Mary Jo White, *Hedge Funds—A New Era of Transparency and Openness* (Oct. 18, 2013), available at *http://www.sec.gov/News/Speech/Detail/Speech/1370539892574.*

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