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ENFORCEMENT

Securities Enforcement 2011 — What Hath Dodd Frank Wrought?



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I. Overview of 2011

For the SEC's Division of Enforcement, 2011 was a year of extremes — record breaking enforcement activity contrasted with a highly publicized challenge to one of the fundamental aspects of its program.

For the fiscal year, the Division reported a record high number of enforcement actions — 735 — resulting in more than $2.8 billion in penalties and disgorgement ordered. In particular, there was a substantial increase in enforcement actions against investment advisers and broker-dealers. Notably, several Enforcement Division initiatives started resulting in cases in areas of investment adviser performance disclosure, management fees and compliance. The Division continued to file a number of significant enforcement actions arising from the financial crisis, including actions against senior executives at financial institutions, and another case against an individual alleging only negligence. And the Division's Office of the Whistleblower officially opened for business and began receiving a steady flow of tips, many of which have resulted in investigations.

However, as 2011 drew to a close, and 2012 begins, the Enforcement Division faces a judicial challenge to an elemental component of its program — whether it can continue to settle cases (and obtain judicial approval of those settlements) on a ''neither admit nor deny'' basis. The answer to this question, now on appeal to the Second Circuit, could have a fundamental impact on both the Enforcement Division and companies and individuals seeking to negotiate a resolution of a potential enforcement action.

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A. The Future Of The ''Neither Admit Nor Deny'' Settlement

We begin at the end of the year, with the case that has put into question the SEC's ability to settle cases on a ''neither admit nor deny'' basis.

On October 19, 2011, the SEC filed a settled action against Citigroup Global Markets alleging that, in connection with the structuring and sale of a collateralized debt obligation (''CDO''), Citigroup negligently did not adequately disclose its role in the selection of assets in

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the CDO, or that it took a short position against the assets it helped select.[1] The negotiated settlement called for a payment of $285 million in disgorgement and penalties. Upon filing in the Southern District of New York, the case was assigned to Judge Jed Rakoff for approval of the settlement. Judge Rakoff has previously subjected SEC settlements to substantial scrutiny, including the SEC's settlement with Bank of America in 2010 and its settlement with WorldCom in 2003.

In reviewing the SEC's settlement with Citigroup, in early November 2011, Judge Rakoff set forth a series of questions regarding the proposed settlement, including why the settlement did not include an ''outright admission or denial'' of wrongdoing by the defendant.[2] After briefing and a hearing, on November 28, 2011, Judge Rakoff rejected the settlement, stating that the allegations were ''unsupported by any proven or acknowledged facts'' and sharply criticized the SEC's longstanding practice of entering into settlements in which the defendant neither admits nor denies wrongdoing. Judge Rakoff wrote that in approving such settlements, ''the court becomes a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance.''[3]

Later that same day, Enforcement Division Director Robert Khuzami issued a statement respectfully disagreeing with the Court's decision, arguing that the practical benefits of the settlement ''outweigh the absence of an admission when that relief is obtained promptly and without the risks, delay and resources required at trial.''[4]

On December 15, 2011, Director Khuzami announced that the SEC would appeal Judge Rakoff's decision. In his statement, Director Khuzami argued that the District Court had ''committed legal error by announcing a new and unprecedented standard that inadvertently harms investors by depriving them of substantial, certain and immediate benefits.''[5]

With a trial scheduled in the District Court and discovery deadlines looming, the SEC (joined by Citigroup) moved to stay the proceedings in the District Court pending review of the settlement by the Second Circuit.[6] On December 27, 2011, Judge Rakoff denied the SEC's motion for a stay, finding that the ''purported statutory basis for the instant appeal[] is patently defective . . . ''and noting that the harm to be suffered by the SEC absent a stay is ''largely illusory.''[7]

The SEC also filed an emergency application for a stay in the Second Circuit, which was granted the following day. The temporary stay will remain in effect until at least January 17, 2012, at which time the SEC's motion will be considered by the Second Circuit motion panel.[8]

On January 6, 2012, the SEC announced that it would no longer include the ''neither admit nor deny'' formulation in settlements with defendants who had already pleaded guilty to criminal charges for the same conduct. This policy would also apply in situations in which a corporate defendant has entered into a deferred prosecution agreement (DPA) or non-prosecution agreement (NPA) in the criminal matter.

The issues raised by Judge Rakoff's decision have a potentially significant impact on the SEC's enforcement program, as well as those companies and individuals who are subject to potential enforcement actions. The extent of judicial review of a proposed settlement raises significant issues regarding when a proposed settlement is final, whether it can be amended at will by a court, and who is responsible for the administration and oversight of the enforcement of the federal securities laws. A requirement of admissions will also undoubtedly make it harder for the SEC, and the defendants, to reach settlements at least in part because admissions can have substantial collateral consequences for defendants that extend far beyond the costs of an enforcement action. Moreover, creating exceptions to the policy can increase the risk of having the policy second-guessed. In his decision rejecting the Citigroup settlement, Judge Rakoff questioned why it did not contain some form of acknowledgment as in the SEC's settlement of a similar case with Goldman Sachs. Thus, the more exceptions the SEC creates to the neither admit nor deny form of settlement, the greater the risk that other courts will also question it in settlements. The far-reaching effects of this issue will make the Second Circuit appeal one of the most important cases to watch in 2012.

B. By The Numbers: 2011 Enforcement Statistics and Trends

1. Number of Civil Actions Decline, Defendants Increase, But Litigation Percentage Remains High

Over the last several years, we have tracked certain metrics of enforcement activity for the calendar year,

[1] *See* SEC Press Release No. 2011-214 (Oct. 19, 2011), http://sec.gov/news/press/2011/2011-214.htm.

[2] *See* Richard Vanderford, Rakoff Reluctant To Bless $285M Citi, SEC Deal (Nov. 9, 2011), *available at* http://www.law360.com/articles/284898.

[3] *See* Evan Weinberger, Rakoff War On Bank Deals May Force SEC's Hand (Nov. 28, 2011), *available at* http://www.law360.com/articles/288598.

[4] *See* Robert Khuzami, Director, Division of Enforcement, Public statement by SEC Staff: Court's Refusal to Approve Settlement in Citigroup Case (Nov. 28, 2011).

[5] *See* SEC Press Release No. 2011-265, SEC Enforcement Director's Statement on Citigroup Case (Dec. 15, 2011), http://sec.gov/news/press/2011/2011-265.htm.

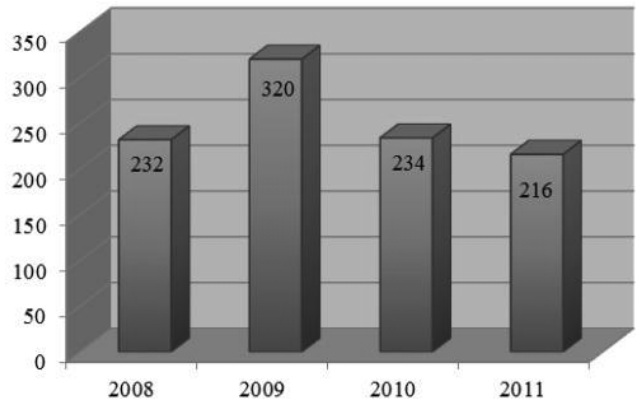
[6] *SEC v. Citigroup Global Markets, Inc.*, Civil Action No.11-CV-7387 (S.D.N.Y. Dec. 27, 2011).

[7] *Id*.

[8] William McGrath, Second Circuit Grants Temporary Stay in Citigroup Case (Dec. 29, 2011), *available at* http://www.fedseclaw.com/2011/12/articles/sec-news/second-circuit-grants-temporary-stay-in-citigroup-case/index.html#axzz1icOEKOqv.

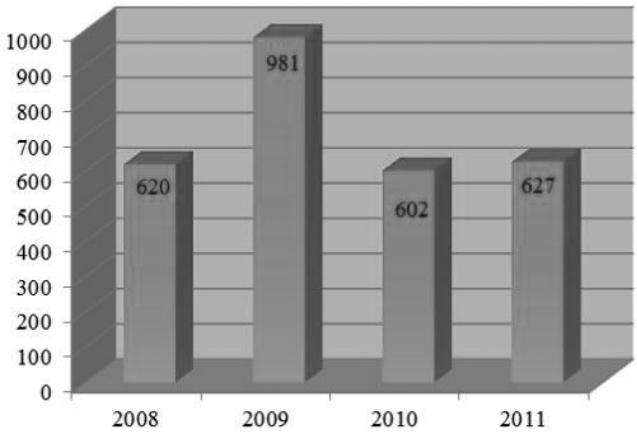
identifying notable trends, including the number of civil actions filed, the number of defendants named in those complaints, and the percentage of defendants who settled at the time of filing. In 2011, the SEC filed a total of 216 civil injunctive actions, only a slight decrease from 2010 but representing a 33% drop compared to 2009.

Figure 1 -- Civil Injunctive Actions Filed



The number of defendants charged in civil proceedings increased this year, up to 627 from 602 in 2010. This however, marks a return to a pre-2009 level, down from a high of 981 in that year.

Figure 2 -- Ị umber of Defendants Charged

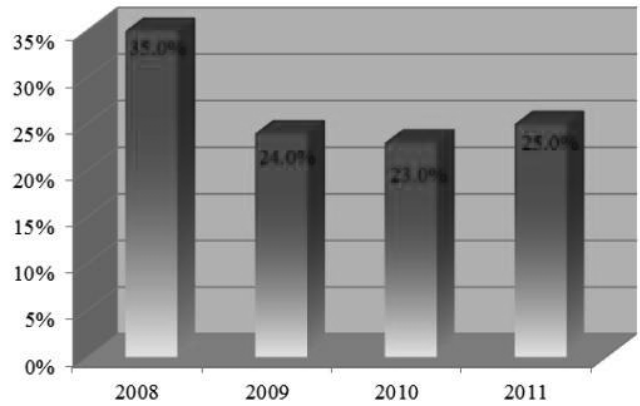


We have also tracked the percentage of defendants who settled at the time of filing. This statistic is significant because it is a potential indicator of the SEC's willingness to charge defendants without settlements and the willingness of respondents to resolve cases before being charged. The percentage of defendants settled increased slightly from 23% in 2010 to 25% in 2011, but still well below the 35% level observed in 2008. This continues a trend we have noted in the years since 2008 of an increased number of cases being litigated with an accompanying burden on the SEC's resources.

2. Fiscal Year End Statistics — A New Record

The SEC filed a record-high 735 enforcement actions during fiscal year 2011 (ended September 30), an 8% increase from fiscal 2010. A closer look at the numbers reveals a disproportionate increase in the number of actions against SEC registrants—investment advisers and broker-dealers. We saw a 30% increase in investment adviser actions from 2010 and a 60% increase for actions related to broker-dealers. 2011 marks the first complete fiscal year since the Commission underwent its significant 2009-2010 reorganization, including the specialized units, the cooperation initiative and changing the screening of tips and complaints.[9]

Figure 3 -- Percentage of Defendants Settled at Filing



The number of injunctive actions increased slightly from 2010, but still remained well below the 2009 figures. Finally, the SEC continued to increase the number of administrative actions filed; however, the 9% increase seems modest when compared to the 22% increase from 2009 through 2010. With the SEC's ability under Dodd-Frank to impose civil monetary penalties against any respondent in an administrative proceeding (and the increased judicial scrutiny of settlement filed in federal court), this trend may continue.

	Fiscal 2009	Fiscal 2010	Fiscal 2011
Total Enforcement Actions	664	681	735
Injunctive Actions	312	252	266
Administrative Proceedings	352	429	469

a. New Formal Investigations Continue to Increase, While Closures Catch Up

Fiscal 2011 saw a decrease in the number of investigations opened and closed. There was a modest 2% decrease of investigations opened from 2010 and the more significant 36% decrease in the investigations closed. The number of closed matters represents a reversal of the trend we saw last year when the number of investigations closed increased by 36%. The data below shows a dramatic decline in investigations pending at fiscal year-end; however, the figures don't tell the entire story because the SEC now only counts matters at the investigative stage as pending matters and excludes matters still in litigation, collections, distributions or other post-litigation activity. The trend upwards in formal orders of investigations opened continued in fiscal year 2011 as well, up to 578.

	Fiscal 2009	Fiscal 2010	Fiscal 2011
Investigations Opened	944	952	933

[9] *See* SEC Press Release No. 2011-234 (Nov. 9, 2011), http://sec.gov/news/press/2011/2011-234.htm.

	Fiscal 2009	Fiscal 2010	Fiscal 2011
Investigations Closed	716	975	628
Investigations Pending at Fiscal Year End	4,316	4,294	1,665
Formal Orders of Investigation	496	531	578

b. Coordination with Criminal Prosecutors

The SEC's collaboration with criminal prosecution remained largely unchanged in fiscal year 2011, only decreasing by two to 137. These charges include filed indictments, informations or contempts and while this figure is not at 2009 levels, it still represents a substantial increase over fiscal year 2008.

	Fiscal 2009	Fiscal 2010	Fiscal 2011
Cases with Criminal Charges	154	139	137

c. Remedies Obtained

In 2010, penalties ordered by the SEC were at a remarkable $1.03 billion, a nearly three-fold increase over prior years. In fiscal year 2011, penalties ordered were still quite high at $928 million. Total disgorgement for fiscal year 2011 was at $1.88 billion, only a slight increase from last year's $1.82 billion. Emergency remedies remained at 2010 levels, only increasing two to 39. Asset freezes continued to decline. In 2011, 42 asset freezes were sought, a decline of 26%.

	Fiscal 2009	Fiscal 2010	Fiscal 2011
Disgorgement Ordered	$2.090 billion	$1.820 billion	$1.878 billion
Penalties Ordered	$345 million	$1.030 billion	$928 million
TROs Sought	71	37	39
Asset Freezes Sought	82	57	42

3. Office of the Whistleblower Opens for Business

In last year's update, we discussed the creation of the SEC's whistleblower bounty program. In the year since that update, the SEC underwent its formal notice-and-comment rulemaking process and, after receiving more than 240 comment letters and 1,300 form letters, on May 25, 2011, the SEC adopted final Regulation 21F, which was effective as of August 12, 2011. The final rules established whistleblower procedures for tip submission and applying for awards, outlined the criteria that the SEC considers in making award decisions and implemented the Dodd-Frank prohibition against retaliation against whistleblowers. In addition, on February 18, 2011, the SEC announced that Sean X. McKessey would head the newly-created Office of the Whistleblower in the Division on Enforcement.[10]

The SEC has only collected data for August and September 2011 so any trends are yet to be seen. Nevertheless, the 334 whistleblower tips received from August 12, 2011 through September 30, 2011, is telling of what will likely be an important tool used by SEC enforcement in the future. Tips have run the gamut of SEC actions but the most common tips received were market manipulation (16.2%), corporate disclosure and financial statements (15.3%) and offering fraud (15.6%). The award threshold is not reached unless the entry of a final judgment or order for monetary sanctions exceeds $1 million. Once a ''Notice of Covered Action'' is posted, the whistleblower then has 90 calendar days to apply for an award. The SEC expects to implement an individualized notification system in the future. Of course, the SEC did not pay any whistleblower awards in fiscal 2011 because the first ''Notice of Covered Actions'' was posted on August 12, 2011, and the 90-day window did not expire.[11]

The SEC continued to bring a significant number of cases related to the financial crisis. According to the SEC's numbers, in fiscal 2011, the agency brought 15 separate actions naming 17 individuals, based on allegations relating to the financial crisis. Over the past two and a half years, this brings the totals to 36 actions against 81 defendants related to the financial crisis, resulting in approximately $1.97 billion in disgorgement and penalties.[12] Consistent with this activity, in the second half of 2011, the Commission continued to file actions arising from the financial crisis.

C. What to Look for in 2012

For 2012, in the short term all eyes are focused on the outcome of the SEC's appeal to the Second Circuit in the Citigroup case and the continued viability of settlements on a neither admit nor deny basis.

But longer term, the Enforcement Division will confront decisions concerning the allocation of resources. As we have noted, for the last three years the Division has devoted substantial resources to cases related to the financial crisis. According to the SEC's numbers, in fiscal 2011, the agency brought 15 separate actions against 17 individuals relating to the financial crisis, bringing the total over the past two and a half years to 36 actions against 81 defendants.[13] As we have discussed, many of these cases have been unsettled and will require substantial litigation for several years. We offer one data point for illustration: in December 2011 a jury in New York returned a verdict dismissing most of the SEC's charges against the sole remaining defendant in a case involving allegedly deceptive mutual fund market timing by a broker.[14] The case had been filed in 2006 and concerned conduct that occurred in 2001-2003. Several cases arising out of the ''tech bubble'' of 2000 remain pending. By this measure, the financial crisis cases the SEC files today, concerning conduct in 2008, could be litigated until 2017 or beyond.

As more time passes since the depths of the financial crisis, the Division will confront decisions on when to close investigations arising from the last crisis in order to maintain focus on the next risks. At the same time, the Division will need to manage the incoming flow of tips to the Office of the Whistleblower.

Director Khuzami recognizes the challenges. As he testified before Congress, ''[fiscal year] 2012 will be a

[10] *See* SEC Annual Report on the Dodd-Frank Whistleblower Program — Fiscal Year 2011 (Nov. 2011), *available at* http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf.

[11] *Id*.

[12] *See* SEC Press Release No. 2011-234 (Nov. 9, 2011), http://sec.gov/news/press/2011/2011-234.htm.

[13] *Id*.

[14] *See* Peter Ortiz, Jury Clears Alleged Timer of Most SEC Charges (Dec. 19, 2011).

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critical period for the SEC.''[15] He identified two overarching priorities going forward: first, ''stop[ping] fraud and misconduct as early as possible,'' and second, serving as an ''effective enforcement and deterrent force in complex markets and with regard to opaque and complicated products and transactions.''[16] The SEC has made great strides in hiring industry experts to help with identifying risks in the markets. But markets evolve and risks change continuously and rapidly. The challenge the SEC will continue to face is whether its expertise can keep pace with the markets. The question will be whether the Enforcement Division can maintain a focus on the risks of the present and future, without getting mired in the problems of the past.

II. Insider Trading

Insider trading remains a priority for federal prosecutors and the SEC. Since August 2009, the United States Attorney in Manhattan has charged 56 individuals with insider trading, and since early December, 53 of those charged have pled guilty or been convicted at trial.[17] Similarly, the SEC brought 37 insider trading actions in 2009; 53 cases in 2010;[18] and 57 actions in 2011, an 8% increase from 2010's total.[19] The SEC has continued to pursue insider trading against hedge funds, financial companies and trades surrounding mergers and acquisitions in 2011. The major developments in this last half year are set forth as follows.

Criminal Charges

In October 2011, federal prosecutors charged Rajat Gupta, a former Goldman Sachs and Proctor & Gamble board member, with providing inside information on both firms to Raj Rajaratnam.[20] The government alleges that Mr. Gupta provided quarterly earnings information from both firms to Mr. Rajaratnam, including tipping Mr. Rajaratnam about Warren Buffett's $5 billion investment in Goldman Sachs in 2008.[21] The SEC also has filed civil insider trading against Mr. Gupta in October 2011.[22] The SEC had previously dismissed its administrative proceeding against Rajat Gupta for the same conduct after Gupta challenged the SEC's authority to bring such charges in an administrative proceeding.

In December, Stanley Ng pleaded guilty to insider trading charges filed in August. Mr. Ng worked at Marvell Technology Group as the reporting manager to the SEC, which provided him with access to the company's earnings before they were released to the public. Mr. Ng passed confidential financial information to Winifred Jiau, a former research consultant with Primary Global Research, LLC.[23] Ms. Jiau subsequently delivered the tips to Noah Freeman and Donald Longueuil, former traders at the hedge fund SAC Capital Management; and Samir Barai, a former hedge fund manager.[24]

Major criminal cases have also moved to the sentencing phase. After being found guilty for insider trading earlier this year, Mr. Rajaratnam, founder of Galleon Management, was sentenced to 11 years in jail in October, the longest term imposed in an insider-trading case.[25] In addition to the prison sentence, Mr. Rajaratnam was fined $92.8 million, the largest penalty ever assessed against an individual in an SEC insider trading case. Zvi Goffer, a former hedge fund trader, was sentenced to 10 years in prison in September for bribing corporate lawyers for information on corporate mergers and trading on this information.[26] Zvi Goffer settled the SEC's civil insider trading case with a fine of $1.2 million and a permanent bar from the securities industry.[27] Mr. Goffer's associates, his brother Emanuel and Brien Santarlas, a former lawyer, were also sentenced in October and November, respectively. Emanuel Goffer was sentenced to three years in prison and ordered to pay a forfeiture of $761,623.[28] Brien Santarlas was sentenced to six months in prison for tipping Zvi Goffer with confidential information he gained from his law firm, Ropes & Gray.[29] Mr. Santarlas's sentence was reduced due to his cooperation with the government.

Hedge Funds

Alleged insider trading by personnel associated with hedge funds remained an SEC focus in the second-half of 2011. In August 2011, the SEC brought charges against H. Clayton Peterson and his son, Drew Clayton Peterson, a managing director at a Denver-based investment adviser.[30] The SEC alleged that the elder Peterson, a board member of Mariner Energy, provided his son with confidential information about Mariner's pending acquisition of Apache Corporation, which allowed Drew Peterson to acquire more than $5.2 million in profits. The SEC amended its complaint in October 2011 to include two other defendants, money manager Drew K. Brownstein, a long-time friend of Drew Peterson, and Big 5 Asset Management LLC, a hedge-fund

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[15] *See* Robert Khuzami, Director, Division of Enforcement, ''Testimony on ''Management and Structural Reforms at the SEC: A Progress Report''' (Nov. 16, 2011), *available at* http://sec.gov/news/testimony/2011/ts111611rk.htm.

[16] *Id*.

[17] *See* Peter Lattman, ''Former Marvell Employee Pleads Guilty to Insider Trading,'' N.Y. Times DealBook (Dec. 7, 2011), *available at* http://dealbook.nytimes.com/2011/12/07/former-marvell-employee-expected-to-plead-guilty-to-insider-trading/.

[18] SEC, *Spotlight on Insider Training* (June 14, 2011), http://www.sec.gov/spotlight/insidertrading.shtml.

[19] *See* SEC Press Release No. 2011-234 (Nov. 9, 2011), http://sec.gov/news/press/2011/2011-234.htm.

[20] *See United States v. Gupta*, Case No. 11- CR- 907 (S.D.N.Y., filed unsealed Oct. 26, 2011).

[21] Aaron Katersky, ''Former Goldman Sachs Board Member Pleads Not Guilty of Insider Trading,'' abcnews.com (Oct. 26, 2011), http://abcnews.go.com/Business/goldman-sachs-director-arrested-insider-trading/story?id=14817416.

[22] *See SEC v. Gupta*, Civil Action No. 11-CV-7566 (S.D.N.Y., filed Oct. 26, 2011).

[23] *See United States v. Ng*, Case No. 11- MJ 2096 (S.D.N.Y., filed Aug. 11, 2011).

[24] *Id.*

[25] *See United States v. Rajaratnam et al.*, Case No. 09- CR-1184 (S.D.N.Y. Oct. 25, 2011).

[26] *See* Judgment as to Zvi Goffer, *United States. v. Goffer et al.*, Case No. 10-CR-56 (S.D.N.Y. Sept. 21, 2011).

[27] *In re Zvi Goffer*, Admin. Proceeding No. 3-14659 (filed Dec. 9, 2011); *see also SEC v. Cutillo et al.*, Civil Action No. 09-cv-9208 (RJS) (S.D.N.Y. Dec. 9, 2011), *SEC v. Galleon LP et al.*, Civil Action No. 09-cv-8811 (JSR) (S.D.N.Y. Dec. 5, 2011).

[28] *See* Judgment as to Emanuel Goffer, *United States v. Goffer et al.*, Case. No. 10-CR-56 (S.D.N.Y. Oct. 7, 2011).

[29] *See United States. v. Santarlas*, Case No. 09-CR-1170 (S.D.N.Y. filed Dec. 7, 2009).

[30] *See SEC v. Peterson*, Civil Action. No. 11-CIV-5488 (S.D.N.Y. Aug. 6, 2011).

advisory firm controlled by Brownstein.[31] The amended complaint charges that Drew Peterson tipped Brownstein with the information he gained from his father, which led Brownstein to purchase shares of Mariner Energy stock. Brownstein pleaded guilty to criminal insider trading charges in October 2011.[32] Clayton Peterson and Drew Peterson pleaded guilty in August 2011; Clayton Peterson was sentenced to two years' probation while Drew Peterson is scheduled to be sentenced in January.[33]

Financial Companies

In the first case to allege insider trading in exchange traded funds, or ETFs, the SEC instituted an administrative action against an employee of Goldman Sachs in September 2011. The action alleges that the employee tipped his father about Goldman's plans to purchase large amounts of securities underlying an ETF and that the two used that information to make profitable trades.[34]

The SEC also has brought insider trading charges against four Chinese citizens with U.S.-based brokerage accounts in December 2011 and obtained an emergency court order freezing the defendants' assets.[35] The complaint alleges that the four traders purchased American Depository Shares of Beijing-based Global Education and Technology Group two weeks before a November 21 public announcement of a planned merger with London-based Pearson plc. The SEC alleged that several of the accounts invested heavily in Global Education shares, with the value of some purchases equaling or exceeding the stated annual income of that trader.

A Spanish trader recently won dismissal of an insider trading lawsuit brought against him by the SEC.[36] In August 2010, the SEC accused Luis Martin Caro Sanchez and Juan Jose Fernandez Garcia, a former Banco Santander SA research analyst, of using material nonpublic information when buying shares of Potash Corp. before the company became the target of an unsolicited takeover bid by BHP Billiton Ltd. Banco Santander had advised BHP on the bid. Garcia settled with the SEC in April 2011.[37] Sanchez decided to go to trial. In his decision in December 2011, Judge Aspen, of the Northern District of Illinois, held that the SEC could not establish that Sanchez received confidential information about the takeover offer. Judge Aspen noted that while the trades were suspicious, the SEC's evidence was too circumstantial and that even though Sanchez had thrown away his laptop after the SEC requested his hard drives, this did not constitute bad faith. While he did note that insider trading can be established through circumstantial evidence, Judge Aspen held that merely showing suspicious transactions that result in large profits was not sufficient to prove insider trading.[38]

Mergers and Acquisitions

In the second half of 2011, the SEC brought several additional insider trading cases for trades allegedly made in advance of merger announcements. The SEC filed suit against Toby Scammell, a former employee of an investment fund, for alleged insider trading on the Walt Disney Company's acquisition of Marvel Entertainment.[39] The SEC alleged that Scammell acquired confidential information from his girlfriend, who worked at Disney, and breached his duty of trust and confidence to his girlfriend by purchasing highly speculative Marvel call options, from which he earned a 3000% return in less than a month.

The SEC filed a settled insider trading case against Douglas DeCinces and three others for making more than $1.7 million in alleged illicit profits through the purchase of shares in advance of an announced merger.[40] The SEC alleges that DeCinces learned of the acquisition of Advanced Medical Optics by Abbott Laboratories Inc. through an inside source and immediately began purchasing shares of Advanced Medical Optics. DeCinces allegedly shared this information with three associates, a physical therapist, a real estate lawyer, and a businessman, who were also alleged to have traded on this information. DeCinces agreed to pay $2.5 million to settle the charges with the SEC; Mr. DeCinces' co-defendants paid lesser disgorgements to settle the charges.

In September, the SEC filed suit against Scott Allen, a former consulting firm executive, and a long-time friend John Michael Bennett for allegedly trading on confidential information in advance of the acquisitions of Millennium Pharmaceuticals Inc. and Sepracor Inc.[41] The SEC alleged that Allen's consulting firm was advising the acquiring companies in the transaction, and Allen obtained confidential information through his employment at the firm. Allen allegedly then provided his friend with details of the acquisitions, and the friend allegedly purchased call options on stock of the companies. The SEC alleges that the trades generated more than $2.6 million in profits.

III. Investment Advisers

Implementing Dodd-Frank: Systemic Risk Assessment

In October 2011, the SEC unanimously adopted a new rule requiring advisers to larger hedge funds and certain other private funds to report information relating to systemic risk issues for use by the Financial Stability Oversight Council (FSOC) under its Dodd-Frank

[31] *Id.*; *see also United States v. Brownstein*, 11-CR-904 (S.D.N.Y. 2011).

[32] *See U.S. v. Brownstein*, 11-CR-904 (S.D.N.Y. Oct. 21, 2011).

[33] *See U.S. v. Peterson*, 11-CR-665 (S.D.N.Y. Aug. 5, 2011); *see U.S. v. Peterson*, 11-CR-664 (S.D.N.Y. Aug. 5, 2011).

[34] *See In re Mindlin*, Admin Proceeding No. 3-14557 (filed Sept. 21, 2011).

[35] *SEC v. All Knowing Holdings Ltd.*, Civil Act. No. 11-CV-8605 (N.D. Ill. Dec. 5, 2011).

[36] *See SEC v. Garcia*, Civil Action No. 10-CV-5268 (N.D. Ill. Dec. 28, 2011).

[37] *See* Final Judgment as to Defendant Juan Jose Fernandez Garcia, *SEC v. Garcia*, Case No. 10-CV-05268 (N.D. Ill. May 2, 2011).

[38] *See SEC v. Garcia*, Case No. 10-CV-5268 (N. D. Ill. Dec. 28, 2011).

[39] *See SEC v. Scammell*, Civil Action No. 11-CV-6597 (C.D. Cal. Aug. 11, 2011).

[40] *See SEC v. Decines*, Civil Action No. 11-CV-1168 (C.D. Cal. Aug. 4, 2011).

[41] *See SEC v. Allen*, Civil Action No. 11-CIV-6443 (S.D.N.Y. Sept. 15, 2011).

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mandates.[42] Under this new rule, SEC-registered fund managers with over $150 million in private assets under management must periodically provide data in a Form PF, which is a joint initiative between the SEC and the Commodity Futures Trading Commission to attempt to minimize the risk that the failure of a financial firm will cascade throughout the system.

The rule separates reporting fund managers into two categories—smaller advisers and large advisers. Large advisers—hedge fund advisers with greater than $1.5 billion in assets under management; liquidity fund advisers with at least $1 billion in liquidity fund and money market assets under management; and advisers with over $2 billion in private equity assets under management—must report quarterly (hedge and liquidity funds) or annually (private equity funds) and provide a high level of detail on specified risk issues. Smaller advisers (all other advisers with over $150 million under management) must report Form PF information annually and are not required to report with the same level of detail as larger advisers. The type of reportable information differs depending on fund type but can include information on leverage, concentration, liquidity, and assets. Form PF reporting requirements will be phased in throughout the second half of 2012.[43]

Notably, the new rule creates the opportunity for greater enforcement activity by the SEC and CFTC (Commodity Futures Trading Commission). First, investment advisers subject to the rule could face liability for compliance and disclosure failures. Second, the detailed disclosures required of certain funds could put additional issues on the Enforcement Division's radar screen. Chairman Schapiro noted in remarks that ''we are committed to building the controls necessary to provide appropriate confidentiality and limit the availability of proprietary hedge fund and other private fund information to those who have a regulatory need to know'';[44] however, the rule release notes that Form PF information may be used in enforcement actions and shared with other federal agencies or with self-regulatory organizations.[45] The coming years will show whether the use of Form PF leads to increased enforcement actions against larger investment advisers and whether the Enforcement Division will increase its focus on these advisers as a result of greater information availability.

Investment Adviser Enforcement Priorities

1. Asset Management Unit

In September 2011, co-chief of the SEC Enforcement Division's Asset Management Unit, Bruce Karpati, discussed his group's enforcement priorities with *Compliance Reporter*.[46] He noted five current priority areas for the unit: valuation and performance; conflicts of interest; governance compliance and controls; trading practices including frontrunning, insider trading, preferential redemption, and controls; and high risk products. In particular, Karpati cited Exchange Traded Funds as an ''emerging risk'' area he wanted the unit to focus on. He noted the unit was also focusing on advisory fee arrangements, cautioning that boards must engage in a substantive review of advisory fees and that advisers must provide full and accurate information for the board's review.

Karpati also noted that the Commission's examination staff have become more adept in recent years at handling complex trading issues, such as those involving quantitative funds and algorithmic trades. One reason may be the addition of three industry experts to the unit: a former hedge fund portfolio manager, a former private equity analyst, and a former execution trader.

Below we analyze key investment adviser cases brought by the SEC in recent months which indicate that many of these priorities have already borne fruit.

2. Office of Compliance Inspections and Examinations

The SEC's Office of Compliance Inspections and Examinations (''OCIE'') will soon issue the agency's first manual on examinations, setting forth the key policies and standards for inspections and exams. The division's director Carl di Florio announced the manual in October before the National Society of Compliance Professionals.[47] When the manual is approved and disseminated by the SEC, investment advisers will for the first time have a comprehensive guidepost on what to expect during an OCIE exam.

OCIE Director Di Florio also cautioned that broker-dealers and investment advisers should ensure ethics issues are incorporated in compliance programs, pointing to Section 206 of the Advisers Act and FINRA Rule 2010. Emphasizing that ''a corporate culture that reinforces ethical behavior is a key component of effectively managing risk across the enterprise,'' di Florio noted that ethics issues will become increasingly important in OCIE exams.[48]

3. Social Media and Investing

On January 4, 2012, the SEC announced the institution of administrative proceeding against an investment adviser who offered fictitious securities to the public through social media.[49] Primarily, the adviser used the networking site LinkedIn to promote ''bank guarantees'' and ''medium-term notes'' that did not exist by starting conversations about the fictitious securities in a discussion forum of the site. In response, several potential investors contacted the adviser by email about the securities he had offered for sale. The adviser faces fraud charges, in addition to charges relating to regis-

[42] *See* Forms Prescribed Under the Investment Advisers Act of 1940, 17 C.F.R. 279.9 *and* Amendments to Form ADV, 17 C.F.R. 275.204(b)-1 (2011).

[43] *See* SEC Press Release No. 2011-226 (Oct. 26, 2011), http://www.sec.gov/news/press/2011/2011-226.htm.

[44] Mary L. Schapiro, Chairman, Chairman, SEC, ''Opening Statement at SEC Open Meeting: Private Fund Systemic Risk Reporting'' (SEC Oct. 26, 2011), http://www.sec.gov/news/speech/2011/spch102611mls.htm.

[45] *See* SEC Release for Rules Implementing Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF (SEC Oct. 31, 2011), http://sec.gov/rules/final/2011/ia-3308.pdf.

[46] *See* Jake Simpson, *SEC Preps Mutual Fund Fee Cases*, Compliance Reporter Sept. 23, 2011, at 15, 15.

[47] *See* Carlo V. di Florio, Director of OCIE, SEC, ''The Role of Compliance and Ethics in Risk Management'' (Oct. 17, 2011), http://www.sec.gov/news/speech/2011/spch101711cvd.htm.

[48] *Id*.

[49] *See* Press Release No. 2012-3 (Jan 4, 2012), http://www.sec.gov/news/press/2012/2012-3.htm.

tration, compliance, books and records, and ethics. In its press release announcing the charges, the SEC also introduced a Risk Alert on ''Investment Adviser Use of Social Media'' encouraging advisers to be aware of rapidly changing technology and reminding advisers of their compliance obligations related to social media.[50] The SEC also posted an Investor Alert titled ''Social Media and Investing: Avoiding Fraud'' prepared by the Office of Investor Education and Advocacy, as well as a related investor bulletin.[51]

Investment Adviser Cases

4. Aberrational Performance Inquiry Initiative

In March 2011, Enforcement Director Robert Khuzami noted in Congressional testimony that the SEC, in response to the Madoff scandal, was engaging in close scrutiny of hedge funds that outperform market indices by 3% on a steady basis, referring to such returns as ''aberrational.''[52] At the time, the details of the Enforcement Division's plan to scrutinize such funds were not clear.

On December 1, 2011, the SEC announced four enforcement actions arising from this initiative, for the first time providing color on this program. The initiative uses proprietary risk analytics and other ''unconventional methods'' to evaluate returns. If the SEC finds performance to be inconsistent with a fund's purported investment strategy or ''other benchmarks,'' the fund may become subject to additional scrutiny.[53] The four actions are summarized here:

- The SEC filed a settled action against hedge fund manager ThinkStrategy Capital Management and its sole managing director Chetan Kapur alleging that they engaged in a pattern of deceptive conduct to bolster the managers' track record, size of assets under management, and credentials.[54] The SEC alleged that defendants materially overstated the fund's performance and gave investors the false impression that the fund had continually positive and steady returns.
- The SEC instituted administrative proceedings against unregistered investment adviser LeadDog Capital Markets and two of its general partners for misrepresentations and omissions concerning one partner's regulatory competence, both partners' compensation, one partner's personal control of and ownership interest in certain investments made by the fund, and significant conflicts of interest and related party transactions.[55]
- The SEC filed an action against Solaris Management and its founder, sole owner, and managing partner Patrick Rooney.[56] The SEC's complaint alleges that, despite representations in a PPM that Solaris followed a ''non-directional'' trading strategy that consisted of ''trad[ing] and establish[ing] long, short, and neutral positions in equities and indices,'' in fact Solaris became wholly invested in Positron Corporation, a financially-troubled molecular imaging company for which Rooney served as Chairman and never disclosed this change in strategy.
- The SEC charged Michael R. Balboa, England-based portfolio manager of the now-defunct Millennium Global Emerging Credit Fund, and Gilles De Charsonville, a purportedly independent broker based in Spain, with a fraudulent scheme to overvalue two large illiquid securities positions.[57] Balboa allegedly caused the New York-based fund to overstate its net asset value by $163 million by scheming with two Europe-based brokers, including De Charsonville, to provide false information to GlobeOp Financial Services, Ltd., an independent valuation agent. Separately, the U.S. Attorney's Office for the Southern District of New York announced the arrest of Balboa and simultaneous filing of a criminal action.

5. Compliance Deficiencies

In late November 2011, the SEC charged three investment advisers with failure to institute sufficient compliance procedures to prevent securities law violations. The SEC's press release announced that the cases stemmed from an initiative within the Enforcement Division's Asset Management Unit to work closely with SEC examiners to ensure firms have sufficient compliance policies and procedures, as required by Rule 206(4)-7 of the Advisers Act, in an effort to prevent frauds before they start.[58] OCIE officials praised the willingness of the SEC's Asset Management Unit to pursue actions based on violations of this rule alone, even in the absence of other violations.[59]

- The SEC's settled administrative proceeding against Asset Advisors, Inc. found that, from October 2004 through April 2007, the firm had no written compliance policies and procedures and from January 2005 through April 2007 had no written

[50] *See* National Examination Risk Alert II:1: *Investment Adviser Use of Social Media* (Jan. 4, 2010), *available at* http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf.

[51] *See* SEC Office of Investor Education and Advocacy, *Investor Alert: Social Media and Investing: Avoiding Fraud* (Jan. 4, 2012), *available at* http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf; SEC Office of Investor Education and Advocacy, Investor Bulletin: Social Media and Investing — Understanding Your Accounts (Jan. 4, 20120), *available at* http://www.sec.gov/investor/alerts/socialmediaandinvesting.pdf.

[52] Robert Khuzami, ''Testimony Before the Subcommittee on Capital Markets and Government Sponsored Enterprises on Oversight of the U.S. Securities And Exchange Commission's Operations, Activities, Challenges, and FY 2012 Budget Request'' (Mar. 10, 2011), http://financialservices.house.gov/UploadedFiles/112-14.pdf.

[53] *See* SEC Press Release No. 2011-252 (Dec. 1, 2011), http://www.sec.gov/news/press/2011/2011-252.htm.

[54] *See SEC v. Kapur et al.*, Civil Action No. 11-CIV-8094 (S.D.N.Y. Nov. 10, 2011).

[55] *In the Matter of LeadDog Capital Markets, LLC et al.*, Admin. Proc. No. 3-14623 (Nov. 15, 2011).

[56] *SEC v. Rooney and Solaris Management, LLC*, Civil Action No. 11-CV-8264 (N.D. Ill. Nov. 18, 2011) (internal quotation marks omitted).

[57] *See* SEC Press Release No. 2011-252 (Dec. 1, 2011), http://www.sec.gov/news/press/2011/2011-252.htm; *see also SEC v. Michael R. Balboa and Gilles T. De Charsonville*., Civil Action No. 11-civ-8731 (S.D.N.Y. Dec. 1, 2011).

[58] *See* SEC Press Release No. 2011-248 (Nov. 28, 2011), http://www.sec.gov/news/press/2011/2011-248.htm.

[59] *See* Jake Simpson, *SEC Preps Compliance Rule Cases*, Compliance Reporter, Oct. 24, 2011, at 15, 15.

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code of ethics.[60] In May 2007, the SEC's exam staff notified the company of these deficiencies. Thereafter, it adopted written procedures and a code of ethics but failed to fully implement and enforce an ethics and compliance program. The settlement assessed a $20,000 penalty and mandated cessation of operations and transfer of the firm's existing advisory accounts to an investment adviser with fully-developed compliance and ethics policies.

- The SEC's settled administrative proceeding against Feltl & Co., Inc. was based on the firm's failure to adopt and implement sufficient compliance and ethics policies and procedures as the firm changed and expanded.[61] The SEC found that the result of these deficiencies was undisclosed fees in its wrap fee program and hundreds of principal transactions made with advisory clients' accounts without proper disclosures or requisite consent. The settlement included a penalty and employment of an independent compliance consultant, among other undertakings.
- The SEC's settled administrative proceeding against OMNI Investment Advisors Inc. and its CEO and sole owner Gary R. Beynon found that, for most of its history, OMNI had no written compliance procedures. Beynon was named as Chief Compliance Officer but performed virtually no compliance functions and spent nearly all of the relevant time period on a religious mission in Brazil.[62] The SEC's order, among other things, barred Beynon and required OMNI to notify its advisory clients of the SEC's cease-and-desist order.

6. Mortgage-Backed Securities

In November 2011, the SEC settled a case filed earlier in the year against a former executive of Charles Schwab Investment Management relating to the Schwab YieldPlus Fund, formerly the largest ultra-short bond fund in its class.[63] The SEC had alleged that Executive Vice President Randall Merk misstated the risks of the fund and the extent of redemptions the fund was experiencing and approved other Schwab funds' redemptions from the YieldPlus Fund at a time when the managers of those funds possessed material, nonpublic information about the YieldPlus fund. Merk agreed to a $150,000 penalty and a 12-month suspension.

7. Fees

In the second half of 2011, the SEC's Asset Management Unit continued to focus on fee arrangements of registered investment funds. In September 2011, co-chief of the unit Bruce Karpati told Compliance Reporter that the Commission was preparing several cases related to fee review process violations under Section 15(c) of the Investment Company Act. Karpati cautioned that boards needed to engage in a substantive review of fees under 15(c).[64]

In November 2011, the SEC instituted settled administrative proceedings against Morgan Stanley Investment Management (MSIM) finding that MSIM represented to the board of directors of The Malaysia Fund that MSIM had engaged a Malaysia-based sub-adviser to provide research, advice, and assistance to MSIM for the benefit of the fund, but that the sub-adviser did not provide services to the fund.[65] Under the settlement, MSIM paid a $1.5 million penalty, reimbursed the Malaysia Fund for the sub-advisory fees and implemented additional policies and procedures.

8. Quantitative Strategies

In September, the SEC instituted a settled administrative proceeding against Barr M. Rosenberg, co-founder of institutional money manager AXA Rosenberg. According to the SEC's order, Rosenberg oversaw the development of the firm's quantitative model for managing assets. In June 2009, he learned that the model's computer code had an error that affected the model's risk management capabilities but directed others not to disclose the error, even when clients raised concerns about the underperformance of investments. Under the settlement, Rosenberg agreed to a $2.5 million penalty and a bar from the securities industry.[66] This action came after a February settlement with the advisory firm AXA Rosenberg and three affiliated advisers.[67]

9. Risk Management and Investor Disclosures

As in prior years, the SEC brought a number of cases alleging that investment advisers misrepresented facts concerning performance and the use of investor funds:

- In July, the SEC filed a settled action against registered investment adviser Benchmark Asset Managers LLC, its parent company Harvest Managers LLC, and the adviser's principal alleging an eight-year fraud and misappropriation of investor funds.[68] The SEC alleged that the defendants misrepresented to investors that their funds would be invested with ''socially responsible'' companies when they instead used incoming funds to pay off debts, make interest and principal payments, and make disbursements to defendants. Defendants consented to the entry of judgment including penalties and disgorgement and, for the adviser's principal, a bar from the securities industry.[69]
- In August, the SEC filed an action and obtained an asset freeze against Belal Faruki, a Chicago-area money manager and his startup quantitative

[60] *In the Matter of Asset Advisors, LLC.*, Admin. Proc. No. 3-14644 (filed Dec. 1, 2011).

[61] *In the Matter of Feltl & Company, Inc.*, Admin. Proc. No. 3-14645 (filed Dec. 1, 2011).

[62] *In the Matter of OMNI Investment Advisors, Inc. and Gary R. Beynon*, Admin. Proc. No. 3-14643 (filed Dec. 1, 2012).

[63] *See SEC v. Daifotis et al.*, No. CV-11-0137 (WHA) (N.D. Cal. Jan. 11, 2011).

[64] Jake Simpson, *SEC Preps Mutual Fund Fee Cases*, Compliance Reporter, Sept. 23, 2011, at 15, 15.

[65] *See* SEC Press Release No. 2011-244 (Nov. 16, 2011), http://sec.gov/news/press/2011-244.htm; *In the Matter of Morgan Stanley Investment Management, Inc.*, Admin. Proc. No. 3-14628 (filed Nov. 16, 2011).

[66] *In the Matter of Barr M. Rosenberg*, Admin Proc. File No. 3-14459 (SEC Sept. 22, 2011).

[67] *In the Matter of AXA Rosenberg Group LLC, et al.*, Admin Proc. File No. 3-14224 (SEC Feb. 3, 2011).

[68] *See SEC v. Folin et al.*, Civil Action No. 11-cv-4447 (E.D. Pa. Jul. 12, 2011).

[69] *See id.*

hedge fund advisory firm, Neural Markets LLC, alleging the defendants misrepresented to investors that the Neural Fund had other wealthy investors and was generating profits when, in fact, it was incurring losses.[70]

- In September, the SEC filed an action against investment adviser The NIR Group and its principal Corey Ribotsky, alleging that the defendants failed to disclose to investors that the hedge fund's investments in PIPE (''private investment in public equity'') transactions were failing and also misappropriated investor fund for personal expenses.[71]

10. An Enforcement Loss

In October, SEC Chief Administrative Law Judge Brenda Murray entered a lengthy decision clearing two State Street Bank executives of fraud claims brought by the SEC.[72] In September 2010, the SEC had charged the former chief investment officer and former product engineer with making misstatements about the Bank's exposure to subprime mortgage investments held by certain bond funds.[73] (State Street Bank settled with the SEC earlier in 2010, agreeing to $300 million in penalties.[74]) Holding that the Supreme Court's recent decision in *Janus Capital Group, Inc. v. First Derivative Traders*[75] applied to SEC enforcement claims as well as private actions, Chief ALJ Murray found that neither executive had ultimate authority and control over the allegedly false and misleading documents at issue, and that the statements were not materially false and misleading.[76] Importantly, she also found that the *Janus* decision controls the proof required for allegations under *both* Rule 10b-5 and Section 17(a) of the Securities Act, even though the language of the statute differs from the language of Rule 10b-5.[77]

IV. Broker-Dealer Developments

Financial Crisis Cases

The SEC continued to make a top priority of cases arising from the financial crisis. In the broker-dealer area, this meant additional cases relating to the structuring and sale of collateralized debt obligations (''CDO'') tied to the performance of mortgage-related assets. These cases have also been notable because of the SEC's willingness to bring unsettled cases against individuals based only on a negligence theory.

We discussed above the SEC's settled case against Citigroup. In a related action the SEC filed an unsettled complaint against a former Citigroup employee involved in the structuring of the CDO at issue in that case. The case is noteworthy because this marked the second time in the past year that the SEC filed an unsettled case against an individual alleging only a negligent violation of the securities laws.[78] As we have discussed in our mid-year review, it is not unusual for the SEC to settle an enforcement action based solely on negligence allegations. It is highly unusual, but apparently becoming more common, for the SEC to file an unsettled action alleging no more than negligence. The continuation of this trend demonstrates the lengths to which the SEC is willing to go to bring cases against individuals for conduct related to the financial crisis.

In a related action, the SEC instituted a settled administrative proceeding against Credit Suisse's asset management unit, which had been the collateral manager for the CDO, and a Credit Suisse portfolio manager involved in the transaction. The SEC's order found Credit Suisse responsible for a lack of adequate disclosure of Citigroup's role in the selection of assets in the CDO. In the settlement Credit Suisse agreed to pay $2.5 million in disgorgement and penalties.

In August, the SEC filed an unsettled case against brokerage firm Stifel, Nicolaus & Co. and a former executive. The SEC alleges that the defendants created a proprietary program to invest in notes linked to the performance of synthetic CDOs and sold the notes to school districts in Wisconsin. The SEC alleges that the defendants misrepresented the risk of the investment and failed to adequately disclose certain facts in connection with the sale of the notes. The SEC's complaint alleges that the sale did not satisfy suitability standards because Stifel was aware that the school districts lacked the experience and sophistication to evaluate the risks of the investment and that they could not afford the heightened risk associated with it.[79] The litigation is continuing.

In a separate action in September, the SEC instituted settled administrative proceedings against RBC Capital Markets alleging that the firm negligently sold the CDO investments to the school districts given suitability concerns and that RBC's marketing materials did not adequately explain the risks associated with the CDOs in light of the school districts' lack of knowledge and sophistication concerning such investments.[80] Under the settlement, without admitting or denying the SEC's findings, RBC agreed to pay directly to the school districts $30.4 million pursuant to a Fair Fund.

SEC and FINRA Rules and Recommendations

On July 1, 2011, FINRA rule 4530 took effect and augmented the reporting requirements found in NASD Rule 3070 and NYSE Rule 351. Broker-dealers are now required to notify FINRA of certain litigation, regulatory, and related events; make quarterly reports of cus-

[70] *See* SEC Press Release No. 2011-174 (Aug. 31, 2011), http://www.sec.gov/news/press/2011/2011-174.htm; *SEC v. Belal K. Faruki et al.*, Civil Action No. 11-cv-05406 (N.D. Ill Aug. 10, 2011).

[71] *SEC v. The NIR Group, LLC et al.*, Civil Action No. 11-cv-4723 (E.D.N.Y. Sept. 28, 2011).

[72] *In the Matter of Flannery and Hopkins*, Initial Decision, Admin Proc. No. 3-14081 (filed Oct. 28, 2011), http://www.sec.gov/alj/aljdec/2011/id438bpm.pdf.

[73] *In the Matter of Flannery and Hopkins*, Admin Proc. No. 3-14081 (filed Sep. 30, 2010), http://sec.gov/litigation/admin/2010/33-9147.pdf.

[74] SEC Press Release No. 2011-21 (Feb. 4, 2010), http://www.sec.gov/news/press/2010/2010-21.htm.

[75] 131 S. Ct. 2296 (2011).

[76] *In the Matter of Flannery and Hopkins*, Initial Decision, Admin Proc. No. 3-14081 (filed Oct. 28, 2011), http://www.sec.gov/alj/aljdec/2011/id438bpm.pdf, at 57.

[77] *Id.* at 42-43.

[78] SEC Press Release No. 2011-265 (Dec. 15, 2011), http://www.sec.gov/news/press/2011/2011-265.htm.

[79] SEC Press Release No. 2011-165 (Aug. 10, 2011), http://www.sec.gov/news/press/2011/2011-165.htm; SEC Litig. Rel. No. 22064 (Aug. 10, 2011, http://www.sec.gov/litigation/litreleases/2011/lr22064.htm.

[80] SEC Press Release No. 2011-191 (Sept. 27, 2011), http://www.sec.gov/news/press/2011/2011-191.htm.

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tomer complaints alleging theft, forgery, or the misappropriation of securities or funds; and file with FINRA copies of certain civil complaints, arbitration claims, and criminal actions. FINRA intends to use this information to identify and initiate investigations of member firms, offices, and associated persons that may pose a risk, and for the swift identification of other regulatory issues. FINRA Rule 4530(a) requires firms to promptly report specified events no later than thirty calendar days after the firm knows, or should have known, of their existence. Moreover, FINRA Rule 4530(b) requires a firm to report to FINRA within thirty calendar days after the firm has concluded, or reasonably should have concluded, that the firm or an associated person of the firm ''has violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization.''[81]

The SEC staff issued a report in July 2011, based on its examination of eleven broker-dealers representing a cross-section of the industry, highlighting common weaknesses found in sales of structured securities products (which promise returns based on underlying asset performance) and detailed steps broker-dealers can take to safeguard investors from fraud and other abusive sales practices.[82] After conducting its examination, the SEC concluded that broker-dealers may have: recommended unsuitable products and traded at disadvantageous prices on behalf of retail investors, failed to disclose material facts about structured product offerings, engaged in problematic sales practices with customers, and employed deficient supervisory measures. Among the SEC's suggestions to broker-dealers were: enhanced training for sales and supervisory personnel, increased vigilance and surveillance of sales practices, improved material fact disclosure, and controls for independent review of structured securities desk prices and for review of product suitability.

Compliance and Registration Cases

In October 2011, the SEC instituted a settled administrative proceeding against EDGA Exchange Inc. and EDGX Exchange Inc., and their affiliated broker Direct Edge ECN LLC (''DE Route''). According to the SEC's order, the exchanges violated Exchange Act Sections 19(b) and (g) as a result of one incident involving improperly tested computer codes, which led to the overfilling of orders and the placement of the shares in DE Route's error account, and a second incident involving the inadvertent disabling of database connections. The order also found that, in the second incident, EDGX violated Regulation NMS Rule 602(a)(3) by failing to immediately remove its public quotations and identifying the quotations as manual. The order also found that DE Route violated Regulation SHO's Rules 200(g) and 203(b) by improperly marking the orders used to sell the shares out of its error account, and failing to obtain locates or to document the availability of shares. Noting the respondents' cooperation and remediation, the settlement imposed no penalties, but included a cease and desist order and continued remedial undertakings to enhance information technology and compliance procedures.

Also in October 2011, the SEC instituted a settled administrative proceeding against Portuguese Banco Espirito Santo S.A. (BES), finding violation of the registration provisions of the securities laws by selling securities to U.S.-resident customers, primarily Portuguese immigrants.[83] According to the order, BES did not register the transactions, did not register with the SEC as either a broker-dealer or investment adviser, and did not employ the intermediation of a registered broker-dealer. In the settlement, BES agreed to pay nearly $7 million in disgorgement and penalties, took remedial action, and agreed to pay a certain minimum rate of interest to its U.S. customers on securities bought through BES and to make whole those customers for any losses on securities purchases through BES.

In November 2011, the SEC instituted a settled administrative proceeding against UBS Securities LLC finding inaccurate recording practices in connection with locating stocks for customers executing short sales. Regulation SHO requires the accurate recording of a broker-dealer's basis for granting a ''locate,'' namely, its determination that it has borrowed, arranged to borrow, or reasonably believes it could borrow the requisite securities to satisfy a short sale. In the settlement, UBS agreed to pay an $8 million penalty and to retain an independent consultant to review its locating practices and policies.[84]

Municipal Securities

The SEC's Municipal Securities and Public Pensions Unit, in coordination with other federal and state agencies, has continued to be an active source of new cases in the second half of 2011 by securing settlements with J.P. Morgan Securities in July 2011[85] and Wachovia Bank N.A. in December 2011[86] for alleged misconduct in the bidding process for municipal bond reinvestment transactions. To date, financial institutions have paid a total of $673 million in settlements stemming from investigations of practices in the reinvestment of municipal bond offering proceeds, including the $228 million settlement with J.P. Morgan Securities and the $148 million settlement with Wachovia in the past six months.

Generally, when investors purchase municipal securities, the municipalities temporarily invest the proceeds in reinvestment products, such as guaranteed investment contracts, repurchase agreements, and forward purchase agreements. In order to preserve tax-exempt status, the proceeds must be reinvested at fair value, typically arrived at through a competitive bidding process. Both settled actions alleged that the financial institutions entered into undisclosed arrangements with bidding agents to obtain ''last looks'' and ''set-ups'' in

[81] *See* FINRA Rule 4530 at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9819.

[82] *See* SEC Press Release No. 2011-157 (July 27, 2011), http://sec.gov/news/press/2011/2011-157.htm; *see also* Staff Summary Report on Issues Identified in Examinations of Certain Structured Securities Products Sold to Retail Investors, *available at* http://sec.gov/news/studies/2011/ssp-study.pdf.

[83] *See* SEC Press Release No. 2011-221 (Oct. 24, 2011), http://sec.gov/news/press/2011/2011-221.htm.

[84] *See* SEC Press Release No. 2011-240 (Nov. 10, 2011), http://sec.gov/news/press/2011/2011-240.htm.

[85] *See* SEC Press Release No. 2011-143 (July 7, 2011), http://sec.gov/news/press/2011/2011-143.htm.

[86] *See* SEC Press Release No. 2011-257 (Dec. 8, 2011), http://sec.gov/news/press/2011/2011-257.htm.

order to win bids for municipal bond reinvestment transactions. The SEC alleged that the defendants' conduct undermined the conclusive presumption of tax-exempt status of the municipal securities.

Sales Practices and Fraud

In a continuing investigation, in July 2011 the SEC charged New York brokerage firm Windham Securities, Inc., its owner and principal and former managing director with fraudulently inducing investors to invest over $1.25 million in Windham by making false claims regarding the intended use of the funds and Windham's historical returns and expertise.[87] The SEC alleged that defendants instead had misappropriated the investment funds earmarked for investment in a privately held company investors were told Windham was going to help take public.

V. Public Company Accounting and Financial Reporting

Financial Crisis Related Cases

In December, the SEC filed unsettled complaints against six former executives of Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). The SEC alleges that the defendants underreported the extent to which their respective companies were exposed to higher risk mortgages.[88] Separately, both Fannie Mae and Freddie Mac entered into non-prosecution agreements in which they agreed to cooperate with the SEC and not dispute the contents of an agreed upon statement of facts in the non-prosecution agreements.[89] This marked another example of the emerging use of non-prosecution agreements by the SEC.

Executive Compensation Clawbacks

In prior alerts we have discussed both the SEC's more aggressive use of its authority created under Sarbanes-Oxley to clawback executive compensation, even in the absence of any allegation of misconduct by the executive. We have also discussed the expansion of that authority under Dodd-Frank beyond CEOs and CFOs to encompass any current or former executive of a restating company. In the latter half of 2011, the SEC reached settlements in two such cases and also obtained a clawback in a third new case.

1. CSK Auto Corporation

Maynard L. Jenkins, former CEO and chairman of CSK Auto Corp., an automotive parts retailer, settled an action with the SEC in November, agreeing to pay back approximately $2.8 million in incentive-based compensation and stock profits.[90] When the SEC filed charges in 2009 against Jenkins, it was the agency's first attempt to seek clawback compensation from an individual not alleged to have committed any other violation of the securities laws.[91]

CSK and O'Reilly Automotive Inc., which acquired CSK, entered into a two-year non-prosecution agreement with the Department of Justice in August following allegations that CSK executives engaged in improper accounting from 2001 to 2006.[92] CSK agreed to pay a $20.9 million penalty to resolve allegations that it failed to write off uncollectible vendor allowance receivables and over recognized vendor allowances. CSK settled charges with the SEC in 2009. Three former CSK executives pled guilty to charges brought by the DOJ in connection with their roles; separate SEC charges against those executives are ongoing. A fourth executive was also charged, but has since passed away.

2. Beazer Homes USA

In August, the SEC settled an action against James O'Leary, the former CFO of Beazer Homes USA.[93] Beazer restated its fiscal year 2006 financial statements in 2008, and the SEC alleged that the company improperly inflated income and earnings by manipulating its reserves and improperly recognizing revenue and income from model homes. Under the terms of the settlement, O'Leary was not charged with misconduct but agreed to reimburse Beazer for his fiscal year 2006 incentive bonus totaling more than $1.4 million, including approximately $1 million in cash incentive compensation, approximately $130,000 received in exchange for restricted stock units, and approximately $275,000 in stock sale profits. As noted in the 2011 Mid-Year Securities Enforcement Update, the SEC reached a similar settlement with Beazer's President and CEO Ian McCarthy in March. In October, Beazer's former Chief Accounting Officer Michael T. Rand was convicted of seven counts, including directing an accounting fraud conspiracy, following a jury trial.[94]

3. Koss Corporation

As part of charges against Koss Corp. and its CEO and former CFO Michael J. Koss filed by the SEC and settled in October, Koss agreed to reimburse his 2008, 2009 and 2010 incentive bonuses, including approximately $450,000 in cash and 160,000 options.[95] Judge Rudolph T. Randa of the District Court for the Eastern District of Wisconsin has questioned the settlement, calling it ''vague,'' and asked the SEC in a December 20 letter to provide an explanation for ''why it believes the

[87] *See* SEC Litig. Release No. 22030 (July 7, 2011), http://sec.gov/litigation/litreleases/2011/lr22030.htm.

[88] SEC Press Release No. 2011-267 (Dec. 16, 2011), http://sec.gov/news/press/2011/2011-267.htm.

[89] *Id*.

[90] *See* SEC Press Release No. 2011-243 (Nov. 15, 2011), http://www.sec.gov/news/press/2011/2011-243.htm.

[91] *See* Gibson, Dunn & Crutcher Client Alert, *SEC's First Use of SOX ''Clawback'' Against Uncharged Executive* (July 27, 2009).

[92] *See* DOJ Press Release (Sept. 9, 2011), CSK Auto Corporation Agrees to Pay $20.9 Million to Resolve Violations of Securities Laws Related to Scheme to Manipulate Corporate Earnings, http://www.justice.gov/opa/pr/2011/September/11-crm-1166.html.

[93] SEC Lit Rel. No. 22074, *SEC v. James O'Leary*, No. 1:11-cv-2901 (N.D. Ga. Aug. 30, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22074.htm.

[94] *See* DOJ Press Release (Oct. 28, 2011), Former Chief Accounting Officer for Beazer Homes USA, Inc. Convicted of Corporate Accounting Fraud, http://www.justice.gov/usao/ncw/press/rand.html.

[95] *See* SEC Lit. Rel. No. 22138 (Oct. 24, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22138.htm.

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Court should find that the proposed final judgments are fair, reasonable, adequate, and in the public interest.''[96]

Koss Corporation's financial statements for fiscal years 2005 through 2009 were materially inaccurate as a result of a former executive's embezzlement and accounting fraud to cover up the embezzlement. Michael J. Koss was the Chief Executive Officer of Koss Corp. for twenty years and was the second largest shareholder as of August 2011; the largest shareholder was his father, John C. Koss, Chairman of the Board and founder of the company.[97] Koss family members controlled more than seventy percent of the company. The SEC alleged in its complaint that the company had inaccurate financial controls, which enabled the fraud and failed to prevent fraudulent transactions. Sujata Sachdeva, Koss's former Primary Accounting Officer, Secretary, and Vice-President of Finance, pled guilty in a separate criminal proceeding and was sentenced to 11 years in prison and $34 million in restitution.

Actions Against Directors and Executives

4. DHB Industries

As we have noted previously, cases against independent directors, acting solely in their capacity as directors, are rarely the subject of an enforcement action. In our mid-year alert, we discussed one such case filed by the SEC in the first half of 2011. In the latter half of the year, the SEC reached a settlement with the defendant directors.

Three former outside directors and audit committee members of DHB Industries, a military body armor supplier, settled charges with the SEC in November, agreeing to permanent bars from acting as officers or directors and more than $1.6 million in disgorgement, prejudgment interest, and penalties.[98] As described in the 2011 Mid-Year Securities Enforcement Update, the SEC brought fraud and aiding and abetting charges against the trio, alleging they willfully ignored red flags and allowed management to manipulate the company's financial statements and conduct fraudulent transactions.[99] DHB settled charges with the SEC in February. The SEC has also brought charges against former DHB executives, which have been stayed pending parallel criminal proceedings.

5. AOL Time Warner

Relying on *Janus Capital Group Inc. v. First Derivative Traders*, in *SEC v. Kelly*, U.S. District Judge Colleen McMahon rejected the SEC's claims against two former AOL senior managers, Mark Wovsaniker and Steven E. Rindner, stemming from an alleged scheme to overstate advertising sales based on ''round-trip'' transactions. In September, Judge McMahon dismissed claims for scheme liability under Rule 10b-5 subsections (a) and (c) because neither manager made a misstatement. McMahon also dismissed claims under Section 17(a) for the same reasons. Wovsaniker and Rindner still face other charges for aiding and abetting, record-keeping, and reporting violations; Wovsaniker also has pending charges for books and records violations and false statements to an auditor in violation of Rule 13b2-2.

The SEC also settled charges against J. Michael Kelly, former CFO of AOL Time Warner Inc., and Joseph A. Ripp, former CFO of the AOL Division of AOL Time Warner.[100] Kelly and Ripp agreed to pay disgorgement and penalties of $260,000 for Kelly and $150,000 for Ripp.

In a separate case against two employees at State Street Bank and Trust Company, SEC Chief Administrative Law Judge Brenda Murray relied on the reasoning in *Kelly* and concluded that the *Janus* test was ''the appropriate standard to apply'' for actions under Section 10(b) and Section 17(a) because ''they have the same functionality when it comes to establishing primary liability.''[101] Judge Murray's decision is on appeal to the Commission.

6. Stiefel Laboratories, Inc.

The SEC filed charges in December against Stiefel Laboratories Inc., formerly the largest private manufacturer of dermatology products and former chairman and CEO Charles W. Stiefel.[102] The case is noteworthy because at the time of the conduct alleged in the complaint, Stiefel Laboratories was a privately held company. It has since been acquired by GlaxoSmithKline. The SEC's complaint alleges that Stiefel Laboratories and Charles Stiefel gained more than $110 million by undervaluing the stock price from 2006 to 2009 and purchasing back stock held by their employees and other shareholders at the artificially low values. It further alleges that they failed to disclose material information about interest in the company from outside investors, including advanced acquisition negotiations with GlaxoSmithKline.

7. D&T Shanghai

In a closely-watched case involving the intersection of the SEC's enforcement authority and the application of the laws of non-US jurisdictions, the SEC also has gone to court in seeking to obtain documents from Deloitte Touche Tohmatsu CPA Ltd, an accounting firm based in mainland China.[103]

PCAOB Proceedings

The PCAOB announced settled disciplinary orders in August against a former Ernst & Young partner and former Ernst & Young senior manager who allegedly

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[96] Letter from the Court to Plaintiff's counsel re: Motion for Entry of Final Judgment (December 20, 2011) [Docket No. 5], *United States Securities and Exchange Commission v. Koss Corporation et al*, Case 2:11-cv-00991-RTR (E.D. Wisc. Oct. 24, 2011).

[97] Koss Corp., Definitive Proxy Statement (Form DEF 14A) (Sept. 2, 2011).

[98] *See* SEC Press Release No. 2011-238 (Nov. 10, 2011), http://www.sec.gov/news/press/2011/2011-238.htm.

[99] One of the directors was also charged with violating Section 13(b)(5) of the Exchange Act and Rules 13b2-1 and 13b2-2.

[100] SEC Lit. Rel. No. 22109 (May 19, 2008), http://www.sec.gov/litigation/litreleases/2011/lr22109.htm.

[101] *In the Matter of John P. Flannery and James D. Hopkins*, Initial Decision Release No. 438, Admin. Proceeding File No. 3-14081 (Oct. 28, 2011). Judge Murray dismissed the charges because the SEC did not ''establish that Respondents' had ultimate authority and control over such documents.''

[102] SEC Lit. Rel. No. 22187 (Dec. 12, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22187.htm.

[103] *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, No. 1:11-MC-00512 (D.D.C. Sept. 8, 2011).

created and altered workpapers during a PCAOB audit.[104] The PCAOB barred a former Ernst & Young partner from associating with a PCAOB-registered accounting firm with the right to petition to remove the bar after three years and a $50,000 civil monetary penalty. The PCAOB also barred a former Ernst & Young senior manager from associating with a PCAOB-registered accounting firm for two years. The PCAOB sought to make the disciplinary proceedings public, but the former Ernst & Young employees did not consent.

The PCAOB also announced in October that it permanently barred an audit partner and permanently revoked a firm's registration for violating a prior settled disciplinary order.[105] The PCAOB's Chief Hearing Officer concluded that Samuel D. Cordovano and his firm, Cordovano and Honeck, LLP, violated the terms of a December 2008 PCAOB settled disciplinary order, which barred Cordovano from association with a PCAOB-registered accounting firm. Despite the prior bar, the Hearing Officer found that Cordovano ''remain[ed] involved in the audits behind the scenes'' in contravention of the order.

[104] PCAOB Release No. 105-2011-005, *In the Matter of Peter C. O'Toole, CPA* (Aug. 1, 2011); PCAOB Release No. 105-2011-004, *In the Matter of Darrin G. Estella, CPA* (Aug. 1, 2011).

[105] *See* PCAOB Press Release (Oct. 13, 2011), PCAOB Announces Sanctions Against an Audit Partner and Registered Firm for Violating a PCAOB Bar, *available at* http://pcaobus.org/News/Releases/Pages/10132011_Announce_Sanctions.aspx.

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