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The Top 10 SEC Enforcement Events of 2011

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This article summarizes the top 10 U.S. Securities and Exchange Commission enforcement events of 2011.

Last year was an eventful year for the Division of Enforcement at the U.S. Securities and Exchange Commission ("SEC" or the "Division"). Following is an assessment of the top 10 SEC enforcement events of 2011.[1]

RECORD-SETTING ENFORCEMENT YEAR

The Division continued its three-year trend of increased activity by filing a record 735 enforcement actions in fiscal year 2011. The Division credited improved collaboration with other SEC offices, increased use of technology, and the recent restructuring of the Division with its success. Areas for enforcement activity involved insider trading, highly complex financial products, and market practices, including those related to the financial crisis. The Division also increased the number of actions brought against investment advisers and broker-dealers, filing a total of 146 actions related to investment advisers and investment companies (a 30-percent increase over

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fiscal year 2010) and 112 actions against broker-dealers (a 60-percent increase over fiscal year 2010).[2] According to the Division, these enforcement actions resulted in more than $2.8 billion in penalties and disgorgement.[3]

INSIDER TRADING

Insider trading cases continued to be a major area of activity for the SEC's enforcement program. In fiscal year 2011, the SEC brought 57 insider trading cases, charging 124 individuals and entities.[4] The most prominent of the insider trading cases brought by the SEC and the Department of Justice ("DOJ") centered on Raj Rajaratnam, the Galleon Management hedge fund manager who was convicted in 2011 on 14 counts of securities fraud and conspiracy. Rajaratnam received an 11-year prison sentence and was fined $63.8 million in criminal penalties and forfeiture, as well as $92.8 million in SEC civil penalties.[5] The Galleon-related cases highlight the convergence of SEC civil and DOJ criminal enforcement, and raise questions about double and excessive penalties in government enforcement actions.

In October 2011, Rajat Gupta, a former Goldman Sachs and Procter & Gamble director, was indicted on six counts of securities fraud and conspiracy and was also sued by the SEC for allegedly passing inside corporate information to Rajaratnam.[6] More cases stemming from the Galleon investigation should be expected in 2012.

FINANCIAL CRISIS CASES

Enforcement actions against firms and individuals linked to the financial crisis also remained a high priority for the SEC in 2011. The Division filed several actions alleging that firms concealed from investors the risks, terms, and improper pricing of collateral debt obligations ("CDOs"). In the most publicized of the CDO cases, the SEC charged Citigroup Global Markets, Inc., with misrepresenting to investors the quality of fund assets and with failing to disclose its short position against the assets.[7] The fund ultimately defaulted and investors sustained heavy losses, while Citigroup profited. Although the allegations against Citigroup appeared to be based on knowing and fraudulent intent, the SEC charged Citigroup only with

negligence-based fraud under Section l7(a)(2) and (3) of the Securities Act of 1933. The SEC similarly charged firms and individuals in other CDO-related cases only with negligence-based fraud.[8] Although the SEC has defended bringing negligence-based claims instead of harder-to-prove intentional claims, the penalties for negligence-based misconduct are much less harsh and, while perhaps warranted, are unlikely to satisfy critics of the SEC.

In October 2011, the SEC reached a settlement with Citigroup.[9] Judge Rakoff of the Southern District of New York rejected the settlement as against the public interest because the SEC did not provide adequate factual support for the court's approval, and because Citigroup did not admit to any misconduct.[10] If other courts adopt Rakoff's reasoning,[11] the SEC may have to provide more evidence to support settlement during judicial proceedings, pressure defendants to admit misconduct, or increase reliance on administrative proceedings to avoid court scrutiny. In December 2011, the SEC decided to appeal Rakoff's decision, stating that the "district court committed legal error by announcing a new and unprecedented standard that inadvertently harms investors by depriving them of substantial, certain and immediate benefits."[12] It is difficult to predict the result here; it is worth noting that, in the wake of Rakoff's decision and the related media attention, the SEC announced on January 6, 2012, that parties will no longer be permitted to settle SEC charges on the basis of "neither admitting nor denying" wrongdoing when they admit to related criminal charges.[13]

THE U.S. SUPREME COURT'S DECISION IN *MATRIXX INITIATIVES, INC. v. SIRACUSANO*

In March 2011, the U.S. Supreme Court considered whether adverse drug event reports must be statistically significant to be material. In *Matrixx Initiatives, Inc. v. Siracusano*, a drug manufacturer did not disclose event reports revealing that nasal spray products caused a loss of the sense of smell.[14] The Court reaffirmed prior case law, holding that materiality depends on the surrounding circumstances, and that information is material if there was "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly

altered the 'total mix' of information made available."[15] The Court said that FDA regulators and medical professionals considered adverse event reports important in certain circumstances and then concluded that reasonable investors also would consider them important.[16] The Court's conclusion that regulators, medical professionals, and investors would all consider the same types of information significant could allow courts to deem broader categories of information as "material" for disclosure purposes.

THE U.S. SUPREME COURT'S DECISION IN *JANUS CAPITAL GROUP, INC. v. FIRST DERIVATIVE TRADERS*

In *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court considered whether separate legal entities within the Janus corporate group (adviser and parent) had exposure to primary liability for the statements of the entity issuing securities and disclosures.[17] In its ruling, the Court interpreted the person who makes a misstatement very narrowly, finding that for Rule 10b-5 liability, "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[18] Accordingly, the Court found that a legally separate adviser entity could not be viewed as having "made" the false statements in the fund entity's prospectus and, therefore, could not be held directly liable under Rule 10b-5 where the fund entity had the ultimate authority over the false statements.[19]

THE IMPACT OF *JANUS*

Lower courts are already grappling with how to apply *Janus*. In *SEC v. Kelly*, the Southern District of New York applied the Supreme Court's reasoning in *Janus* to a case brought by the SEC.[20] The SEC conceded that *Janus* addressed liability under Rule 10b-5(b), but argued that "scheme liability" claims under subsections (a) and (c) of Rule 10b-5, as well as claims under Section 17(a), survived *Janus*, because unlike Rule 10b-5(b) claims, these claims were not dependent on the word "make."[21] The court rejected the SEC's argument, finding that scheme liability under subsections (a) and (c) of Rule 10b-5 was not available where "the primary pur-

pose and effect of a purported scheme [wa]s to make a public misrepresentation or omission."[22] The court also held that *Janus* precluded liability under Section 17(a), despite the language differences between Section 17(a) and Rule 10b-5. In contrast, the Northern District of California held in *SEC v. Daifotis* that *Janus* did not apply to claims brought under Section 17(a).[23] The SEC sued two executives, alleging that they made false statements or substantially contributed to the creation of the misstatements. The court allowed the SEC to bring its claim under Section 17(a) based on a determination that *Janus* was rooted in the Supreme Court's interpretation of the word "make" in Section 10(b) and Rule 10b-5(b), and that "make" was "absent from the operative language of Section 17(a)."[24]

In *SEC v. Landberg*, the Southern District of New York upheld the SEC's claim against a CFO on the ground that the misstatements could be attributed to him implicitly.[25] The SEC alleged that the CFO generated false accounting statements, misrepresented financial performance, and concealed the fraud. The court concluded that "the SEC allege[d] adequate surrounding circumstances for a reasonable fact finder to conclude that the statements alleged to be fraudulent were implicitly attributable to [the CFO], which is 'strong evidence' that [he] is the 'maker' of those statements, thereby satisfying *Janus*."[26]

Janus also had an impact on SEC administrative proceedings. In October 2011, Chief Administrative Law Judge ("ALJ") Brenda Murray dismissed the SEC's suit against two State Street executives for allegedly misleading investors about the risks associated with a fund heavily invested in subprime bonds.[27] The ALJ rejected the SEC's argument that *Janus* applied only for implied private claims under Rule 10b-5(b) and did not affect scheme liability claims pursuant to Rule 10b-5(a) and (c) or Section 17(a).[28] The ALJ determined that the executives did not have liability under *Janus* because they did not have ultimate authority over the disclosure documents at issue in the case.[29]

EXECUTIVE CLAWBACKS

In 2011, the SEC became increasingly aggressive in its interpretation of the executive compensation clawback Section 304 of the Sarbanes-Ox-

ley Act of 2002.[30] Section 304 provides that if an issuer restates its financials because of misconduct, then the CEO and CFO "shall" reimburse any bonuses or other incentive-based compensation, or equity-based compensation, received during the year following the issuance of the incorrect financials. The SEC recovered compensation from executives even in instances where the executives were not personally charged with the underlying alleged misconduct at the company. The SEC brought this type of claim against the CEO and CFO of Beazer Homes, USA, Inc. and the CEO of CSK Auto Corp.[31] The SEC's trend towards enforcing no-fault executive clawbacks likely will continue once Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is implemented in the first half of 2012.[32] Section 954 requires executive clawbacks regardless of whether misconduct occurred at the issuer.

COOPERATION INITIATIVE AND KHUZAMI'S CRITICISM OF THE DEFENSE COUNSEL BAR

In May 2011, the SEC entered into its first-ever deferred prosecution agreement ("DPA"). The agreement involved allegations that Tenaris S.A. violated the Foreign Corrupt Practices Act by bribing foreign government officials.[33] The SEC agreed to the DPA with Tenaris because of its "immediate self reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training…."[34] Under the terms of the DPA, the SEC agreed not to bring an enforcement action against Tenaris in exchange for Tenaris' agreement to pay more than $5 million in disgorgement and prejudgment interest, and to perform certain undertakings.

The Tenaris DPA is the result of the Division's new cooperation initiative.[35] The first example of the initiative came in December 2010 with the non-prosecution agreement ("NPA") between Carter's Inc. and the SEC.[36] Unlike the Tenaris DPA, the SEC did not impose any monetary penalty in connection with the Carter's NPA. Neither agreement appears to be subject to judicial scrutiny. Typically, the SEC settles enforcement actions by filing a consent judgment in federal court, or by an administrative order instituting proceedings and imposing sanctions. The SEC's use of

non-traditional tools to resolve both the Carter's and the Tenaris matters indicates a willingness to reward companies for cooperation.

While the SEC has sent a clear message that it is interested in rewarding cooperation, it also has sent a clear message that it is in some ways prepared to take an increasingly aggressive approach to conduct by defense counsel that the staff perceives, at a minimum, as a lack of cooperation. In a June 2011 speech to members of the defense bar, Division of Enforcement Director Robert Khuzami described "episodes of questionable tactics [employed] by defense counsel in SEC investigations."[37] Khuzami stated that his remarks were not intended to "chill a vigorous defense, or to retaliate against 'disobedient' defense counsel."[38] Khuzami addressed five areas of concern in his speech, including:

- conflicts arising from counsel's representation of multiple individuals;
- the lack of witness recollection during testimony;
- signaling by counsel to clients during testimony;
- document production issues; and
- questionable tactics in connection with internal investigations.

Although many of the examples cited by Khuzami appear to address extreme conduct, we understand that in some more recent situations the staff has raised similar concerns in circumstances that, in our view, raise no reasonable objection to defense counsel's behavior. This development raises serious questions about how the message in Khuzami's speech is being construed by the staff.

WHISTLEBLOWER RULES FINALIZED

The SEC's whistleblower provisions of the Dodd-Frank Act officially became effective on August 12, 2011.[39] The program is intended to incentivize whistleblowers to report potential securities violations to the SEC, because the whistleblower may be entitled to a reward of between 10 and 30 percent of any monetary recovery exceeding $1 million. To qualify for the reward, the whistleblower must "voluntarily" provide "original in-

formation" that leads to successful enforcement proceedings. Although the rules do not require a whistleblower to report first internally, the SEC does consider an employee's initial participation in a company's internal compliance program as a factor to increase the amount of an award. The SEC's Office of the Whistleblower was established to administer the whistleblower program, and reported that it received whistleblower submissions from individuals in many states and several foreign countries. The most common complaint categories included market manipulation (16.2 percent), corporate disclosures and financial statements (15.3 percent), and offering fraud (15.6 percent).[40] Although the SEC received 334 tips from August through September 2011, the Office did not pay out any whistleblower awards in fiscal year 2011.[41]

DELOITTE SUBPOENA ENFORCEMENT

In September 2011, the SEC sued the Shanghai office of Deloitte Touche Tohmatsu CPA Ltd. ("Deloitte Shanghai") to enforce an investigation subpoena.[42] Subpoena enforcement proceedings are relatively rare because companies would rather avoid the publicity and the SEC would prefer to negotiate with the company to obtain critical documents. Deloitte Shanghai served as the outside auditor to China-based Longtop Financial Technologies, Ltd ("Longtop"), but resigned after discovering alleged financial improprieties. As part of its Longtop investigation, the SEC subpoenaed Deloitte Shanghai's Longtop audit work papers. In response, Deloitte Shanghai refused to produce any documents, contesting the SEC's ability to compel an audit firm to produce documents predating the Dodd-Frank Act and asserting that the production was prohibited under Chinese law. On January 4, 2012, a court granted the SEC's show cause motion requiring Deloitte Shanghai to file a brief by mid-January 2012 and to appear at a hearing in early February, thereby forcing Deloitte Shanghai either to concede jurisdiction by appearing at the hearing, or to risk default judgment.[43]

NOTES

[1] WilmerHale represented clients in some of the matters discussed in this article.

[2] Year-by-Year SEC Enforcement Actions, http://www.sec.gov/news/newsroom/images/enfstats.pdf (last visited Jan. 19, 2012).

[3] *Management and Structural Reforms at the SEC: A Progress Report*: Testimony Before S. Comm. on Banking, House and Urban Affairs, S. Comm. on Sec., Ins., and Inv. 112th Cong. (2011) (statement of Robert Khuzami, Director of Enforcement, U.S. Securities and Exchange Commission), available at http://www.sec.gov/news/testimony/2011/ts111611rk.htm.

[4] FY 2011 Performance and Accountability Report 199 (Appendixes) (Nov. 15, 2011), available at http://www.sec.gov/about/secpar/secpar2011.pdf#2011review.

[5] *U.S. v. Rajaratnam*, 2011 WL 3585075 (S.D.N.Y. Aug. 11, 2011); *SEC v. Rajaratnam*, 2011 WL 5374112 (S.D.N.Y. Nov. 8, 2011).

[6] *United States v. Gupta*, No. 11-00907 (S.D.N.Y. filed Oct. 25, 2011); SEC Press Release, SEC Files Insider Trading Charges against Rajat Gupta (Oct. 26, 2011), http://www.sec.gov/news/press/2011/2011-223.htm.

[7] *SEC v. Citigroup Global Markets, Inc*., No. 11-07387 (S.D.N.Y. filed Oct. 19, 2011).

[8] *See e.g., SEC v. Stifel, Nicolaus & Co*., 11-00755 (E.D. Wis. filed Aug. 10, 2011) (charging Stifel Nicolaus and one executive with recklessly or negligently violating Section 17(a)(2) and (3), and Section 10(b) and Rule 10b-5); *SEC v. J.P. Morgan Securities LLC*, 11-04206 (S.D.N.Y. filed June 21, 2011); *SEC v. Steffelin*, 11-04204 (S.D.N.Y. filed June 21, 2011) (charging J.P. Morgan and an investment adviser employee, Steffelin, with negligently violating Sections 17(a)(2) and (3)).

[9] SEC Press Release, Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market (Oct. 19, 2011), http://www.sec.gov/news/press/2011/2011-214.htm.

[10] *SEC v. Citigroup Global Markets, Inc*., 2011 WL 5903733, at *2 (S.D.N.Y. Nov. 28, 2011).

[11] Indeed, since Rakoff's decision, at least one court has taken a similar approach. *SEC v. Koss Corp*., No. 11-00991 (E.D. Wis. Dec. 20, 2001).

[12] SEC Press Release, SEC Enforcement Director's Statement on Citigroup Case (Dec. 15, 2011), http://www.sec.gov/news/press/2011/2011-265.htm.

[13] Edward Wyatt, *S.E.C. Changes Policy on Firms' Admission of Guilt*, N.Y. TIMES, Jan. 6, 2012, available at http://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html?_r=1&hp.

[14] 131 S. Ct. 1309 (2011).
[15] *Id*. at 1318 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)).
[16] *Id*. at 1320-21.
[17] 131 S. Ct. 2296 (2011).
[18] *Id*. at 2302.
[19] *Id.*
[20] 2011 WL 4431161 (S.D.N.Y. Sept. 22, 2011).
[21] *Id.* at *3-4.
[22] *Id*. at *3.
[23] 2011 WL 3295139, *5-6 (N.D. Cal. Aug. 1, 2011).
[24] *Id*. at *5.
[25] 2011 WL 5116512, *4 (S.D.N.Y. Oct. 26, 2011).
[26] *Id*.
[27] *In re Flannery*, Admin Proc. No. 3-14081 (SEC, Oct. 28, 2011) (initial decision), http://www.sec.gov/alj/aljdec/2011/id438bpm.pdf.
[28] *Id.* at 42.
[29] *Id.* at 57. Murray also determined that the statements were not materially false or misleading. *Id.*
[30] 15 U.S.C. § 7243.
[31] SEC Press Release, SEC Obtains Settlement With CEO to Recover Compensation and Stock Profits He Received During Company's Fraud (Mar. 3, 2011), http://www.sec.gov/news/press/2011/2011-61.htm; SEC Press Release, SEC Recovers CFO's Bonus and Stock Sale Profits Received During Beazer Homes Accounting Fraud (Aug. 30, 2011), http://www.sec.gov/news/press/2011/2011-172.htm. The CEO of CSK Auto Corp. unsuccessfully challenged the SEC's clawback as a "grossly excessive" punishment in violation of the Eighth Amendment. *SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1074-75 (D. Ariz. 2010). The CEO ultimately settled with the SEC and agreed to reimburse the company. SEC Press Release, Former CEO to Return $2.8 Million in Bonuses and Stock Profits Received During CSK Auto Accounting Fraud (Nov. 15, 2011), http://www.sec.gov/news/press/2011/2011-243.htm.
[32] Pub. L. No. 111-203, 124 Stat. 1376 (2010). Section 954 of the Dodd-Frank Act adds new Section 10D to the Securities Exchange Act of 1934.
[33] SEC Press Release, Tenaris to Pay $5.4 Million in SEC's First-Ever Deferred Prosecution Agreement (May 17, 2011), http://www.sec.gov/news/press/2011/2011-112.htm.
[34] *Id*.

[35] SEC Press Release, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010), http://www.sec.gov/news/press/2010/2010-6.htm.
[36] SEC Press Release, SEC Charges Former Carter's Executive With Fraud and Insider Trading (Dec. 20, 2010), http://www.sec.gov/news/press/2010/2010-252.htm.
[37] Robert Khuzami, Director, Division of Enforcement, SEC, Remarks to Criminal Law Group of the UJA-Federation of New York (June 1, 2011), http://www.sec.gov/news/speech/2011/spch060111rk.htm.
[38] *Id.*
[39] SEC Press Release, SEC's New Whistleblower Program Takes Effect Today (Aug. 12, 2011), http://www.sec.gov/news/press/2011/2011-167.htm.
[40] SEC Annual Report on the Dodd-Frank Whistleblower Program 5, (Nov. 2011), http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf.
[41] *Id.* at 8.
[42] SEC Press Release, SEC Files Subpoena Enforcement Action Against Deloitte & Touche in Shanghai (Sept. 8, 2011), http://www.sec.gov/news/press/2011/2011-180.htm.
[43] *SEC v. Deloitte Touche Tohmatsu CPA Ltd.*, No. 11-00512 (D.D.C. filed Sept. 8, 2011).