



## SEC Enforcement Developments in 2014, and a Look Forward

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday March 18, 2015

**Editor's Note:** The following post comes to us from [Bill McLucas](#), partner and chair of the securities department at Wilmer Cutler Pickering Hale and Dorr LLP, and is based on a WilmerHale publication by Mr. McLucas; the complete publication, including footnotes, is available [here](#).

As we noted last year in our memorandum focused on 2013 developments, Securities and Exchange Commission Chair Mary Jo White has called for the SEC to be more aggressive in its enforcement program. By all accounts, the Enforcement Division has responded to that call. The past year saw the SEC continue the trend, started under Enforcement Director Robert Khuzami in 2009, of transforming the SEC's civil enforcement arm into an aggressive law enforcement agency modeled on a federal prosecutor's office. This should not come as a surprise since both Andrew Ceresney, the current Director, and George Cannellos, Ceresney's Co-Director for a brief period of time, like Khuzami, spent many years as federal prosecutors in the Southern District of New York. And the Commission itself is now led for the first time by a former federal prosecutor, Mary Jo White, the US Attorney for the Southern District of New York from 1993 to 2002. Given the events of the past decade involving the Madoff fraud and the fallout from the 2008 financial crisis, we believe both the aggressive tone and positions the SEC has taken in recent years will continue.

In this post, we outline some of the developments in the SEC's enforcement program and the remedies it has pursued over the past year. We also discuss important developments in areas where we expect to see continued enforcement attention during 2015, including insider trading law, the private equity industry, and accounting and financial reporting matters.

## **Enforcement Program Focus**

### ***Adopting a “Broken Windows” Approach to Enforcement***

One of the significant and over-arching approaches to the enforcement agenda under Chair White’s leadership is the so-called “broken windows” style of enforcement. Emulating tactics introduced by the New York City Police Department in the mid-1990s, the Commission has pledged to crack down on even minor securities law infractions in an effort to deter more significant violations.

Chair White has explained that the purpose of the “broken windows” approach is twofold: to ensure that the SEC is punishing “even the smallest infractions” while still pursuing the larger violations, and to make “you feel like we are everywhere.” Extending the policing analogy further, she has said that “[i]t is important because investors in our markets want to know that there is a strong cop on the beat—not just someone sitting in the station house waiting for a call, but patrolling the streets and checking on things.” To the extent the approach is designed to make clear that the Commission will attempt to have a presence in virtually every sector of the markets and that it will enforce all of the agency’s rules, the program should be neither controversial nor unique. The concern in the corporate sector, however, has focused on the extent to which the “broken windows” policy means that disproportionately harsh sanctions, adverse publicity, and reputational harm will be the consequence of transgressions that may indeed be minor.

In announcing the program, Chair White suggested that a group of actions in 2013 relating to violations of Rule 105 of Regulation M (prohibiting certain short sales of a security in advance of a public offering of the same security) were an early example of this approach. Since then, however, the only matter explicitly described as a “broken windows” effort was a group of actions announced in September 2014 against 28 corporate insiders (officers, directors, and major shareholders) for failure to timely and properly file reports of securities ownership. It is noteworthy that these actions do not seem to have been the result of a significant time investment by the Enforcement staff. Rather, as described by the Commission, the actions were an example of the SEC’s recent investments in new technology—the deficient filers were identified using sophisticated computer analysis. This may ultimately be a key feature of this initiative—that more powerful computer-based analysis will expose technical violations of filing or other requirements that may previously have gone unnoticed, allowing the Commission to bring such message cases without distracting significantly from other enforcement priorities.

Some Commissioners have been publicly critical of the program, a highly unusual step for sitting Commissioners to take with respect to the Chair’s leadership and the direction in which the

agency's enforcement resources are focused. Commissioner Michael Piwowar has noted that by trying to focus on everything, the Commission will inevitably focus on nothing. This is consistent with the Commissioner's view that an overly aggressive enforcement policy can have deleterious effects on the economy: "Rather than enabling vital and important economic activity, we will have unnecessarily shackled it." In an environment in which enforcement resources are limited, he believes the "broken windows" approach is misguided.

Commissioner Kara Stein has joined in this criticism. She believes the Commission needs to focus on impact cases that most efficiently use the Commission's resources: "In any enforcement context, we are never going to be able to address every single issue out there. We're always going to have limited resources and we have to use those strategically, to deploy them smartly, and get the most bang for the buck."

The debate over this enforcement policy will continue. Each Chairman and each Enforcement Director over the past several decades has worried about both the breadth and reach of the enforcement program, attempting to have a presence throughout the markets and attempting to identify all manner of violative behavior, whether delinquent filings or even very technical violations. The Chair's public articulation of a policy, analogized to the "broken windows" approach, was perhaps the lightning rod here, and the SEC may now be trying to ratchet back that rhetoric. Enforcement Director Ceresney has recently said that the "broken windows" approach is not about turning every violation into an enforcement action but, rather, is about targeting rules where "we have seen a pattern of a lack of compliance" and bringing cases that "send a strong message" to the market.

### ***Increasing Use of the Administrative Forum***

The SEC has said that it will increasingly use the authority it gained through the Dodd-Frank Act to bring more actions administratively. Previously, the Commission was limited in the types of actions it could bring and the relief it could obtain in administrative proceedings. Dodd-Frank significantly expanded the relief the SEC can obtain administratively. The SEC is now authorized to bring actions against non-regulated entities and individuals and to impose significant penalties in administrative actions. The remedies available to the SEC in the different fora are now effectively the same.

In preparing to both bring and likely litigate more administrative actions, the SEC recently increased the number of its Administrative Law Judges from three to five and increased the ALJs' staff. The SEC has also expanded the types of cases that it will consider bringing administratively. In June 2014, shortly after two well-publicized trial losses, Director Ceresney

noted that, although it had been rare in the past, the SEC would likely bring insider trading cases as administrative proceedings going forward. The SEC has since filed several insider trading cases administratively, and the Staff has said that it expects to bring more FCPA cases in the administrative forum as well.

After judicial challenges to a number of negotiated settlements and losses in court over the past several years, many observers have suggested that the increased use of administrative proceedings is an effort by the SEC to secure a “home-court advantage” and avoid the scrutiny of federal judges and juries. In fiscal year 2014, the SEC won all six of its litigated administrative proceedings, but only 11 of its 18 federal court trials. While lauding the agency’s trial record on the one hand, Ceresney has not been shy about highlighting the advantageous features of the administrative forum, including prompt decisions, specialized fact-finders, and less stringent rules of evidence.

Not surprisingly, the SEC’s decision to use its administrative forum in more cases has come under criticism. For example, Judge Rakoff of the Southern District of New York has discussed the dangers of bringing more cases administratively, including concerns about the securities laws being interpreted in a non-judicial forum and the fairness of the administrative proceedings due to the inapplicability of the federal rules of evidence, the lack of a jury trial, and the deference the decisions are entitled to on appellate review. James Cox, a professor at Duke University School of Law, has similarly commented that the SEC must be “sensitive to the benefits” of developing precedent in the federal courts. While there is no basis to believe that the ALJs in these proceedings are not fair and, indeed, that this forum may be more advantageous to respondents in some cases, the process concerns (absence of clear discovery rules, appeal to the Commission itself if one loses) and appearance issues (an in-house forum) should concern the Commission and the Staff.

A number of respondents in SEC administrative actions have filed suit in recent months challenging the actions on constitutional and procedural grounds. Thus far, none of these challenges has been successful, though several remain pending. In the first action to be decided, the District Court for the District of Columbia held that it lacked subject matter jurisdiction over the action because no final decision had been rendered by the Commission. Even then, the court noted, the Exchange Act provided for initial judicial review in the Court of Appeals, not the District Court. That case is now on appeal to the DC Circuit. In December, Judge Lewis Kaplan of the SDNY similarly held that the district court lacked jurisdiction to consider an action seeking to enjoin the SEC from proceeding with an administrative action against an investment adviser and his firm. Several other cases remain pending. Recently, a former Standard & Poor’s executive filed a pre-emptive declaratory judgment action against the SEC after being notified that the Staff

intended to recommend that the Commission bring an administrative proceeding against her. She is asking the court to enjoin the SEC proceeding and to find that, because the SEC's Administrative Law Judges are officers of the executive branch who cannot be removed from office directly by the President, the SEC's adjudicatory system violates Article II of the Constitution.

The SEC itself has been dismissive of complaints that its administrative proceedings are unfair. In the face of criticism regarding the Commission's increased use of administrative proceedings and the argument that it is unfair or unconstitutional, Director Ceresney defended the practice, noting that the Commission is still bringing a "significant" number of cases in district court and arguing that the SEC's use of its administrative forum is "eminently proper, appropriate, and fair to respondents."

### ***Emphasizing Individual Culpability***

The past year saw the continuation of a trend that we have seen building for several years in which the Staff is increasingly unwilling to present a proposed settlement to the Commission that does not include individual respondents. The Commission generally believes that actions against individuals are more effective in deterring bad conduct than actions simply against entities. Director Ceresney has said that imposing personal liability on "bad actors" will continue to be a "high priority" for the Commission. This is especially true in the case of large public companies where the impact of penalties and disgorgement is viewed as being ultimately felt by the shareholders, not the officers and directors who may have been involved in the alleged wrongdoing. It is also in these cases where charges against individuals often pose the most worrisome fairness concerns. There are situations where the alleged failures of the enterprise are the product of structural deficiencies or mistakes by a number of individuals, all of which may have contributed to an inaccurate disclosure, an omission, or some other violation. Yet, it may be appropriate and fair to conclude that no one individual so clearly failed or acted so recklessly or negligently that he or she should be subjected to a potentially career-ending enforcement action. It is often in this category of cases that discussions with the Staff are the most frustrating and difficult, as the Staff seems simply to insist on what they perceive to be the view of their superiors and the Commissioners—that an individual must be included as part of any settlement with the company.

In seeking to impose individual liability, the Staff is also increasingly focused on those in so-called "gatekeeper" roles, including compliance officers, accountants, and attorneys. This focus, which harkens back to the Stanley Sporkin era in the 1970s, was, if anything, sharpened in 2014 with the Commission introducing an initiative it refers to as "Operation Broken Gate." This is an effort

to look even more closely at the role of such gatekeepers—those who are “obviously central to our system”—in enforcement actions.

This focus appears designed to achieve at least two goals: (1) sending a message to the public that the SEC is getting tough on individuals in positions of authority within public companies who may have benefited from improper conduct; and (2) incentivizing those in the private sector who can prevent violations because they hold the keys to disclosure and investor protection by pushing them “to actively look for red flags, ask the tough questions, and demand answers.”

We expect this focus on “gatekeepers” to continue into 2015 and beyond.

## **Remedial Developments**

### ***Eroding the “No Admit/No Deny” Settlement Model***

As we noted in last year’s memo, in 2013, the Commission announced a change to its long-standing policy of concluding nearly all settled enforcement cases without an admission from the respondent. Previously, the SEC had required admissions only in cases where the respondent had already pled guilty to criminal charges stemming from the same conduct. SEC settlements generally included language stating that the respondent neither admitted nor denied the factual allegations set forth in the Commission’s complaint or order. The policy change comes after the SEC has been subject to significant criticism from federal judges and others for submitting such “no admit/no deny” settlements to the courts for approval. Over the past few years, several proposed SEC settlements have been delayed and scrutinized as a result of concerns raised by the presiding judge.

Judge Rakoff started the trend of federal judges refusing to “rubber-stamp” SEC settlements and has been the most vocal critic of the Commission’s no admit/no deny settlement policy. He initially refused to approve the Commission’s proposed \$285 million settlement with Citigroup over its role in structuring and marketing a package of mortgage bonds to investors. Other courts have followed Judge Rakoff’s lead. For example, Judge Kane of the District of Colorado issued an opinion rejecting a proposed settlement, stating that “[l]ike Judge Rakoff, I will not be a mere handmaiden to a settlement negotiated on unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance.” Although Judge Rakoff’s refusal to approve the Citigroup settlement was overturned by the Second Circuit, the Commission has nonetheless said it will continue to demand admissions in certain cases.

The new policy reflects the Commission’s view that admissions increase accountability and boost investor confidence in the SEC and the markets. The SEC has since sought and obtained

admissions in a number of cases. Under the new policy, the SEC will potentially seek admissions where:

- a large number of investors were harmed or the conduct was “egregious”;
- the conduct posed “significant risk” of harm to the markets or investors;
- the admissions would “aid investors deciding whether to deal with a particular party in the future”; and
- reciting the facts of the case would “send an important message” to the market.

Significantly, according to Director Ceresney, admissions are not negotiable. Once the SEC determines there should be an admission in a particular case, there is no room for negotiation. For example, according to Ceresney, the SEC will not accept a larger penalty in lieu of an admission. The respondent must either admit or litigate.

Such admissions can potentially have very dramatic consequences in shareholder or derivative litigation relating to the same facts. The doctrine of offensive collateral estoppel allows a plaintiff in a civil lawsuit to preclude relitigation of issues previously lost against another plaintiff by a defendant. It is arguable that facts admitted in a settled SEC action may have a preclusive effect in subsequent private litigation relating to the same facts.

That said, allegations and findings in every case are subject to negotiation, and defense counsel can attempt to negotiate the scope of any required admissions with an eye towards limiting the consequences of any estoppel. For example, in most cases that have included admissions, the SEC has required only that respondents admit to “violations of the federal securities laws,” not to violations of particular provisions (e.g., Rule 10b-5) tied to particular facts.

Apart from the impacts on civil litigation related to the same facts, admissions may also have collateral consequences wholly unrelated to the underlying conduct. For example, after hedge fund manager Philip Falcone agreed to settle with the SEC and admit to misappropriation of client assets and market manipulation, among other charges, the New York State Superintendent of Financial Services used that admission to bar Falcone and his firm from controlling insurance companies in New York State for seven years. Falcone was also barred from serving as an officer or director of an insurance company in the state.

It appears that the impacts of the SEC’s admissions policy will remain modest in terms of the number of cases where admissions are demanded as the price of settlement. While the SEC will continue to seek admissions in certain cases, it seems that will remain the exception and not the rule.

### ***Declining to Relieve Collateral Consequences of Settlements***

When public companies or regulated entities settle enforcement actions with government regulators, including the SEC, there are often automatic consequences that apply. These collateral consequences can be quite dramatic and have significant negative impacts on the settling entity. In the SEC context, for example, a public company that settles to violations of the anti-fraud provisions of the securities laws automatically loses its status as a Well-Known Seasoned Issuer, or WKSI. WKSI status allows a company to issue new securities without going through the SEC's typical review process, allowing for faster capital raising. Similarly, Dodd-Frank required the SEC to implement a so-called "bad actor" rule that disqualifies broker-dealers with "a relevant criminal conviction, regulatory or court order, or other disqualifying event" from relying on a Rule 506 exemption to sell certain private investments, like interests in hedge funds and private-equity funds.

The consequences of these disqualifications can be avoided if the settling party obtains a waiver from the Commission. Historically, such waivers were more often than not routinely granted to most large, well-known, established financial institutions in connection with settling SEC enforcement matters, and the granting of such exemptions had been delegated by the Commission to the Staff, which made sense given the Staff's expertise in assessing the facts and issues relevant to the granting of relief.

That changed significantly in 2014, with Commissioners Stein and Luis Aguilar publicly criticizing the agency's approach to waivers. In April and September 2014, Commissioner Stein dissented from the grant of waivers to Royal Bank of Scotland and Citigroup, respectively. In dissenting from the decision to grant RBS a WKSI waiver, Commissioner Stein stated that the disqualification provisions "have the potential for deterrence at large institutions that no one-time financial penalty could ever wield," and suggested that the Commission was instituting a new policy that some firms are "just too big to bar."

Challenges to the routine granting of waivers seems likely to continue into 2015. Recently, the Department of Labor, which oversees a similar disqualification regime, took the unusual step of holding an open meeting on a waiver request from Credit Suisse in connection with a disqualification from managing pension funds as a result of its resolution of a tax evasion case with federal prosecutors. Historically, the DOL staff had routinely granted such waivers. In Credit Suisse's case, however, consumer advocates and members of Congress objected to the waiver, prompting the DOL to hold public hearings on the question in early January 2015. Consumer advocate Ralph Nader testified against granting the waiver. While the DOL decision-making process seems to be more protracted than the SEC's, allowing interested parties more



opportunity to participate in the process, it seems likely that activists will eventually turn their attention to the SEC waiver process, increasing the political pressure on the Commissioners in considering such requests.

There is a practical issue here that has been ignored by those demanding that the waivers at issue be presumptively denied, or granted in only the most compelling circumstances. Given the breadth of operations and the complexity of the markets and regulatory landscape most financial services enterprises face today, along with the heightened regulatory and law enforcement scrutiny, it is not surprising that virtually every major institution has experienced and now faces some regulatory enforcement action on a host of fronts. The notion that all such actions should bring into play the disabilities that would significantly affect business activities that had nothing to do with the violative activity ignores the damage to the public interest that would be caused by such a harsh approach. It is, in effect, a hidden penalty that may be many multiples of the actual fine that a regulator deems appropriate. For instance, suggesting that an advisor to a mutual fund with billions under management and tens of thousands of clients be immediately disabled from providing such services because of some violation by the advisor or by an affiliate—whether or not involving fund management—would wreak havoc in the markets. It is certainly appropriate—and necessary under the statutes and rules—to carefully assess whether particular collateral consequences are necessary to protect investors, but they should not be imposed for the purpose of punishing the company and its shareholders. That is the purpose of a civil monetary penalty, available to the Commission in every case, and imposed in almost every case in accordance with the Commission's precedents and the Staff's and Commission's assessment of the particular circumstances. We hope that in 2015 the Commission will revisit its overall approach to collateral consequences and the waiver process.

### ***Tying Penalties to the Respondent's Financial Position, Not the Underlying Activity***

Although the federal securities laws by their terms tie penalty amounts to the nature of the conduct at issue, the Commission has nonetheless announced its intention to tie the size of penalties in settled cases to the financial size and condition of the respondent. Chair White has said that the SEC must be “aggressive” in its use of its penalty authority, noting that “meaningful monetary penalties ... play a very important role in a strong enforcement program.” Indeed, since 2000, enforcement penalty amounts have grown, on average, 30% per year, while growth in cases filed has been just 3% per year.

Chair White's views have been echoed by Director Ceresney, who recently noted that in fiscal 2014 the SEC used its penalty authority “more aggressively” than in the past. This includes a \$16 million penalty for net capital violations (the largest ever imposed for such violations by a factor of

40); the largest penalty to date against an Alternative Trading System (\$5 million); and the largest penalties ever assessed against individuals in an FCPA action (\$1.6 million against three individuals).

We expect that the SEC will continue to push for ever-larger penalties in 2015, especially in cases, as with the examples cited above, where the respondent is not a public company and the impact of the penalties will not be passed on to shareholders. Under the discretion the securities laws give the Staff and the Commission to set penalties, and citing “deterrence” as the key consideration, the Commission will continue to take into account the size and financial wherewithal of an individual or an enterprise in setting the amount of any penalties sought or assessed.

## **Substantive Developments**

### ***Insider Trading Law***

The year 2014 may have seen the rolling back of the tide of successful insider trading cases brought both by the Manhattan US Attorney’s Office and the SEC. Last year saw the SEC bring 52 insider trading actions, charging 80 people, an increase over the 44 cases brought in 2013. Despite this uptick in charges, the year saw a streak of insider trading trial losses for the SEC in federal court, as well as a Second Circuit decision that raised the bar for imposing insider trading liability in certain cases.

The SEC’s recent losses included the high-profile cases against entrepreneur Mark Cuban (decided in late 2013) and investment manager Nelson Obus. These cases may indicate that courts and juries will reject the SEC’s broad interpretation of the elements required to prove insider trading as well as the aggressive use of circumstantial evidence to prove them. For example, in *SEC v. Steffes*, the jury declined to adopt the SEC’s expansive view of what constitutes material nonpublic information and in *SEC v. Obus* and *SEC v. Moshayedi*, the juries were not convinced by the circumstantial evidence presented by the SEC.

In what may be one of the most significant insider trading cases in years, the Second Circuit reversed the convictions of two hedge fund managers in *United States v. Newman*. Prior cases, *Dirks v. SEC* and *SEC v. Obus*, arguably left open the issue of whether a tippee must know that the tipper, the corporate insider, derived a personal benefit in exchange for his or her tip in order to be held liable for insider trading. The Second Circuit addressed this issue in *Newman* and clarified what is meant by “personal benefit” and what the tippee needs to know in order to be held liable.

The court held that a tippee can be liable for insider trading only if he or she has knowledge that the tipper obtained a personal benefit. The court also found that the evidence in the case was insufficient to establish that any personal benefit existed. The court explained that there is no personal benefit “in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”

Already, the US Attorney’s Office has filed a brief in another insider trading case, *United States v. Durant*, arguing that the Second Circuit decision should be construed narrowly. The government argued that, while “[t]he *Newman* decision dramatically (and, in our view, wrongly) departs from thirty years of controlling Supreme Court authority,” the decision does not apply in *Durant*. *Newman* applies to insider trading cases brought under the classical theory of liability the government argued, while *Durant* was brought under the misappropriation theory.

On January 23, the US Attorney’s Office asked the three-judge panel that decided the case to reconsider its ruling. If the court elects not to reconsider its decision, the government may request that the entire Second Circuit hear the case *en banc* or petition the Supreme Court to hear the appeal. That said, the decision is already having an effect. On January 29, Southern District prosecutors indicated that, as a result of *Newman*, the Office would drop charges against five men who had been indicted on insider trading charges relating to IBM’s acquisition of a software company in 2009.

### ***Asset Management Industry***

The SEC has been focused on the private equity sector for several years. In 2014, the Office of Compliance Inspections and Examinations began completing a series of “presence exams” it had been conducting of a large number of industry participants since 2012. The results of the exams were sufficiently troubling to the SEC that, in April 2014, the Commission announced that it was launching a new unit within OCIE dedicated to the examination of private equity and hedge funds. In addition to this new unit, two other groups within the SEC continue to focus on private equity: the Asset Management Unit, established in 2010, and the Financial Reporting and Audit Task Force.

Andrew Bowden, the Director of OCIE, has said that over half of the private equity advisers that have been examined under the presence exam initiative appear to be violating laws or have material weaknesses around how they assess fees and expenses to clients. The SEC has filed several enforcement actions arising out of those exams.

The actions brought include the Commission's first-ever action against a private equity firm for violating the pay-to-play rules. Those rules prohibit investment advisers from providing advisory services to a government entity for two years following a campaign contribution to an elected official of that entity. The SEC also brought an action relating to the fees and expenses charged by a private equity firm. The SEC alleged that the firm and its president violated the anti-fraud and other provisions of the securities laws by misallocating assets from the funds to pay expenses of the management company, including rent, salaries, and other employee benefits. The SEC also alleged that after depleting the funds' assets, the management company made loans to the funds at "excessive" interest rates. Finally, the SEC brought fraud charges against a private equity fund manager for breaching its fiduciary duty by inappropriately allocating expenses between two of its funds.

Given the breadth of the presence exams and the establishment of a new unit focused specifically on this industry, we expect to see more actions against private equity firms in 2015.

### ***Accounting and Financial Reporting***

Another area where we expect to see increased SEC enforcement activity in 2015 is in accounting and financial reporting cases. Although this has not been much of a focus area since the financial crisis, that is beginning to change. After several years of seeing the number of such actions decline year over year, the number of financial reporting and disclosure cases brought by the SEC shot up 45% in fiscal 2014. The SEC has said it expects to "continue the momentum in pursuing financial reporting and accounting fraud" in 2015.

The Financial Reporting and Audit Task Force mentioned above was established by the Commission to identify and develop potential cases that can then be referred to the Enforcement Division for investigation. While the Task Force has begun issuing information requests to public companies, it remains to be seen how active or effective it will be in generating enforcement recommendations.

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This remains a challenging environment for individuals and enterprises who find themselves involved in regulatory investigations. The SEC has demonstrated its increasing willingness to push traditional boundaries—including bringing more actions administratively, naming individuals, and seeking admissions in settled matters—suggesting that is not likely to either change course or become less demanding anytime soon.