SEC Enforcement Report

News and Issues in Securities Regulation and Litigation

Cooley LLP

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Trend Spotting: Where Is the SEC Going Next?

When the SEC decides to investigate a company or an individual, that decision likely is not being made in isolated fashion. SEC enforcement often focuses upon particular aspects of the securities laws at different times. Put differently, SEC enforcement activity tends to exhibit trends. These trends generally reflect the evolving priorities of the SEC.

Trends can be identified in several ways. A trend can be identified simply by discerning a series of individual enforcement actions within a discrete period of time, all of which share a distinct point of commonality. The commonality may be a particular industry or type of alleged violator. Or it could just as easily involve alleged violations of a particular statute or regulation, or violations of a statute or regulation in a particular manner. The SEC might be testing out a new theory of enforcement, or it might be pursuing enforcement actions in a particular manner or with particular tools. A series of such related enforcement actions brought within a discrete period of time suggests an enforcement trend is on the rise.

Another method of identifying trends involves the analysis of statements or writings by SEC personnel. Although SEC personnel often do not identify future enforcement activity with great clarity, the public statements of SEC commissioners or enforcement personnel may confirm an existing trend of enforcement activity or portend a future one.

Finally, the passage of new legislation or new regulations might suggest that particular trends of SEC enforcement activity will arrive shortly. The size and complexity of recent legislation that heavily affects SEC enforcement activity—such as the Sarbanes-Oxley Act of 2002 or the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, for example—make the reliable prediction of future SEC activity an uncertain endeavor. Nevertheless, an analysis of new legislation or regulation can provide strong clues about future SEC activity.

SEC enforcement trends are hardly new. For instance, the late 1990s saw a distinct increase in enforcement surrounding violations of the Investment Advisers Act

key attorney contacts

Name / Email	Office / Phone
Scott Balber sbalber@cooley.com	New York +1 212 479 6550
Christopher Durbin cdurbin@cooley.com	Seattle +1 206 452 8769
John C. Dwyer dwyerjc@cooley.com.	Palo Alto +1 650 843 5228
Koji Fukumura kfukumura@cooley.com	San Diego/Broomfield, CO +1 858 550 6008
Bill Grauer grauerwe@cooley.com	San Diego +1 858 550 6050
Robert Lovett rlovett@cooley.com	Boston +1 617 937 2313
Lyle Roberts lroberts@cooley.com	Washington, DC +1 202 842 7855
Tower C. Snow, Jr. tsnow@cooley.com	San Francisco +1 415 693 2077

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of 1940, with increased penalties for such violations as well. And, from roughly 2006 through 2008, the SEC initiated significant enforcement activity focusing upon stock-options backdating.

Certain historical enforcement trends appear to be longstanding and continuing unabated. Insider-trading actions have long been an SEC priority. As another example, in the late 1990s and early 2000s, the SEC began to increase its investigations into accounting fraud as well as disclosure and financial-reporting violations, and these investigations often targeted improper revenue recognition or booking fictitious sales.

Other trends are more recent. For example, Section 304 of the Sarbanes-Oxley Act permits the SEC to claw back certain compensation from corporate executives of a securities issuer when that issuer has to prepare an accounting restatement because of violations of financial-reporting requirements that resulted from misconduct. The SEC, however, virtually never exercised its authority under Section 304 until 2008, when it began a pattern of pursuing enforcement actions under that Section. As yet another example, after Regulation FD was adopted in 2000 to prevent the selective disclosure of corporate information, the SEC brought virtually no actions enforcing it for nearly a decade, when it began enforcing Regulation FD with some frequency. The SEC's recent trend of bringing actions under Regulation FD is explored more fully in this issue.

Further examples of current trends abound: ever since a statement made by former SEC Chairman Christopher Cox in 2006, the SEC has been pursuing greater financial penalties against corporations. Following the passage of Sarbanes-Oxley, the SEC has brought a number of insider-trading actions specifically against attorneys. The late 2000s also witnessed an increase in parallel civil and criminal actions based on the same activity, pursued concurrently by the SEC and the Department of Justice. The list goes on.

What is the utility of identifying and analyzing trends of SEC enforcement activity? The exercise is more than an academic one. A current trend necessarily provides some insight into what enforcement activity the SEC might undertake in the future. Of course, companies and individuals should ensure compliance with all aspects of the securities laws at all times. But prudent officers, directors, general counsels, and other participants in the securities markets would be wise to keep abreast of the trends that suggest where the SEC might choose to spend its enforcement resources in the future, to avoid becoming the *subject* of an SEC investigation. •

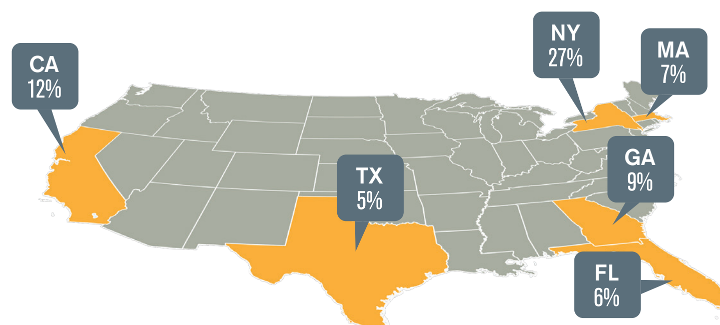
SEC SPEAKS

So Much to Do, So Little Time

Could Congress have overloaded SEC regulators' plates with Dodd-Frank and other mandates related to the financial crisis? Commissioner **Daniel M. Gallagher** seems to think so. At a September 2012 regional conference hosted by the Securities Industry and Financial Markets Association, Mr. Gallagher said: "It is not an exaggeration to say that the Commission is handling ten times the normal rulemaking volume. And 'normal' was the post Sarbanes-Oxley normal, which was a marked increase from the pace before that law's enactment. Any one of the rules we promulgated in the last three months would have been considered the 'rule of the year' just five or six years ago." Mr. Gallagher said that the SEC "will be busy implementing Dodd-Frank for a long time to come," and worried that the SEC might become "so inundated with external mandates that it risks losing focus of its core responsibilities."

SEC Enforcement By the Numbers

Litigation Release Hotspots



The SEC routinely issues notices called "Litigation Releases" regarding new enforcement actions and activity in existing actions. The SEC issued 175 such releases in the fourth quarter of 2012. These releases discussed new and ongoing litigation in 35 federal district courts in 24 states, the District of Columbia, and Puerto Rico.

SEC Enforcement Report

Editor in Chief . . . . Lyle Roberts

Contributors . . . . George Anhang
Mike Herring
Kyle Reynolds

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SEC Enforcement: Procedural Primer

The Commission, as well as private practitioners, use the term "enforcement actions" to refer to a wide variety of SEC activity. Generally, the term refers to one of five types of investigations or proceedings, although sometimes the term is used to refer exclusively to civil proceedings instituted in federal district court or before an administrative law judge.

Informal Investigation: This is typically the first stage of the involvement of the Enforcement Division in a potential violation of the securities laws. The division might begin an investigation after a tip from the public, a referral from another investigation (either another SEC investigation or that of a different government agency), or after routine monitoring of the markets or company filings uncovers evidence of wrongdoing. At this stage, enforcers rely on voluntary cooperation of individuals and firms with a connection to the case, because they do not yet have formal subpoena power.

Formal Investigation: SEC procedures allow all supervisors responsible for Enforcement matters above the level of Associate Director or Associate Regional Director to issue a Formal Order of Investigation. Once such an order issues, Enforcement staff may administer oaths, compel testimony, and compel the production of documents or other evidence. At the end of the formal investigation, Enforcement staff will either decline to recommend further action, or will recommend to the Commission that formal proceedings be instituted against the prospective defendant.

Wells Process: At the close of an investigation, if Enforcement staff have decided to recommend that proceedings be commenced against a prospective defendant, the staff will usually provide notice of this decision to the defendant. Called a "Wells notice", this letter informs the defendant of the potential violations at issue and invites them to submit arguments or evidence that they wish to bring to the Commission's attention. A prospective defendant's reply to the Wells notice is called a "Wells submission", and is typically due within a month of the Wells notice.

Though an enforcement action that results in formal proceedings typically goes through each of the three stages listed above, not every step is required in every case. Depending on the complexity and time-sensitive nature of the case, Enforcement staff might recommend formal proceedings at the close of an informal investigation without having conducted a formal investigation. In other cases, the investigation might begin as a formal one, without any preceding informal investigation. Finally, the SEC's Enforcement Manual encourages staff to skip the Wells process if it would delay immediate action that is necessary to protect investors or might give potential defendants time to hide assets.

Civil Proceedings: If the Commission is unpersuaded by the Wells submission, it may authorize an administrative proceeding before an administrative law judge, or a civil suit in federal district court. In FY 2011 and FY 2012, the average time elapsed between the opening of an investigation and the filing of the first civil action in that case was 21-22 months. In civil proceedings, the SEC may seek cease-and-desist orders, disgorgement of trading profits, revocation or suspension of an individual or entity's registration, bars or suspensions from employment, and/or monetary penalties.

Criminal Proceedings: The Commission does not itself bring criminal cases. Instead, it typically refers such cases to the Department of Justice (DOJ). A defendant might be subject to both criminal and civil proceedings, as criminal prosecution does not preclude the imposition of civil fines and vice versa. The DOJ need not wait for a formal or informal referral from the SEC to seek indictments against a defendant on its own initiative. In many cases, criminal proceedings arise out of the investigation itself, such as charges of obstruction of justice or perjury. •

SEC SPEAKS

SEC Seeks Stiff Penalties on Individuals, not Just Companies

At the 2012 Securities Enforcement Forum in Washington, D.C. held in October, Commissioner **Luis A. Aguilar** spoke about his vision of an effective enforcement program. The SEC, Mr. Aguilar said, sends "the wrong message in those cases when it charges an entity with wrongdoing without charging an individual for misconduct." Instead, the SEC should "creatively and aggressively" find ways to penalize "every responsible individual, regardless of title" for violations of the securities laws. And, according to Mr. Aguilar, the SEC wants to impose more than a slap on the wrist —it will seek officer and director bars whenever possible. Mr. Aguilar and other Commissioners (including Mary L. Schapiro and Elisse B. Walter) have also urged Congress to pass the SEC Penalties Act, which would increase penalties for each violation of securities laws up to the greater of (i) $1 million for individuals or $10 million for entities, (ii) three times the gross pecuniary gain, or (iii) the losses incurred by investors as a result of the violation.

Featured Topic: Regulation FD Actions

Regulation Fair Disclosure—more commonly referred to as "Regulation FD" or "Reg FD"—became part of the SEC's enforcement arsenal in 2000, and it aims to prevent selective disclosure of information by publicly traded companies and other issuers. At its most basic, Regulation FD prescribes that, if a company chooses to disclose material, nonpublic information to investors, it must disclose such information to all investors at once and not just certain investors.

The details are more complicated. Regulation FD prohibits an issuer's selective disclosure of material information to brokers and dealers, investment advisers and managers, investment companies, or anyone affiliated with such entities. It also prohibits selective disclosure to a shareholder if it is reasonably foreseeable that that shareholder will trade on the information—which it almost always is, in the absence of a concrete duty of trust or confidence owed by the individual to the company.

If an issuer or someone acting on its behalf chooses to selectively disclose information to these persons or entities intentionally, the information must be publicly disclosed at the same time. Disclosure is "intentional" when the person making the disclosure knows—or is reckless in not knowing—that the information that is selectively disclosed is material and nonpublic.

But what about accidental or unintentional selective disclosures? Such disclosures will not run afoul of Regulation FD so long as a full public disclosure is made promptly. "Promptly" means as soon as reasonably practicable, but no later than either (1) 24 hours after a senior official of the issuer learns of the disclosure or (2) the start of the next day's trading on the New York Stock Exchange after the senior official learns of the disclosure, whichever is later.

Unlike other provisions of the securities regulations—most notably Rule 10b-5—Regulation FD is not an anti-fraud rule. It covers only knowing or reckless failures to disclose information in accordance with its provisions. Indeed, it specifically states that a failure to make a public disclosure required by Regulation FD shall not, without more, be deemed to be a violation of Rule 10b-5. Nevertheless, market participants should be aware that violations of Regulation FD might assist Rule 10b-5 actions, for example by establishing the materiality of information withheld from a broader market.

As noted elsewhere in this issue, the SEC enforced Regulation FD sparingly after its adoption in 2000. Starting in roughly 2009, however, the SEC appears to have made Regulation FD an enforcement priority, and it has brought a number of actions to enforce it since that time.

The SEC has even initiated enforcement actions against companies for selective disclosures of an *indirect* nature. For example, in March 2010, Presstek, Inc. settled an enforcement action for $400,000, in which the SEC had alleged that the CEO of Presstek violated Regulation FD by using "elliptical" language to signal to an investment adviser that the company's results would not be as strong as projected. In October 2010, Office Depot settled with the SEC for a similar alleged violation of Regulation FD. The CEO and CFO had encouraged and prepared the company's investor-relations department to "signal" to certain analysts that the company's quarterly earnings would be lower than projections. The department's employees did so by initiating uncharacteristic one-on-one calls with analysts, referring to peer companies' slowing earnings, and reminding the analysts of the company's prior cautionary public statements. Despite the indirect nature of the disclosure, Office Depot paid a $1 million penalty (with additional individual penalties paid by Office Depot's CEO and CFO) for the violation.

Furthermore, an *accidental* violation will not necessarily preclude SEC enforcement activity. For example, in November 2011, Fifth Third Bancorp settled with the SEC for an unintentional violation of Regulation FD. Fifth Third elected to redeem a class of securities for a below-market price, and to do so it had to give notice to the Depository Trust Company. Fifth Third gave notice to DTC, which selectively disclosed to the beneficial securities holders that Fifth Third would be redeeming the securities at the below-market price. Fifth Third did not issue a public disclosure until after it learned that those beneficial holders were selling the securities to buyers who were unaware of the below-market redemption. The SEC took the position that Fifth Third failed to consider how its decision to redeem securities and its selective disclosure would affect investors in the market. The SEC also necessarily took the position that DTC was an agent of Fifth Third and that Fifth Third had a responsibility to ensure that DTC's communications complied with Regulation FD. Because of the nature of the disclosure and the remedial measures taken by the company, however, the SEC imposed only a cease-and-desist order and did not impose a civil penalty.

There is little question that the greatest risk of a Regulation FD violation, even for an issuer or agent with the best of intentions, arises during one-on-one interactions with analysts or other outsiders, especially at the end of reporting periods or when internal company circumstances have changed. That risk can be mitigated by avoiding one-on-one meetings unless absolutely necessary. If a company must have a one-on-one interaction, it should consider preparing and following a script to ensure that no material, nonpublic information is selectively disclosed. It also should consider establishing a system for recording all public disclosures so personnel can easily review and determine what has been publicly disclosed, or designating a compliance officer or committee responsible

for determining whether information is material, has been publicly disclosed, or may inspire shareholders to trade. Companies also would be wise to establish procedures to make speedy public disclosures—ideally within 24 hours—in the event of any unintentional selective disclosure. It is important to note that the SEC appears willing to reduce or even eliminate civil penalties if a company takes significant remedial steps following a Regulation FD violation. •

SEC SPEAKS

Enforcement Priorities, Straight from the Source

How has the SEC described its own enforcement priorities over the past three years? Outgoing Chairman Mary L. Schapiro had a chance at the October 2012 New England Securities Conference to discuss the "evolution" of the Enforcement Division since the beginning of her tenure in 2009. She identified municipal finance investigations, overseas bribery and corruption, and enforcement actions brought against individuals and firms involved in the financial crisis as priorities from the recent past likely to persist in the near future. Insider trading remains a perennial focus of the Commission, and Ms. Schapiro referenced both the record number of enforcement actions, and the novel techniques SEC enforcers now employ, such as sophisticated computer algorithms designed to automatically detect suspicious trading patterns.

Featured Investigation: Netflix, Social Media, and Regulation FD

The SEC is no stranger to social media. Those interested in quickly digestible news from the SEC might visit the SEC's Twitter pages: @SEC_news or @SEC _enforcement. The relationship between social media and the securities laws, however, remains a murky one and the SEC's views on the subject have not yet been fully formed.

The featured investigation for this issue lies at the intersection of Regulation FD and social media. As noted elsewhere in this issue, Regulation FD mandates that disclosures of material, nonpublic information must be made publicly or not at all. Regulation FD, however, does not define with great clarity what it means to make a "public"—as opposed to a "selective"—disclosure. The provisions of Regulation FD specifically state that a public disclosure can be made by filing a Form 8-K with the SEC or by disseminating the information through another method or methods "that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public." The customary methods of making public disclosures, accordingly, involve SEC filings, company press releases distributed through a major news service, and the like.

In 2008, the SEC issued guidance on whether and when information that is put on a company's website is "public" for the purposes of Regulation FD. The SEC advised that in evaluating whether information is public, companies must consider whether and when "(1) a company web site is a recognized channel of distribution, (2) posting of information on a company web site disseminates the information in a manner making it available to the securities marketplace in general, and (3) there has been a reasonable waiting period for investors and the market to react to the posted information." The SEC concluded that, depending on the circumstances and a number of factors, information posted on a company's website might be sufficiently public so as not to trigger Regulation FD. The SEC has not yet, however, issued any guidance as to how to navigate Regulation FD through social media.

This issue has been tested—unintentionally, it seems—by Netflix, Inc. and its CEO Reed Hastings. Netflix streams video of movies, television shows, and other media over its website. In July 2012, Mr. Hastings posted on his Facebook page that "Netflix monthly viewing exceeded 1 billion hours for the first time ever in June. When House of Cards and Arrested Development debut, we'll blow these records away." The company did not issue a contemporaneous press release or file a Form 8-K disclosing this information. That day, Netflix stock rose by approximately 13%.

In December 2012, Netflix filed a Form 8-K disclosing that the company had received a Wells Notice from the SEC staff regarding the Facebook post. This Notice indicated that the staff intended to recommend that a cease-and-desist proceeding or a civil injunctive action be brought against Netflix and Mr. Hastings for violating Regulation FD.

Mr. Hastings took the unusual step of offering a specific response on his Facebook page—which, incidentally, was also filed as an exhibit to a Form 8-K. This response stated that the Facebook post had gone out to "the over 200,000 of you who subscribe to me." In addition to drawing attention to the sheer numbers of his subscribers, Mr. Hastings emphasized that the message was likely transmitted beyond his Facebook subscribers, noting that "[s]ome of you re-posted my post" and that "[t]here was press coverage as there are many reporters and bloggers among you, my public followers." He concluded that these factors made the posting "very public."

Will the SEC agree? It remains difficult to say, and it depends heavily on the standards that the SEC considers applicable to social

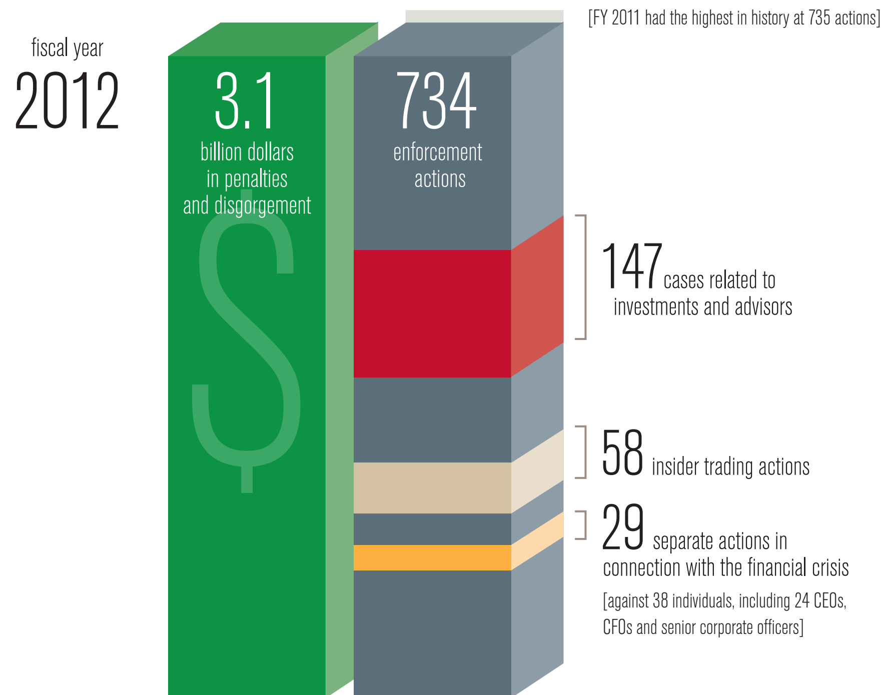
media disclosures. The SEC's 2008 guidance appears easily adaptable to social media. For example, according to the SEC, whether a company website is a "recognized channel of distribution" will depend on "the steps that the company has taken to alert the market to its web site and disclosure practices, as well as the use by investors and the market of the company's web site." A company could easily take steps to alert the investing public to its social media accounts and the fact that it provides corporate information through those accounts, although this is clearly not the norm now. A company's quarterly and annual reports typically include the company's website prominently; they do not typically promote the company's Facebook presence or Twitter handle. Moreover, "the use by investors and the market of the company's web site"—a factor identified by the SEC—is similarly adaptable to social media, and could turn on the popularity of the company's social-media account or of the social media platform generally. As a final example, an SEC inquiry into the manner in which information is disseminated to the general securities market through social media could turn on the same factors that are applicable to websites: the ease and efficiency of access to the information on the social media platform; whether the information is entirely available or, for example, requires a password or membership to access fully; whether the interface is designed to lead investors easily to investor-specific information; etc.

Regardless of whether the SEC extends its 2008 guidance to cover social media, the Netflix investigation represents a clear signal that the SEC is interested in the nexus between social media and the securities laws, and that it is not afraid to pursue enforcement actions in this area.

Mr. Hastings has stated that he and Netflix "remain optimistic" that the matter "can be cleared up quickly through the SEC's review process." Nevertheless, companies should remain exceedingly cautious about disclosing corporate information on social media, especially on new forms of social media and especially considering that a significant segment of the investing public may not use social media at all. Given the SEC's interest in Netflix, now is not the time to upload a press release to Instagram but nowhere else. Companies should consider revising their Regulation FD policies to cover social media communications and re-training personnel accordingly. They also might consider adopting a policy under which all communications made on behalf of the company on social media platforms are reviewed for Regulation FD compliance after they are made and, if necessary, followed up with prompt public disclosures through traditional methods.

Social media—which encourages spontaneity of communication—is obviously a poor forum for direct communication with investors and analysts. And as the cautionary tale of former Representative Anthony Weiner makes all too clear, companies would be wise to rigidly segregate usage of company social media accounts from any account that might be used by employees for personal purposes. In light of the Netflix Wells Notice, boards of directors and general counsels should review the ways in which their companies use social media with a critical eye toward Regulation FD compliance and possible red flags for the SEC. •

SEC Enforcement By the Numbers



379 dormant companies had trading suspended on May 14, 2012 to prevent them from being hijacked and used for fraudulent reverse merger or pump-and-dump schemes.

Whistleblower Program Takes Flight

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") directed the SEC to establish a new office within the Commission called the Office of the Whistleblower ("OWB"). One of the principal missions of the OWB is to make monetary awards available to individuals providing voluntary information leading to an SEC enforcement action resulting in the imposition of more than $1 million in sanctions. The awards can vary between 10% and 30% of the sanctions recovered.

The SEC established the OWB in early 2011, began receiving tips in August of 2011, and received 334 tips during the remainder of the fiscal year. In FY 2012, the first full year of the program, the SEC received 3,001 tips from eligible individuals seeking awards. Tips came in from every single state, the District of Columbia and Puerto Rico. California led the nation, generating over 17% of domestic reported tips, followed by New York at 10% and Florida at 8%. Tips also came in from 49 foreign countries. The United Kingdom led the way, accounting for 74 tips, which is far more than most individual states generated. Canada and India also accounted for significant numbers of tips: 46 and 33 respectively.

The SEC has reported that the most common complaints in FY 2012 concerned "corporate disclosures and financials" (18% of tips), "offering fraud" (16%), and "manipulation" (15%). Other categories that tipsters used to characterize the subject matter of their complaints included "insider trading" (6%), "trading and pricing" (5%), "Foreign Corrupt Practices Act" (4%), "unregistered offerings" (3%), "market event" (3%), and "municipal securities and public pension" (2%). (Twenty-eight percent of tipsters did not indicate that their complaints fell within any particular category.)

The first Whistleblower program award was made to a tipster in August 2012, in the amount of nearly $50,000. In a November 2012 press release, the SEC stated that tips relating to 143 enforcement judgments and orders potentially qualified for an award under the program during FY 2012. Given that it can take many months (even a number of years) for SEC enforcement proceedings to reach a final resolution, the tips received by the SEC in FY 2011 and FY 2012 may continue to lead to judgments and orders over the next couple years.

The OWB has set up a website that encourages potential whistleblowers to come forward, and has even posted instructions on You Tube on how to submit tips. And the SEC is not the only entity offering encouragement to blow the whistle. Plaintiffs' law firms have set up websites—complete with banner headlines such as "BE THE FIRST TO NOTIFY THE SEC"—to draw potential whistleblowers.

Given these developments, it is more important than ever for companies to have effective methods to bring employee concerns to the attention of upper management, before those concerns turn into SEC enforcement actions. (And management must take all complaints seriously, regardless of the source.) *See "SEC Speaks" on this page.*

Companies also need to take care to avoid any perceived retaliation against a potential whistleblower. A potential whistleblower who can show retaliation within six years of blowing the whistle may be entitled to reinstatement and double back-pay, attorneys' fees, and other costs. The aggrieved employee could succeed against the company even if the tip is not ultimately eligible for an award under the SEC's program. And, according to the SEC, in some situations the anti-retaliation provisions of Dodd-Frank kick in even if the employee only reports wrongdoing internally and never actually contacts the SEC. District courts in New York, Tennessee, and Connecticut have agreed with the SEC's interpretation. Yet another reason to handle internal reporting with care. •

SEC SPEAKS

Whistleblower Complaints: Handle with Care

Most sophisticated corporations know to thoroughly investigate any internal allegation of wrongdoing. But how seriously should one take a charge from an employee who seems unreliable, or has an axe to grind, or has a personnel file full of black marks? To quote a 1974 Melvin Van Peebles album cover, "As Serious as a Heart-Attack." In December 2012, **David Bergers**, Director of the SEC's Boston Regional Office, advised firms to separate an employee's allegations from the opinion the firm has about the employee. Not only does this ensure that all allegations receive adequate attention, but Mr. Bergers noted that the SEC will scrutinize a company's whistleblower policy and its execution of that policy when deciding whether to file an enforcement action. "We want to see that the company is taking their concerns seriously, and how they are talking about them," said Mr. Bergers, regardless of what else might be in the employee's file.