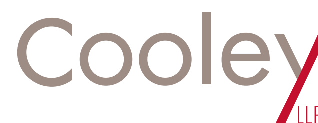
SEC Enforcement Report

News and Issues in Securities Regulation and Litigation



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Out With the Old, In With the New

Change is afoot at the SEC. After nearly four years in office, former Chair Mary Schapiro and former head of enforcement Robert Khuzami have left for the private sector. Stepping into their places are Mary Jo White as the SEC's thirty-first Chair, and newly minted co-directors of enforcement George Canellos and Andrew Ceresney. So what's in store under the new leadership?

New enforcement style?

Mary Jo White spent a large portion of her career as a white-collar prosecutor, eventually serving as United States Attorney for the Southern District of New York. Likewise, George Canellos and Andrew Ceresney both spent time in the U.S. Attorney's Office in Manhattan—indeed, both served as Deputy Chief Appellate Attorney and were members of the Securities and Commodities Fraud Task Force and the Major Crimes Unit. All this is more than biographical trivia: it suggests the Enforcement Division will investigate and pursue cases in an aggressive manner.

President Obama appears to have selected Chairman White *because* of her tough prosecutorial background. In nominating her, the President highlighted her experience as U.S. Attorney and drew attention to her prosecutions of New York mafiosi and violent terrorists, concluding that White "does not intimidate easily" and that "you don't want to mess with Mary Jo." There is nothing to indicate that the new SEC leadership will pursue enforcement actions any less actively or aggressively than the previous regime, and, indeed, there is ample reason to believe that the new regime will be even more willing to litigate matters.

There already are indications that the Enforcement Division will be busy. White recently announced that the SEC would abandon its blanket policy of permitting defendants to enter into settlements with the SEC without admitting to wrongdoing—commonly referred to as "neither admit nor deny" settlements. The SEC's previous policy was to permit defendants to settle without admitting any wrongdoing (a policy that met with judicial skepticism in certain cases). White's

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announcement indicates that the SEC will now require settling defendants to admit their wrongdoing in appropriate instances. "Public accountability in particular kinds of cases can be quite important and if we don't get [admissions], then we litigate them," she said.

According to White, such cases may include those that involve "widespread harm to investors," "egregious intentional misconduct," or interference with the SEC's attempts to investigate the facts. This new policy of extracting admissions of wrongdoing would seem to reflect a distinctly prosecutorial approach to SEC enforcement, inasmuch as federal prosecutors are accustomed to striking plea deals that necessarily require criminal defendants to admit to their wrongful conduct. It bears note that the new policy poses a significant danger to defendants in SEC actions insofar as the plaintiffs' bar will undoubtedly seek to leverage a defendant's admission of wrongdoing in any related private securities litigation.

New enforcement priorities?

The SEC appears to be at a crossroads. In the wake of the 2008 financial crisis, the SEC turned its focus toward Wall Street and financial institutions and devoted its resources to cases involving, for example, mortgage fraud or subprime loans. But now, in 2013, that post-financial-crisis enforcement activity is on the wane. Under its new leadership, the SEC can be expected to shift its focus, at least in part, to areas of traditional concern, such as public company accounting fraud and other violations that arise out of problematic financial disclosures.

According to the *Wall Street Journal*, these types of cases made up more than a quarter of SEC enforcement actions in the mid-to-early 2000s. Around 2011–2012, however, that figure had dropped to just over 10%. Although some commentators have speculated that this trend reflects better financial reporting as a result of Sarbanes-Oxley, the SEC has signaled that it will be looking closely at issuers' financial disclosures and that it is keenly aware of the ongoing possibility of accounting fraud.

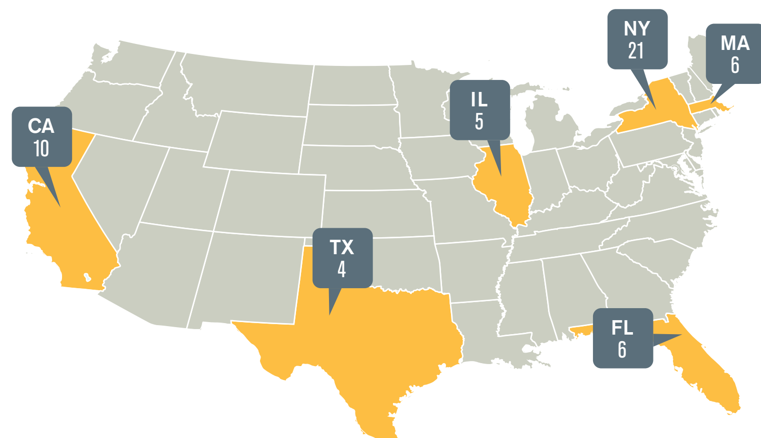
One still-unknown factor that will influence the SEC's enforcement agenda is the development of the Dodd-Frank Wall Street Reform and Consumer Protection Act's whistleblower program. As the previous installment of this Enforcement Report discussed, the SEC has set up a new Office of the Whistleblower to field tips and distribute awards to those who provide information that lead to a successful enforcement action involving more than $1 million in sanctions. As of mid-2013, the SEC had announced only two sets of whistleblower awards; however, SEC officials reportedly plan to announce more awards in the upcoming year, and those awards are expected to be larger than the awards that have been handed out to date. Although there are not yet enough data points to predict how the whistleblower program will affect enforcement, it bears mentioning that the SEC's most recent report on the program indicated that tips relating to "Corporate Disclosures and Financials" made up the largest category of tips received by the Office.

Increasing use of technology as enforcement tool?

The SEC is a technologically sophisticated agency and it has a wide range of tools at its disposal. In some sense, the SEC has no choice, as modern market trading is highly dependent on technology. For example, the SEC employs technology to monitor high-frequency trading—such as its "Market Information Data Analytics System," or "MIDAS," which is based on high-frequency-trading software and collects enormous quantities of daily market data to analyze

SEC Enforcement by the Numbers

Litigation Release Hotspots – Q1 2013



The SEC routinely issues notices called "Litigation Releases" regarding new enforcement actions and developments in existing actions in federal district courts around the country. In the first quarter of 2013, the SEC issued releases on 76 different matters, of which 52 were concentrated in six states (see above).

SEC Enforcement Report

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SEC SPEAKS

Enjoining Lawful Conduct

The SEC has often used its enforcement powers to seek, among other remedies, so-called "obey the law" injunctions that bar defendants from future violations of federal securities laws. At the "**The SEC Speaks in 2013**" conference held this past February, Co-Director of Enforcement **George Canellos** called these injunctions "one size fits all solutions" that the SEC should "resist or rethink." Instead, he said, the Commission should seek specific conduct injunctions, which are more "powerful" and "effective."

Canellos was referring to injunctions that prevent a defendant from engaging in facially legal conduct that is related to the defendant's underlying securities law violations. Under Section 305 of the Sarbanes-Oxley Act, the SEC is able to seek "any equitable relief that may be appropriate or necessary for the benefit of investors." Such injunctions can include bars on receiving compensation for engaging in certain securities-related activities or bars that prevent defendants from providing certain brokerage or other services with respect to all securities or a particular class of securities. These kinds of injunctions, unlike "obey the law" injunctions, are punitive in nature, and Canellos' endorsement of them reflects the SEC's view that punishment of wrongdoers is a core component of its mission.

such trading. But the SEC also has other sophisticated tools to deal with issues that predate the digital age.

One such technological tool in development—which further reflects a renewed focus on financial disclosures—is a computer program that analyzes language in issuers' financial reports in an effort to detect wrongdoing. As reported by the *Wall Street Journal*, the SEC is developing software that will focus on word choice and phrasing in the portions of companies' annual reports where management analyzes the company's past performance and future prospects. SEC officials have indicated that certain phrasings or word choices can provide insight into whether the company is manipulating its numbers. These linguistic signals reportedly include a company's use of verbiage that focuses more on "benign" issues than its competitors. The software also is reported to identify certain numerical issues that could amount to signs of malfeasance, including "big differences between net income and actual cash outflows available to investors," "declining market share," "weak profitability compared with rivals," or "an unusually high number of off-balance sheet transactions."

If this program proves to be reliable, SEC officials have said, it will be added to the SEC's analytical arsenal, which already includes tools to analyze data from a large number of public companies and to detect unusual trading patterns. In sum, issuers should be aware that their disclosures may be scrutinized not just by flesh-and-blood employees, but by highly complex software.

Beyond enforcement

The SEC, of course, does not simply investigate potential violations of the securities laws and bring enforcement actions. It is also a rulemaking body, responsible for promulgating many regulations under the securities laws of the United States.

The Dodd-Frank Act was passed in 2010, and a large number of regulations required under that Act—including the controversial Volcker Rule, which calls for a degree of separation between a bank's consumer-lending functions and certain forms of speculative investments designed to benefit the bank—have yet to be promulgated. At this point, hundreds of rulemaking deadlines have come and gone, and, as of July 2013, nearly a third of the Act's required rules have still not even been proposed. The need to also promulgate regulations under the April 2012 Jumpstart Our Business Startups Act (the "JOBS Act") will pose a further challenge to the SEC's new leadership.

In testimony Mary Jo White gave at her confirmation hearing before the Senate Committee on Banking, Housing, and Urban Affairs, she bluntly stated that, with respect to Dodd-Frank and the JOBS Act, the SEC "needs to get the rules right, but it also needs to get them done. To complete these legislative mandates expeditiously must be an immediate imperative for the SEC." Stay tuned. •

Not All 10b5-1 Plans are Created Equal

In the present age of aggressive SEC enforcement of insider trading laws, companies and their officers and directors sometimes rely on certain SEC-prescribed stock trading plans called "10b5-1 plans" to help them sleep at night. But implementing a poorly designed 10b5-1 plan might be worse than not having one at all.

Illegal insider trading is generally defined by the SEC as "the buying or selling of a security in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security." In 2000, the SEC adopted Rule 10b5-1, which provides that an insider trade is *not* illegal if made in accordance with a trading plan entered into before the insider became aware of the material, nonpublic information at issue. The plan must either (i) specify in advance, for each trade, the date of the trade, the price of the trade, and the number of shares that will be bought or sold; *or* (ii) provide that trades will be conducted pursuant to a specified algorithm or formula; *or* (iii) provide that trades will be made by a broker over whom the insider does not exercise any subsequent influence. Importantly, the Rule also states that the plan cannot be part of a scheme to evade liability.

If trades are executed according to a qualifying plan, the insider has an affirmative defense to any insider trading claims that are based upon those trades. Just as valuable as the plan's effect on the ultimate question of liability is the fact that the Commission might consider the existence of a qualifying plan as a sufficient reason to forego bringing an enforcement action in the first place.

A poorly designed trading plan can backfire, however, if it gives the Commission or private plaintiffs a foothold to argue that the plan might be a sham. Indeed, 10b5-1 plans have recently drawn considerable scrutiny and criticism, including negative articles in the press and criminal probes from the offices of two U.S. Attorneys in New York. The key issue has been whether the trading plans in question were designed to assist, as opposed to avoid, the insider's misuse of material, nonpublic information. As at least one commentator has noted, regulators originally envisioned that the algorithms in 10b5-1 plans would result in orderly trades of small fractions of an insider's stake at regular intervals. But Rule 10b5-1 itself does not specify that the algorithms must be simple or result in small, regular trades. A plan whose algorithm uses price triggers, capital requirements, or more complex rules to determine how to trade might produce the kinds of large trades, irregularly timed trades, and/or trades at peak prices that draw attention from the SEC and private plaintiffs. Even worse, a plan that looks like a sham can itself be used as evidence of a fraudulent scheme.

With this background in mind, the following should be considered when implementing a Rule 10b5-1 plan. First, does the plan satisfy all the formal requirements of Rule 10b5-1 and is it being implemented during the company's open trading window (when, presumably, there is less chance that the insider will possess material, nonpublic information)? Second, for plans that incorporate the use of a trading algorithm, what kind of trades is the algorithm likely to produce? Most desirable is a simple trading algorithm that results in regular, small sales rather than infrequent and large ones. Third, does the plan allow for immediate trading? Ideally, the plan should provide that trading will not commence for anywhere from thirty to ninety days after adoption. Fourth, is it replacing an existing plan? If it ain't broke, don't fix it: corporate officials should avoid replacing an existing and well designed plan with a new one. The longer a plan has been in place before an allegedly suspicious trade, the better.

Once a trading plan is in place, there are advantages to letting the market know that it is being used. At a minimum, any subsequently filed Form 4—which is the form that officers and directors must file with the SEC to report trades in their company's stock—should be drafted in such a way as to make clear that the trade was performed pursuant to the plan. In the event the individual is ever sued in a securities fraud case, and the plaintiff's complaint alleges that the individual's trades were suspiciously timed and indicate a fraudulent state of mind, defense counsel will likely be able to use the Form 4 to help refute those allegations. •

SEC Enforcement by the Numbers

SOX Clawbacks on the Rise

then **2** number of clawbacks sought by the Commission from 2002 – 2008

now **3** number of clawbacks sought in Q1 2013 alone

In the event that a company must prepare an accounting restatement due to misconduct, Section 304 of the Sarbanes-Oxley Act requires the company's CEO and CFO to reimburse it for one year's worth of their respective bonuses and other incentive compensation, as well as any profits they earned that year from the sale of company stock. The SEC sought clawbacks of this type in twelve cases in 2012.

Regulation FD and Netflix – An Update

The last issue of this Enforcement Report discussed the SEC's high-profile investigation of Netflix, Inc. and its CEO Reed Hastings. Mr. Hastings had posted on his Facebook page that Netflix viewing exceeded one billion hours in June 2012, a landmark the company had not previously disclosed to the market. Although the SEC issued Wells Notices to Netflix and Mr. Hastings that suggested that it considered the disclosure of this information on Facebook to violate Regulation FD (which prohibits selective disclosure of material information), the SEC had never provided explicit guidance on how Regulation FD applies to social media disclosures.

In April 2013, the SEC broke its silence with the issuance of a Report stating that in certain circumstances, a company might in fact make disclosures on social media without running afoul of Regulation FD. The SEC advised that when making disclosures on social media, issuers should rigorously examine whether the social media channel they are employing is a "recognized channel of distribution" for disseminating information to investors, such that a posting on the channel would provide broad, non-exclusionary distribution of the information to the investing public. In assessing whether a social media channel is a "recognized channel of distribution," the SEC emphasized the importance of the steps that the issuer has taken to alert the investing public to the fact that it intends to disclose information to the market through that channel. For example, an issuer might indicate in an SEC filing, press release, and/or on the issuer's website that it intends to make disclosures of material information through a particular social media channel, and investors can then take steps to ensure they timely receive any such information.

In a direct reference to Mr. Hastings's Facebook post, the SEC stated in its Report that "disclosure of material, nonpublic information on the personal social media site of an individual corporate officer, *without* advance notice to investors that the site may be used for this purpose, is unlikely to qualify as a method 'reasonably designed to provide broad, non-exclusionary distribution of the information to the public.'" This is true, the SEC asserted, regardless of the number of friends, subscribers, or contacts the individual posting the information may have.

Despite the SEC's apparent indication that Mr. Hastings's Facebook post did *not* meet the requirements of Regulation FD, the SEC nevertheless announced that it would not pursue an enforcement action against either Mr. Hastings or Netflix. But now that the SEC has provided guidance on the subject, any companies or company officials who repeat Mr. Hastings's conduct do so at their extreme peril. While disclosure of company information on social media may sometimes be permissible under the SEC's newly stated position, caution should be exercised. While under the SEC's newly stated position disclosure of company information on social media may sometimes be permissible, caution should be exercised. Even if material information is disseminated through a social media channel, companies are strongly encouraged to simultaneously disclose the information through a more traditional vehicle, such as a Form 8-K or press release. And, if a company chooses to make material disclosures through social media, it should inform investors about its intent to do so in multiple ways—for example, through SEC filings, press releases, and the company's website—and as far in advance of the social media disclosure as possible.

Companies also should ensure that their social media channels of choice are regularly updated, widely used, easy to navigate, and that there are no barriers to access, such as a subscription fee, registration process, or similar obstacle. Even if a company takes all these precautions, it also should regularly review its Regulation FD practices and training, investor usage of its social media channel, and the state of the law and SEC enforcement. This area of the law could well continue to evolve in unexpected ways—not unlike social media itself—and companies should take pains to stay abreast of developments. •

SEC SPEAKS

SEC Keeps More Cases Closer to Home

In addition to pursuing civil suits against defendants in federal district courts, the SEC's Enforcement Division has long had the ability to pursue certain remedies in administrative proceedings before administrative law judges ("ALJs"). These ALJs work for the Commission, but the Administrative Procedure Act mandates that they be independent of the Enforcement Division. Before 2010, the SEC's ability to seek monetary penalties in administrative proceedings was limited to cases brought against certain regulated entities and individuals, such as brokers and investment companies. Under Section 929P of Dodd-Frank, however, the Commission may now seek monetary penalties against *any* defendant in such proceedings. At "**The SEC Speaks in 2013**," Co-Director of Enforcement **George Canellos** candidly admitted that the Commission is taking full advantage of this change, and hinted that the SEC perceives the administrative forum as comparatively friendly: "We are now actively utilizing the authority … to assess against any person sanctions in administrative proceedings, a forum that gives the Commission greater control over the development of the law and a vehicle for analyzing and clarifying the law that often doesn't exist in district court proceedings."

SEC Enforcement by the Numbers

$601,747,463.22. That's the amount that CR Intrinsic Investors—an affiliate of beleaguered hedge fund SAC Capital Advisors—recently agreed to pay to settle charges that it participated in an insider trading scheme. It is the largest ever insider trading settlement with the SEC. Under the alleged scheme, Matthew Martoma, a CR Intrinsic portfolio manager, received inside information relating to clinical trials for Alzheimer's drugs conducted by two large pharmaceutical companies. He then caused hedge-fund portfolios managed by CR Intrinsic and SAC Capital to trade on the information, resulting in illicit profits and avoided losses totaling approximately $275 million.

Under the terms of the settlement, CR Intrinsic neither admitted nor denied any wrongdoing. More than a few commentators have opined that there is an apparent disconnect between CR Intrinsic's refusal to admit to improper conduct and its willingness to pay the SEC more than $600 million. Indeed, U.S. District Court Judge Victor Marrero, who is presiding over the matter, asserted that "it is both counterintuitive and incongruous" for a defendant to refuse to admit wrongdoing while paying such an enormous sum, and he conditioned his approval of the settlement on the outcome of the pending Second Circuit case of *SEC v. Citigroup Global Markets*, in which the SEC's policy of permitting neither-admit-nor-deny settlements is under review. Regardless of the fate of the SEC's policy, it remains abundantly clear that the SEC's interest in aggressively pursuing insider trading claims continues unabated. •

SEC SPEAKS

Whistleblower Official Weighs in on "Waiver" Practice

In the last issue of this Enforcement Report, we wrote on the subject of retaliation against whistleblowers. At "**The SEC Speaks in 2013,**" Deputy Chief of the Office of the Whistleblower, **Jane Norberg**, spoke out against a different form of anti-whistleblower conduct that she's been hearing about "over and over." Some companies, according to Ms. Norberg, are asking employees to sign agreements that purport to "waive" their right to contact the Office of the Whistleblower and/or waive their right to an award if the Commission brings a qualifying enforcement action. Needless to say, the SEC frowns on such agreements, which are likely problematic under several different statutory provisions and Commission rules. Ms. Norberg pointed out that one such provision is SEC Rule 21F-17, which provides: "No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities violation, including enforcing, or threatening to enforce, a confidentiality agreement."