SEC Enforcement Report
News and Issues in Securities Regulation and Litigation

Cooley LLP

in this issue

UPCOMING

SEC Enforcement: Assessing the Agency's Policies and Practices
Featuring Entrepreneur Mark Cuban

Thursday, February 20, 2014

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Not Your Grandparents' SEC: The Commission Adapts to Innovative Financial Concepts

The SEC is a venerable government agency, established in 1934 as part of the New Deal. But this of course does not mean that it fails to adapt with the times. Two noteworthy examples of recent SEC activity confirm its flexibility.

Crowdfunding. Finance is not what it used to be. Companies—particularly small companies—often look beyond traditional initial or secondary stock offerings into other, more innovative forms of financing. One such method of raising capital is "crowdfunding," or the attempt to raise small amounts of money from a large number of investors through the use of the internet. Websites such as Kickstarter or Indiegogo are known for providing opportunities for small businesses or creative projects to raise funds in such a way. Because of registration requirements and restrictions, however, companies were largely unable to use the crowdfunding concept to offer securities to potential investors.

Until recently, that is. The Jumpstart Our Business Startups Act (the "JOBS Act") was signed into law in 2012, and Title III of the Act permits securities issuers to offer and sell securities through unregistered, crowdfunded offerings, subject to certain disclosure requirements and requirements placed on crowdfunding intermediaries. The SEC and FINRA were supposed to issue rules and regulations to put this new framework into place. In October 2013, after significant delay, the SEC finally proposed Regulation Crowdfunding, which consisted of a set of proposed regulations relating to crowdfunded private offerings of securities. FINRA issued its own rules shortly thereafter.

What does the statutory and regulatory framework look like? For starters, anyone, not just accredited investors, may invest in a crowdfunded offering. Many American companies are eligible to participate in crowdfunded offerings as long as they have a specific business plan, have no historical

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black marks, are not investment companies, and are not otherwise subject to reporting requirements under the Securities Exchange Act. Companies cannot raise more than $1 million in a twelve-month period through such offerings.

The restrictions on investors who may participate in a given crowdfunded offering are somewhat complicated. Briefly, in a twelve-month period, investors whose annual income or net worth is less than $100,000 may invest the greater of $2,000 or 5% of their annual income or net worth. Investors whose income or net worth exceeds $100,000 may invest up to the greater of 10% of their annual income or their net worth, with a $100,000 maximum.

Crowdfunded offerings will be made on internet-based platforms, and companies may use a single intermediary to control the platform, so long as that intermediary is either a registered broker-dealer or a new type of entity referred to as a "funding portal" that is registered with the SEC and FINRA. Generally speaking, these funding portals are subject to a lighter version of the regulatory requirements and restrictions to which broker-dealers are subject. Intermediaries have certain affirmative duties in maintaining a crowdfunding platform, such as taking steps to prevent the risk of fraud by a company engaging in a crowdfunded transaction and denying access to an issuer if the intermediary believes that the offering poses the possibility of fraud. Intermediaries also must make sure that investors comply with the limitations on investment described above. Moreover, the intermediary or certain parties related to the intermediary may not have any kind of ownership interest in the issuer.

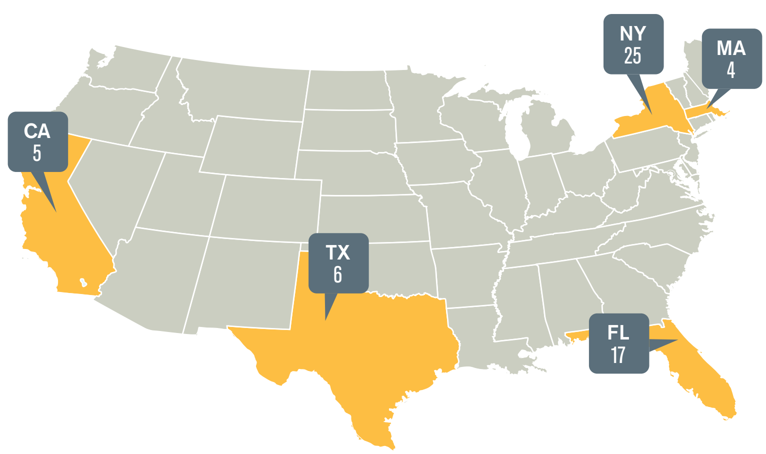
To invoke the crowdfunding exemption, an issuer has to make certain disclosures to the SEC at least three weeks before the offering. These disclosures also need to be provided to investors and posted on the crowdfunding platform by the intermediary. Among other things, the disclosures must include specific information about the company, its officers, certain significant shareholders, and the company's business plan. The issuer also must disclose certain details of the offering—including the proposed use of the funds raised through the offering, the public offering price, and the target amount—and risks associated with the investment. After the offering, crowdfunding issuers must make annual reports to the SEC.

What enforcement activity can be expected from this new framework? The fact that the regulations are merely proposed at this stage does not mean that the SEC is not looking ahead to potential enforcement activity. In fact, the SEC's release of the proposed regulations made clear that certain anti-fraud and civil-liability provisions of the securities laws would apply to crowdfunded offerings. In addition, the JOBS Act itself makes clear that issuers may be liable to purchasers of securities in a crowdfunded offering if they make any false or misleading statements in connection with that offer or sale. The possibility for enforcement activity with respect to intermediaries is a particularly interesting issue, and the SEC has signaled that it may consider intermediaries to be "issuers" with respect to this provision of the JOBS Act.

The SEC's proposed regulations, of course, may not ultimately become final. The purpose of crowdfunding is to provide a low-cost method of raising funds for small companies, but the regulations appear to impose burdens on such potential issuers, which may discourage them from taking advantage of crowdfunding. As a result, it is conceivable that the SEC will ultimately modify or withdraw certain of its proposed rules. Comments on the proposed regulations are due in February 2014. No matter what happens, the SEC's exploration of and interest in crowdfunding show that the Commission is looking to adapt its regulatory regime—and possibly its

SEC Enforcement by the Numbers

Litigation Release Hotspots – Q3 2013



Over the past two years, New York, Florida, California, and Texas have consistently been the states with the most enforcement activity, with occasional bursts of activity in Massachusetts, Illinois, Georgia, Colorado, Pennsylvania, and New Jersey.

SEC Enforcement Report

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enforcement agenda—to new, more modern forms of financing transactions.

Bitcoin. Just as finance is not what it used to be, neither is money. Bitcoin is a wildly fluctuating, digital, cryptography-based currency not issued by any nation, not backed by fiat or commodities, and not subject to the regulation of any central bank. Bitcoin has some degree of acceptance as a traditional currency, however, and it has attracted the interest of high-profile investors. But Bitcoin is often associated with being used for malfeasance, such as illegal online gambling, or its status as the default currency for the Silk Road—an anonymous online black market for drugs and other contraband that was shut down by the FBI in October 2013 (but is reported to have resurfaced in another form shortly afterward). For these and other reasons, Bitcoin and the exchanges on which Bitcoins are traded have grabbed the attention of regulators and law-enforcement agencies of different stripes.

Those agencies include the SEC, which has concluded that Bitcoin might provide the basis for more old-fashioned types of fraud, such as Ponzi schemes. The SEC recently brought an action against a Texas man, Trendon Shavers, and his company Bitcoin Savings and Trust. According to the SEC's complaint, Shavers and his company offered Bitcoin-denominated investments over the internet in 2011 and 2012, raising more than 700,000 Bitcoins in the process. (At the time of the investments, this amounted to roughly $4.5 million. At the time the SEC filed its complaint in mid-2013, it announced that 700,000 Bitcoins were worth more than $60 million.) The SEC alleged that the operation had all the hallmarks of a traditional Ponzi scheme. Shavers promised impressive interest payments with little risk, supposedly based on his and the company's ability to engage in arbitrage in Bitcoin markets. But, in reality, the interest paid to investors came from the principal invested by newer investors, and Shavers was using some of the investors' Bitcoins for his own trading and personal expenses. Shavers allegedly made a number of rosy and comforting statements to his investors before the scheme collapsed in September 2012. The SEC claimed that Shavers and the Bitcoin Savings and Trust engaged in various violations of the securities laws, including violations of Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5.

Shortly after bringing suit against Shavers and the Bitcoin Savings and Trust, the SEC Office of Investor Education and Advocacy issued an alert to investors. This alert warned investors that certain investment opportunities involving virtual currencies might be scams or Ponzi schemes, provided a list of red flags, and assured investors that "[a]ny investment in securities in the United States remains subject to the jurisdiction of the SEC regardless of whether the investment is made in U.S. dollars or a virtual currency."

Although the SEC was confident of its regulatory authority over Bitcoin-based investments, Shavers was not. He challenged the court's jurisdiction on the basis that his investments were not "securities" and were therefore not subject to the jurisdiction of the SEC. In response, the SEC did not argue (and the court did not determine) that Bitcoins themselves are "securities" as defined by the securities laws. Rather, the SEC argued, and the court agreed, that the investment opportunities that Shavers offered consisted of an investment of money—in the form of Bitcoins—in a common enterprise with the expectation of profit. As such, the investments could be considered "investment contracts" and thus subject to the securities laws. As of this writing, the case is ongoing.

It is probably reasonable to suspect that securities fraud rooted in Bitcoin-denominated investments will not occupy a large portion of the SEC's enforcement resources anytime soon. Nevertheless, enforcement actions such as this one should underscore that the SEC is in many ways a modernized, adaptable organization that is capable of applying its old rules to new financial concepts and instruments. •

SEC Enforcement by the Numbers

Investigation into insider trading at New York-based hedge fund manager Galleon Group ultimately went far beyond founder Raj Rajaratnam.

15	number of different securities involved in investigation
34	number of firms and individuals charged
96	amount ($ millions) of alleged illicit profits

SEC SPEAKS

Good Cop, Bad Cop

At the fall conference of the Council of Institutional Investors in September 2013, SEC Chair **Mary Jo White** said that, to get the country to take notice, the SEC must be a "strong and effective cop on the beat." Chair White said "most Americans do not see how well our experts examine a financial firm, review a regulatory filing, or conduct economic analysis on a complex rule. But they do pay attention when we bring a major enforcement action against a major financial institution, when we charge a hedge fund executive with insider trading, when we freeze a suspected Ponzi schemer's assets, or when we charge a CEO with fraud." She compared the SEC's new approach to former New York Mayor Rudy Giuliani's "Broken Windows" approach to policing, which "pursued infractions of law at every level—from street corner squeegee men to graffiti artists to subway turnstile jumpers" to "send a message of law and order." Chair White promised that the Enforcement Division would pursue "[n]ot just the biggest frauds, but also violations such as control failures, negligence-based offenses, and even violations of prophylactic rules with no intent requirement…" Chair White added: "I believe the SEC should strive to be that kind of cop—to be the agency that covers the entire neighborhood and pursues every level of violation. An agency that also makes you feel like we are everywhere."

Chair White's tone was somewhat softer at the October 2013 conference of the National Society of Compliance Professionals. She emphasized that the SEC's ability to charge alleged offend-

Recent SEC Initiatives and Ongoing Enforcement Trends

SEC enforcement trends are often evidenced by a series of individual enforcement actions. In addition, the SEC may confirm enforcement trends by announcing particular programs or initiatives that it has established. Two such recent programs or initiatives are worth noting.

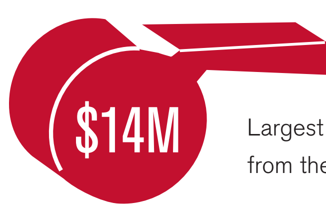
First, the SEC appears to be in a period of enforcement transition—specifically, transitioning away from its recent focus on financial-crisis cases and turning back to areas of traditional concern. One such area is accounting and financial-disclosure fraud, particularly by companies issuing periodic reports to the SEC.

In 2013, the SEC announced the establishment of a new Financial Reporting and Audit Task Force. According to the SEC, this Task Force will focus on "expanding and strengthening the [Enforcement] Division's efforts to identify securities-law violations relating to the preparation of financial statements, issuer reporting and disclosure, and audit failures." The "principal goal" of the Task Force, according to the SEC, will be "fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures." Of particular interest to the Task Force will be determining and investigating areas in which fraudulent financial reporting might be particularly prevalent, as well as identifying and employing technology and tools that would assist it in rooting out this type of fraud. The Task Force will be staffed by SEC attorneys and accountants nationwide.

Second, the SEC has expressed an interest in bringing more enforcement actions against "gatekeepers"—that is, attorneys, accountants, auditors, and other professionals who might be in a position to prevent fraud or wrongdoing. From the SEC's perspective, bringing enforcement actions against these individuals is particularly fruitful because, in addition to deterring individuals from engaging in violations of the securities laws themselves, actions against gatekeepers also encourage other gatekeepers to adhere to strict professional standards and to be on the lookout for and prevent wrongdoing.

In October 2013, the SEC announced a series of enforcement actions against auditors of public companies for failure to abide by U.S. standards for auditing. Perhaps more significant than the individual details of the actions is that the SEC stated that the actions were part of an initiative that had been internally designated as "Operation Broken Gate," which specifically focused on bringing actions against gatekeepers. Although this initial round of activity focused on auditors only, the SEC made clear that the initiative was broader and that "[t]he actions are part of the agency's ongoing effort to hold gatekeepers accountable for the important roles they play in the securities industry." As to whether this trend will continue, SEC Chair White allowed little room for doubt: "You should expect more of these cases." •

SEC Enforcement by the Numbers



Largest ever award (announced in October) from the SEC's Whistleblower program.

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ers must "be wielded appropriately with discretion…The decision to charge can obviously have tremendous negative consequences…We're acutely aware that a charge is an extremely serious step to take." And, Chair White sought to dispel any image of enforcement agents breaking down doors that might have been conjured by her earlier comments: "Let me also assure you that we do not think that every deficiency warrants an enforcement response…Indeed in the vast majority of cases, we address instances of noncompliance through engagement with the registrant, deficiency letters and other approaches short of an enforcement action." A heavy hand would be reserved for repeat violations and "programmatic violations," said Chair White, adding, "[i]t's not a game of 'gotcha' at all."

Different Views on Corporate Penalties

The SEC's Commissioners don't always see eye to eye. In 2006, the SEC Commissioners in office at the time issued a Statement Concerning Financial Penalties ("Penalty Statement"), a guide to assessing the appropriateness of corporate penalties. At the fall conference of the Council of Institutional Investors in September 2013, SEC Chair Mary Jo White conceded that Commissioners have differing views and that the Penalty Statement "was not then, and is not now, binding policy for the Commission or the staff." Nevertheless, she added that the Statement "sets forth a useful, non-exclusive list of factors that may guide a Commissioner's consideration of corporate penalties, such as the

Polizzotto Settlement Underscores Benefits of Training on Regulation FD and Having a "Compliance Culture"

Regulation FD prohibits selective disclosure of material information. As Michele Wein Layne, Director of the Commission's Los Angeles Office, recently described the Regulation: "All investors, regardless of their size or relationship with the company, are entitled to the same information at the same time." The March 2013 issue of this Report discussed the risks of an unintentional Regulation FD violation inherent in one-on-one, unscripted interactions with analysts or other outsiders, and suggested steps to minimize these risks. That article closed by noting that "the SEC appears willing to reduce or even eliminate civil penalties if a company takes significant remedial steps following a Regulation FD violation."

Associate Director of Enforcement Stephen L. Cohen struck a similar note at the 12th Annual Compliance and Ethics Institute hosted by the Society of Corporate Compliance and Ethics in October 2013, calling it "common sense" that a company would benefit by "demonstrat[ing] an effective compliance program and a genuine commitment to ethical principles." Mr. Cohen added: "I cannot emphasize enough the level of trust that you can inspire by demonstrating a genuine commitment to these principles, and the level of distrust that ignoring or merely paying lip service to these principles can yield."

These principles were on full display in a settlement in September 2013 between the SEC and Lawrence D. Polizzotto, former head of investor relations for Arizona energy company First Solar Inc. According to the SEC, after learning that the company would not receive one of three anticipated loan guarantees from the U.S. Department of Energy, Mr. Polizzotto conducted approximately 20 one-on-one phone calls with analysts and institutional investors, in which he read from talking points that he had prepared concerning the loan guarantee. While Mr. Polizzotto did not unequivocally tell any particular investor that First Solar would not receive the guarantee, the SEC alleged that he did "effectively signal" this news by emphasizing that one loan guarantee was of lower probability than the others. The settlement with the Commission did not require Mr. Polizzotto to admit the SEC's allegations, but did come with a $50,000 penalty and a cease-and-desist order barring future violations.

The agency's press release on the settlement made clear that First Solar was able to avoid charges through a combination of a preexisting culture of compliance and quick remedial action: "Prior to Polizzotto's selective disclosure… First Solar cultivated an environment of compliance through the use of a disclosure committee that focused on compliance with Regulation FD." The SEC credited First Solar's prompt discovery of the selective disclosure, its issuance of a press release before the market opened the following morning, and its self-reporting to the Commission. First Solar also took remedial measures while the SEC investigation was still ongoing, such as conducting additional Regulation FD training for relevant employees. First Solar's experience shows that a combination of these proactive and remedial measures can and does reduce a company's potential exposure to liability following a Regulation FD violation. •

SEC SPEAKS

egregiousness of the misconduct, how widespread it was, and whether the company cooperated and had a strong compliance program."

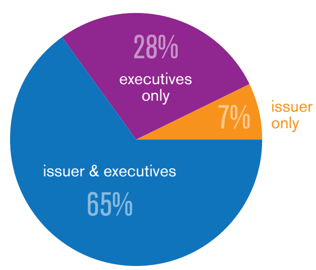
At the 20th Annual **Securities Litigation and Regulatory Enforcement Seminar** in October 2013, however, Commissioner **Luis A. Aguilar** did not mince words in voicing his opinion about the Statement. Calling the Penalty Statement, "fatally flawed," Mr. Aguilar said "in deciding whether to impose a corporate penalty, it prioritized two factors that took the focus away from the actual misconduct"—"whether there was a benefit to the corporation" and "whether there was actual shareholder harm." Mr. Aguilar added: "The fallacy of focusing on corporate benefit as a dominant factor in assessing penalties was laid bare by a number of cases during the financial crisis where a company's fraudulent misrepresentations resulted in relatively small benefits to a company but caused enormous losses to investors." Instead, Mr. Aguilar said, the focus should be on "[t]he nature of the misconduct and the violation," and "[t]he nature of the defendant, its governance, and its other conduct prior to the violation." Mr. Aguilar encouraged SEC Staff to use these factors in providing recommendations to the Commission, stating that they "place appropriate focus on the conduct at issue."

SEC by the Numbers

Who does the SEC charge when it brings an enforcement action? Does the Commission mainly go after companies while shying away from charging individuals? Does it charge low-level employees rather than those at the top? Michael Klausner, the Nancy and Charles Munger Professor of Business and Professor of Law at Stanford Law School, and Jason Hegland, Project Manager for Stanford Securities Litigation Analytics, set out to answer these and related questions using data from the year 2000 through 2013. Their study focused on enforcement actions involving fraud, books and records violations, and claims relating to internal controls.

Klausner and Hegland found that in two-thirds of these enforcement actions, the company and at least some of its executives were named as defendants. In almost 30 percent of cases, some individual defendants were named but the company was not. While the named individual defendants have often been CEOs and CFOs, they are even more frequently lower-level executives. Finally, as could be expected, companies have paid much larger fines than individuals, and CEOs have paid more in fines than any other executives.

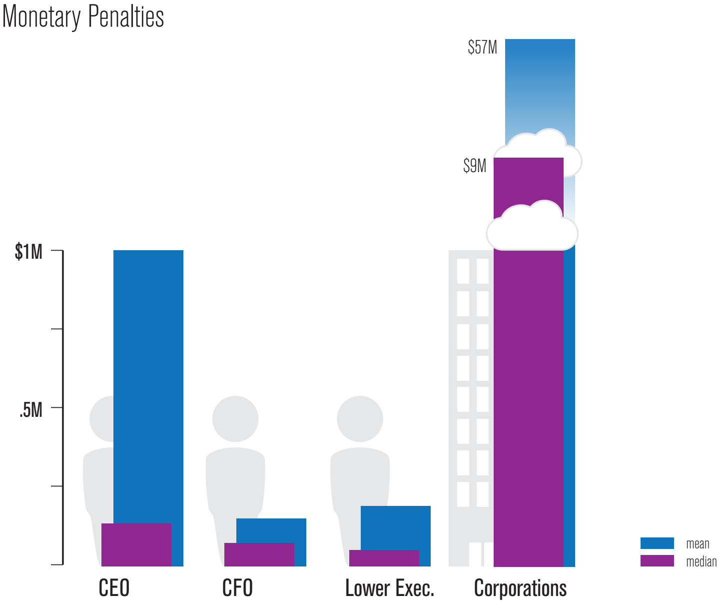
Whom Does the SEC Name as Defendants?



Executives Named by SEC

(% of cases per Klausner & Hegland study)

Size of Monetary Penalties



SEC SPEAKS

SEC Embraces Trials

Responding to criticism about the limits SEC Chair White imposed on the Commission's no admit/no deny settlement protocol, Chair White, speaking at the 5th Annual **Judge Thomas A. Flannery Lecture** in November 2013, defiantly said that the agency's lawyers are "ready to go up against the best of the white collar defense bar." Praising the place of trials in the American justice system, Chair White highlighted two benefits in particular: "Trials allow for more thoughtful and nuanced interpretations of the law in a way that settlements and summary judgments cannot," and, "the public does not often enough have [the] kind of public airing and adjudication that trials uniquely provide." Chair White touted the SEC's 80% trial success rate over the past three years, implying that she was ready to put that record to the test.

Chair White concluded by arguing that, whichever parties come out ahead in these additional trials, the winner will be the public: "If, in fact, a result of our change in settlement policy results in more trials, one clear winner will be the administration of justice, which will always fare best in the open for the public to see and to take stock of what a defendant did and what its government is doing. It also would make our lives as lawyers and judges more interesting and…even more exciting from time to time. Also not a bad thing."

UPCOMING

Conference: SEC Enforcement—Assessing the Agency's Policies and Practices

Featuring Entrepreneur Mark Cuban

Please join Cooley LLP for a half-day conference on the enforcement activities of the U.S. Securities and Exchange Commission. The event will bring together academics, practitioners, and former officials of the SEC, who will share their insights and perspectives on the SEC's current enforcement policies and practices. The conference will conclude with a fireside chat featuring entrepreneur Mark Cuban, who will offer a litigant's (*SEC v. Cuban*) and market participant's perspective on the SEC's enforcement objectives.

Thursday, February 20, 2014
8:30 am – 12:00 pm
Washington, DC

For the conference agenda, please visit www.cooley.com/69216. For additional details and to register, please contact Alicia Brewster at +1 703 456 8195 or abrewster@cooley.com.

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SEC Enforcement by the Numbers

OPERATION "SHELL EXPEL"

61

Number of companies for which the SEC suspended trading in June in one of the largest ever crackdowns against stock manipulation involving microcap "shell" companies.