SEC Enforcement Report

News and Issues in Securities Regulation and Litigation

Cooley LLP

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key attorney contacts

Jonathan Bach jbach@cooley.com	New York +1 212 479 6470
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
Doug Lobel dlobel@cooley.com	Reston +1 703 456 8019
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

SEC: Breaking Bad

SEC practitioners recently have been talking about broken windows. In this case, "broken windows" refers to a theory of law enforcement that considers no violation too small to pursue. The theory—famously implemented by Rudy Giuliani when he was mayor of New York City—posits that overlooking seemingly minor violations of law such as petty vandalism sends the message that disorder and crime will be tolerated. The idea is that, in contrast, investigating and punishing the smallest of violations powerfully conveys a message that following the law is always important, and breaking it always bad.

In late 2013, SEC Chair Mary Jo White publicly adopted this theory. As she put it, the broken-windows theory "can be applied to our securities markets—minor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines. And so, I believe it is important to pursue even the smallest infractions."

She apparently wasn't kidding. In September 2014, the SEC announced charges against *twenty-eight* officers, directors, and shareholders for violations that some might regard as distinctly minor in nature: failing to timely report stock transactions and holdings. The SEC also charged six companies in connection with these violations.

Exactly what legal obligations were the twenty-eight accused of violating? Generally speaking, Section 16 of the Securities Exchange Act of 1934 requires certain insiders—*i.e.*, officers and directors of a company with a registered class of equity securities, and beneficial owners of more than 10% of such a class—to file with the SEC certain reports regarding their holdings of the company's securities, and any changes in those holdings. The most prominent filing is Form 4, on which insiders must report most transactions in the company's stock within two days. Other filings include Form 3, on which an insider must report his or her beneficial ownership upon becoming an insider, and Form 5, which must be filed within forty-five days of the end of the calendar year and contain all information that should have been reported on a Form 3 or 4 that year but was not. In addition, under Section 13 of the Securities Exchange Act, individuals who beneficially own or acquire more than 5% of a company's shares must file a Schedule 13D or 13G at certain times.

Why might violations of these laws ordinarily be considered minor? There is no question that these rules exist, subject to certain nuances, and that corporate insiders must comply with them. And the SEC made clear that the targets of its sweep were "repeated late filers." But certain factors make stock-reporting violations less significant than the misconduct that typically has attracted the SEC's enforcement interest.

First, violations of these reporting rules do not amount to fraud on their own. There is no mental-state requirement for a violation, so violating these rules could be accidental. But, as Enforcement Director Andrew Ceresney put it, "inadvertence is no defense to filing violations, and we will vigorously police these sorts of violations through streamlined actions." In fact, some of the corporate insiders who were targeted by the SEC reported their trading to their employer and were supposedly told that the company had made timely SEC filings. Yet, as the SEC stated, this is no excuse "because an insider retains legal responsibility for compliance with the filing requirements, including the obligation to assure that the filing is timely and accurately made."

Second, many of the filing violations did not involve stock transactions that were unreported altogether. They were reported, just not promptly enough. (Although some of the late filings were months or even years late.)

Third, and finally, the SEC has a recent history of focusing on these types of reporting violations only where they were accompanied by other, more serious conduct. It is thus likely that—in the absence of a new, vigorous broken-windows approach—the SEC may not have considered these violations worth the dedication of enforcement resources.

There are some other aspects of the SEC's recent announcement that are noteworthy. For example, the sweep of the SEC's enforcement activity included more than just officers, directors and shareholders. The SEC also announced charges against six publicly traded companies. These companies were charged not with failing to report transactions or holdings, but with "contributing to filing failures or failing to report their insiders' filing delinquencies." For example, some of the companies were charged with violating Item 405 of Regulation S-K, which requires certain public companies to disclose in Form 10-Ks or proxy statements information about insiders' late or missing filings. Moreover, although companies are encouraged by the SEC to assist their insiders with complying with Section 16 filing requirements, the SEC has taken the position that companies "who voluntarily accept certain responsibilities and then act negligently in the performance of those tasks may be liable as a cause of Section 16(a) violations by insiders."

Moreover, according to the SEC's announcement, the targets in question paid sizable monetary penalties for their noncompliance. The thirty-three individuals and companies (of thirty-four charged) who agreed to settle the SEC's claims paid total financial penalties of $2.6 million. The penalties for the insiders ranged from $25,000 to $120,000, and the penalties for the public companies ranged from $75,000 to $150,000. These penalties are not enormous, but they demonstrate that the cost of noncompliance can nonetheless be high.

The SEC also disclosed that it had detected the filing violations in question by using "quantitative analytics." This is consistent with the SEC's recent announcements that it will be relying more on sophisticated technological and analytical tools to support its enforcement program. For example, in 2013 the SEC's Enforcement Division created a specific entity—the Center for Risk and Quantitative Analytics—for the express purpose of using quantitative data to detect misconduct.

Overall, the SEC's announcement leads to some interesting compliance issues. The fact that the SEC made clear that it was pursuing "repeated late filers" should provide some degree of comfort for those concerned about an accidental, isolated late filing. Nevertheless, the SEC's increasing reliance on analytics suggests that it is able to identify violations with more precision than ever before. Public companies therefore should engage in a close review of their policies and procedures relating to Section 16 reporting, and to provide additional training as necessary to make clear what role the company does and does not play in assisting insiders with their reporting obligations. In the course

SEC Enforcement Report

Editor in Chief . . . . Lyle Roberts

Contributors . . . . .Peter Adams
George Anhang
Kyle Reynolds
Adam Trigg

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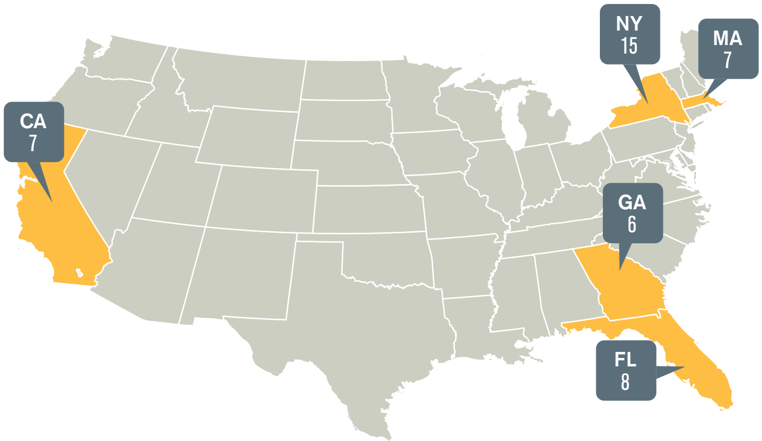
SEC Enforcement by the Numbers

Litigation Release Hotspots – Q3 2014



The SEC routinely issues notices called "Litigation Releases," which discuss new enforcement actions and developments in existing actions. In the second quarter of 2014, the SEC issued 65 such releases, two-thirds of which involved actions concentrated in 5 states (NY, FL, CA, MA and GA).

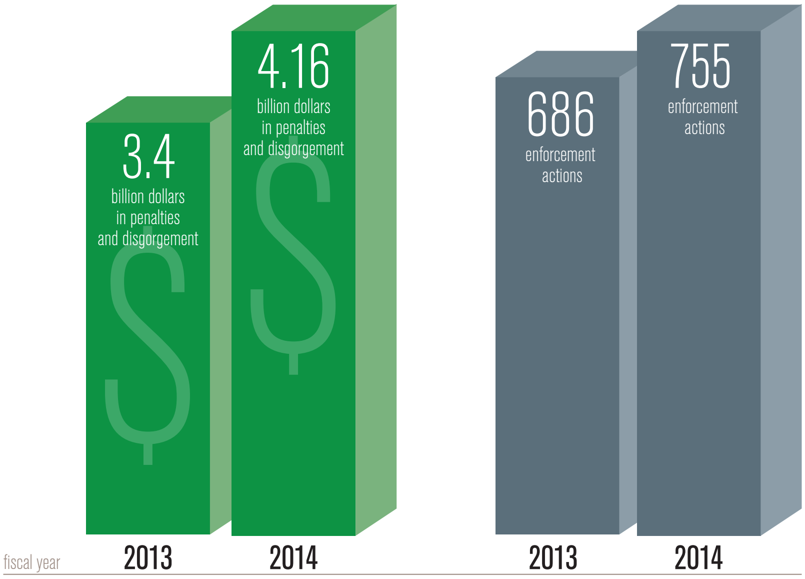
of such training, companies should emphasize that insiders ultimately bear the responsibility for ensuring accurate, timely reporting.

If a company does assist its insiders with reporting, it should be aware at all times of exactly which officers, directors, and shareholders are subject to Section 16 reporting requirements. It also should establish clear procedures and divisions of labor with respect to receiving information from insiders about beneficial holdings, accurately recording the information on the appropriate form, and filing the form with the SEC before the expiration of the deadline. These procedures would be strengthened by making sure that the company regularly coordinates with necessary third parties—such as brokers, financial advisers, stock-plan administrators, and the like—who are involved with insiders' securities holdings and transactions.

And companies should consider establishing policies under which directors and officers are required to report holding and transaction information on their D&O questionnaires, or policies encouraging insiders to provide the company with advance notice of anticipated transactions. Depending on their size, public companies also might consider establishing a dedicated team to review materials and conduct diligence as necessary to comply with Item 405 in its proxy statements and Form 10-Ks.

More generally, what can be expected from the SEC as it continues to implement its broken-windows policy? There can be no doubt that, by announcing charges in such large numbers for arguably minor violations, the SEC is sending a message that it is serious about broad enforcement. Indeed, it seems unlikely that the SEC will stop at simple insider-reporting violations. Market participants can expect more enforcement actions targeted at seemingly minor violations, placing an even higher premium on having effective securities compliance programs—across a whole spectrum of issues —than usual. Stay tuned. •

SEC Enforcement by the Numbers



SEC SPEAKS

Charging Individuals and Negligent Corporations

At the NYC Bar Association's Third Annual White Collar Crime Institute on May 19, 2014, SEC Chair Mary Jo White gave a speech in which she discussed the SEC's current enforcement environment.

Chair White emphasized that the SEC regularly charges and will continue to charge individuals in its enforcement actions. She noted that since 2011 the SEC has charged individuals in 83% of its enforcement actions, and will "continue to look for ways to innovate in order to further strengthen our ability to charge individuals."

One such innovation is to use Section 20(b) of the Exchange Act. Section 20(b) imposes primary liability on a person who, directly or indirectly, does anything "by means of any other person" that would be unlawful for that person to do on his or her own. Ms. White said the SEC will be "focusing" on Section 20(b) as "a very powerful tool that can reach those who have participated in disseminating false or misleading information to investors, but who might not be liable under Rule 10b-5(b) following the Supreme Court's decision in *Janus* because they may not be the 'maker' of the statement."

Chair White also discussed the SEC's willingness to charge entities with negligence-based violations of the securities laws. She said "charging only corporations with negligence can be appropriate when an entity makes a material misstatement or omission in the offer or sale of securities and the evidence will not support holding any individual responsible."

The SEC's Renewed Focus on Accounting and Financial Fraud

In 2007, the SEC prosecuted over 200 enforcement actions involving financial fraud and issuer disclosure. At the time, these cases comprised nearly one-third of all SEC enforcement actions. However, with the onset of the financial crisis in 2008, the number of accounting fraud cases precipitously declined as the SEC turned its attention to investigating financial institutions. As a result, the number of accounting fraud cases fell to a decade-low 68 in 2013.

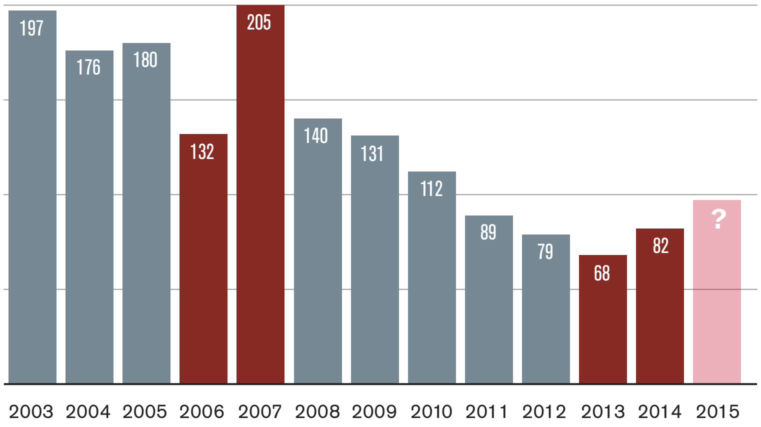
Last year, however, the SEC signaled that it was going back to basics—*i.e.*, to combatting accounting irregularities, financial fraud, and disclosure violations. In July 2013, the Enforcement Division announced formation of the Financial Reporting and Audit Task Force, which serves as an "incubator" for potential investigations by performing early assessments and referring matters to others in the Division.

A key weapon in the Task Force's early-assessment arsenal is the Accounting Quality Model (AQM), a predictive analytics tool that identifies registrants with anomalous filings relative to their peers. Taking advantage of the SEC's ability to mine its own data, the AQM (also known as "RoboCop") culls data from filed financial reports and generates a risk score, which the SEC then uses to identify companies for priority examinations. In addition, the SEC is not just looking at numbers. It is also analyzing text (*e.g.*, MD&A disclosures, press releases, and other investor communications) to reveal warning signs of earnings manipulation and other accounting red flags.

Earlier this year, and in light of these developments, SEC Enforcement Director Andrew Ceresney characterized financing reporting and audit fraud as the "next frontier" for the SEC and forecasted "a lot of activity" in that space. This forecast was recently confirmed by SEC Chair Mary Jo White, who, on October 1, 2014, reported a "significant jump" (from 68 in 2013 to over 80 in 2014) in the number of SEC enforcement actions targeting financial fraud and issuer disclosure.[1] Not surprisingly, Chairman White directly attributed this increase to the "new approaches and efforts" of the Task Force, which "has taken advantage of new sources of data on financial reporting, using innovative analytical tools to more quickly identify potential issues in financial statements and disclosures that merit further investigation."

The steady decline in enforcement actions for accounting and financial reporting violations would appear to be over. The new, upward trend is expected to continue in 2015 as the Commission continues to rely on big-data analytics, makes more inquiries, and files more lawsuits. As a result, public companies

2014 saw the first year-over-year increase in enforcement actions involving financial fraud and issuer compliance since 2007



Source: SEC's Year-by-Year Enforcement Statistics; SEC's "Spotlight on Foreign Corrupt Practices Acts" listed on the agency's website.

Prior to fiscal year 2011, this category of actions included FCPA cases. Therefore, the pre-2011 figures presented have been adjusted to separate out FCPA matters. In 2011, the SEC started tracking FCPA actions separately in its Annual Performance and Accountability Report. The reported number of Financial Fraud / Issuer Disclosure cases for 2014 is an estimate reflecting the announced 21 percent increase over 2013.

SEC SPEAKS

SEC Commissioner Calls on the SEC to Seek Amendment of Dodd-Frank Act

On October 16, 2014, at the 15th Annual A.A. Sommer Jr. Lecture on Corporate, Securities and Financial Law at Fordham Law School, SEC Commissioner Daniel M. Gallagher criticized the mandates imposed on the SEC by the Dodd-Frank Act and called on the commission to return to its "tripartite mandate" of maintaining orderly and efficient markets, facilitating capital formation, and investor protection.

In particular, Mr. Gallagher lamented the "prudential regulators'" increasing influence on the SEC, which distracts from the commission's core mission by burdening it with sociopolitical "issues *du jour*" like conflict minerals and extractive resources. He called for the SEC to "affirmatively engage Congress and the Administration and work with them to remove the useless or counterproductive elements of the Dodd-Frank Act."

The SEC's Whistleblower Office—Rewarding Whistleblowers And Punishing Retaliation

On September 22, 2014, the SEC announced that it will award more than $30 million to a whistleblower who provided critical information that led to a successful enforcement action. The award is the largest ever handed out by the SEC's whistleblower office, more than doubling the prior record award of $14 million.

The SEC's whistleblower program, established under the Dodd-Frank Act of 2010, rewards "high-quality, original information" that results in enforcement actions leading to the imposition of more than $1 million in sanctions. Awards, which can range from 10 to 30 percent of the sanctions collected, are paid through an investor protection fund financed by enforcement actions.

Sean McKessy, director of the whistleblower office, said he hoped September's record award would encourage individuals "to come forward with credible information about potential violations of the U.S. securities laws." Mr. McKessy, as well as many legal analysts, expect that such large awards will continue the steady increase in whistleblower tips the Commission has seen since the program's inception, and also increase the number of individuals who bypass internal company mechanisms for reporting potential wrongdoing.

Companies should ensure that they are properly handling any whistleblowers. In addition to the power to give awards to whistleblowers, the Dodd-Frank Act also empowers the office of the whistleblower to take action against companies that try to prevent whistleblowers from coming forward. Mr. McKessy has indicated that the SEC will be cracking down on employers who try to retaliate against whistleblowers.

The agency brought its first retaliation case in June against Paradigm Capital Management, accusing the hedge fund adviser of punishing a trader for tipping off the agency about allegedly improper principal transactions between Paradigm and an affiliated broker-dealer. According to the SEC, the whistleblower had been the head trader at Paradigm, but after the firm learned of his actions he was demoted repeatedly until he resigned. Paradigm neither admitted nor denied the allegations, but agreed to pay $2.2 million in sanctions to settle the charges.

Mr. McKessy said bringing additional retaliation cases is a "priority" for the SEC and that its enforcement attorneys are "on the hunt" for the next big case. This increased scrutiny includes seeking the personnel records of the employees that raised issues internally, as well as scrutinizing severance agreements for language that could deter employees from reporting to the SEC. •

SEC's Renewed Focus *continued*

should be increasingly cautious when filing reports with the SEC. The most obvious way to stay off the SEC's enforcement radar screen is to avoid making mistakes in SEC filings, thereby prompting revisions or restatements. With the AQM, the SEC can complete an "automatic examination" of a company's financial document within 24 hours of its filing, and outliers can then be sent on for additional review. As such, knowing that the SEC is looking for outliers, it is important for companies to have clearly defined processes, controls, and procedures for reviewing financial facts presented to the SEC, and to benchmark their accounting and financial reporting relative to their peers. Public companies should consider disclosing additional information when deviating from peer or industry practices, and be prepared to provide detailed explanations of discretionary accounting policies. •

[1] On October 16, 2014, the SEC announced that in fiscal year 2014 it filed 755 enforcement actions and charged more than 135 parties with violations relating to reporting and disclosure. Detailed enforcement data has not yet been reported. However, Director Ceresney did disclose in September 2014 that accounting cases in 2014 had increased 21 percent as compared to 2013, suggesting that the number of financial fraud and issuer disclosure actions in 2014 was around 82.

SEC SPEAKS

A Record Year For the SEC

When former white collar prosecutor Mary Jo White assumed the helm of the SEC last year, some commentators predicted that under her leadership, the Commission would be more willing than ever to aggressively investigate and pursue cases. Recent data released by the SEC appears to bear that out. In the fiscal year that ended in September 2014, the SEC filed more enforcement actions—755, to be exact—than in any previous year in the agency's 80-year history.

Touting the SEC's record-setting year, SEC Chair White said, "Aggressive enforcement against wrongdoers who harm investors and threaten our financial markets remains a top priority and we brought and will continue to bring creative and important enforcement actions across a broad range of the securities markets."

Andrew J. Ceresney, Director of the SEC's Division of Enforcement, also weighed in on the SEC's banner year, noting that, "Time and again this past year, the Division's staff applied its tremendous energy and talent, uncovered misconduct, and held accountable those who were responsible for wrongdoing." Looking back at the past year and ahead to 2015, Ceresney said, "I am proud of our excellent record of success and look forward to another year filled with high-impact enforcement actions."