

# Securities Enforcement & Litigation Alert

## SEC Speaks 2014: Charting a New Course for Enforcement Efforts

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This year's "SEC Speaks" conference in Washington, D.C., was most notable for an obvious shift in the SEC's enforcement priorities. Several significant issues and efforts that had been the subject of extensive discussion last year – including financial crisis and insider-trading cases and the task force devoted to new and structured products, among others – received little or no attention this year. On the other hand, several new initiatives received very substantial emphasis, including principally the Commission's new efforts in the public company accounting and financial statements area, and in the microcap fraud area. SEC Chair Mary Jo White highlighted the Commission's new policy of requiring admissions of wrongdoing in certain settlements, the public company Financial Reporting and Audit Task Force, and the new Microcap Task Force; Division of Enforcement Director Andrew Ceresney echoed those remarks and also noted a renewed emphasis on the role of public company "gatekeepers," such as auditors and in-house counsel.

Although it seems clear that this refocusing will result in *different* enforcement efforts, it is unclear whether it will result in *more* enforcement efforts.

The SEC came under significant criticism for its relatively flat to declining enforcement efforts in FY 2013, but, since assuming her post as head of the SEC, Chair White has consistently stressed that she views a very vigorous enforcement program as central to the SEC's efforts. She has spoken about the SEC needing to take a broad-based "broken windows" approach to enforcement, and recently said that 2014 "promises to be an incredibly active year in enforcement."<sup>1</sup> At the same time, Chair White has made clear that she thinks the SEC needs to try more cases, both against entities and individuals.<sup>2</sup> Taken together, these priorities could conflict, since trying more cases generally requires more manpower, and the primary place to get that manpower is from the Enforcement staff; a further complicating factor is the SEC's recent trial record, which includes several high-profile losses, *e.g.*, the Mark Cuban matter. Accordingly, it remains to be seen how the SEC will balance these issues and execute on its new enforcement priorities.

## Public Company Accounting and Financial Statement Fraud Initiative

### The Task Force and AQM

Perhaps in response to significant criticism of its recent lack of activity in this area – public company accounting and financial statements cases fell to their lowest level in 16 years in FY 2013 – the SEC has revitalized its approach to such matters by forming the new Financial Reporting and Audit Task Force and the new Center for Risk and Quantitative Analysis. According to David Woodcock, the task force's new Chair, the task force is composed of 12 members, including lawyers, forensic accountants, and audit accountants in nine out of 11 regional offices and the home office. Woodcock touted the group's combined "125 years of enforcement experience," and explained that the task force has five principal goals:

- to seek to better understand accounting and financial reporting fraud in terms of how and where it is happening by reviewing cases the SEC has previously brought, and by reviewing the work of academics and other third parties (which we take to mean investors and short-sellers) that have looked at these issues in depth;
- to develop a system to identify and investigate accounting and financial reporting fraud;
- to share within the law enforcement community best practices for identifying accounting and financial fraud;
- to collaborate with other regulators and law enforcement partners; and
- to engage public partners, including working with academic and other third party institutions that focus on market integrity issues and encouraging whistleblowers in financial reporting fraud cases.

In a particularly interesting disclosure, Woodcock said the task force would also look at companies that have a pattern of filing multiple financial statement revisions because, although the underlying issues may not have been sufficiently material to warrant a restatement, they may reflect substantial weaknesses in internal controls. Woodcock also noted the task

force will increase monitoring of companies' financial statement reporting and may incubate matters not yet ready for an enforcement action by issuing targeted document requests or referring matters to an investigative team.

The key feature of the SEC's Quantitative Analytic effort is its Accounting Quality Model (AQM), a program that systematically searches public companies' financial statements for problematic filings and disclosures for further follow-up. AQM's main focus is on discretionary accounting decisions in which management has substantial subjective input, such as bad-debt expense and other reserves, and fair value accounting. The AQM effort will seek to identify problematic decisions by using certain "red flag" indicia, such as the use of off-balance sheet accounting, changes in auditors, adoption of aggressive accounting policies, and the degree to which accounting income outstrips reported taxable income. The last of these factors may suggest that management may be more afraid of lying to the IRS than to the SEC.

### Operation Broken Gate

Through Operation Broken Gate, the task force is also focusing on bringing cases against auditors by examining audits and determining whether auditors missed or ignored red flags, failed to maintain or request proper documentation, and/or failed to follow professional audit standards.<sup>3</sup> Woodcock cited the SEC's recent \$8.2 million settlement with KPMG as an example: That matter involved allegations that KPMG had violated the independence rules and found that, from 2007 to 2011, KPMG provided non-audit services, such as restructuring and corporate finance, to several of its audit clients.<sup>4</sup>

### Importance of the Audit Committee

Finally, it is noteworthy that, later in the conference, the SEC's Chief Accountant, Paul Beswick, gave a detailed presentation regarding audit committees, and his was the only staff presentation posted on the SEC's website.<sup>5</sup> Beswick emphasized that audit committees are in a unique position to represent investors and play an important role in promoting

high-quality, transparent financial reporting to investors. He noted that monitoring independence is an ongoing responsibility of the audit committee, and he stressed that frequent dialogue with management and a direct line of communication with the auditor are important parts of the committee's oversight role. He encouraged audit committees to think critically about disclosures to investors about the committee's work.

## Litigation Issues

### New Provisions Used

As he did last year, Joseph K. Brenner, the Chief Counsel to the Division of Enforcement, discussed the Enforcement Division's use of statutes and rules that have rarely, if ever, been used before. For example, the SEC recently used Exchange Act Rule 17a-25, which requires broker-dealers to submit securities transaction information upon request by the SEC, against Scottrade for failing to provide the agency with complete and accurate "blue sheet" data, *i.e.* information about trades by the firm and its customers.<sup>6</sup> This past year the SEC also used Section 20(d) of the Exchange Act, which prohibits trading in options while in possession of material nonpublic information, to charge a Microsoft portfolio manager with trading in Microsoft options ahead of company announcements.<sup>7</sup> In October 2013, the SEC for the first time used Exchange Act Rule 15c3-5, which requires broker-dealers to have risk controls in place before providing customers market access, to charge Knight Capital for lacking safeguards to prevent millions of erroneous orders in a 2012 incident that disrupted markets.<sup>8</sup> In August 2013, the SEC used Rule 38a-1(c) of the Investment Company Act for the first time. This rule prohibits misleading a fund's chief compliance officer, and the SEC used it to sanction a portfolio manager for forging pre-trade approvals and misleading the firm's chief compliance officer investigating the portfolio manager's trading.<sup>9</sup> Finally, in December 2012, the SEC used Section 26 of the Exchange Act, which prohibits representing that the SEC has passed on the merits of a security, to charge a GLR Capital fund manager for providing investors with account statements that falsely claimed "Member NASD and SEC Approved."<sup>10</sup>

For the second year in a row, Brenner stated that as a result of the Supreme Court's 2011 *Janus* decision, holding that only the "maker" of a statement is subject to Section 10(b) liability,<sup>11</sup> the Enforcement Division will bring claims under Section 20(b) of the Exchange Act, which imposes liability for securities violations caused indirectly through others.<sup>12</sup> Brenner stated that Section 20(b) will be used in a case this year.

### Choice of Forum Issues

Brenner's colleague, Charlotte Buford, Assistant Chief Counsel, noted that the Enforcement Division will increasingly seek to use the administrative forum for litigated cases and will no longer be "bound by false ties to outdated presumptions" that certain categories of cases must be brought as administrative proceedings and others must be brought in federal district court. She cited as a classic example insider-trading cases, which the SEC has historically always brought in federal court. Buford explained that, going forward, the staff would examine several factors in determining whether to proceed before an ALJ or a district court, including the relative speed and efficiency of the forum (as an ALJ must reach a final decision within 300 days, this would weigh in favor of an ALJ); whether the case would benefit from regulatory expertise (which would also weigh in favor of an ALJ); discovery issues; and, in negotiated settlements, the preference of defense counsel. Buford expressed confidence that the administrative forum provides individuals with due process protection and that the SEC has the authority to pursue financial penalties against individuals before an ALJ. It remains to be seen the extent to which the Enforcement Division will attempt to shift cases to the administrative forum.

### Trial Issues

In an apparent acknowledgement of recent losses in insider-trading trials, Matthew Solomon, Chief Litigation Counsel, emphasized that the SEC will not be deterred from trying insider-trading cases and stated that "we can't be too cautious with insider trading because deterrence requires it." Solomon said they will even bring small cases, in which the gain is less than \$50,000, and are prepared to

proceed in cases where there is no parallel criminal case and bring cases without the benefit of criminal investigation tools, such as wiretaps. Solomon noted that Chair White is “very focused” on the SEC’s trial capabilities, and that the staff is hiring federal prosecutors from various U.S. Attorneys’ offices to bolster its trial teams, which already include 115 dedicated trial attorneys.

Solomon also cited a recent important appellate victory in which the Second Circuit upheld a summary judgment order requiring a defendant fund manager to disgorge all profits earned from his insider trades, including profits that accrued to the fund rather than directly to the defendant. Solomon said this establishes an important precedent, at least in the Second Circuit, that the SEC may seek disgorgement of any profits earned from insider trades, including profits funneled to friends, family, or clients.<sup>13</sup> The ruling is also noteworthy in that, in a parallel appeal in the criminal case against the same defendant, the Second Circuit reversed a criminal forfeiture judgment for profits that were gained through the *same trades* because they did not flow to the defendant. The court noted that criminal forfeiture could not be used to disgorge proceeds from innocent third parties, as it can only be used to punish the offender by forfeiting those funds which he actually received or controlled.<sup>14</sup>

### Admissions Policy

Andrew Ceresney, who recently became the sole Director of the Division of Enforcement after George Canellos resigned as Co-Director in January 2014, highlighted the new policy established by Chair White in June 2013 of requiring defendants and respondents to admit liability in certain cases. Ceresney noted that the Commission has required admissions of wrongdoing in five cases to date. Specifically, in a February 2014 settlement, Credit Suisse admitted to providing cross-border brokerage and investment advisory service to U.S. clients without first registering with the SEC.<sup>15</sup> In an August 2013 settlement, Hedge Fund Adviser Philip Falcone admitted to improperly using \$113 million in fund assets to pay his personal taxes, secretly favoring certain customer redemption requests at the expense of other investors, and

conducting an improper “short squeeze” in bonds issued by a Canadian company.<sup>16</sup> In a September 2013 settlement, JPMorgan admitted to misstating financial results and lacking internal controls to detect and prevent its traders from fraudulently overvaluing investments to conceal hundreds of millions of dollars in trading losses in portfolios in its London chief investment office.<sup>17</sup> In a December 2013 settlement, three ConvergEx brokerage subsidiaries and two former employees admitted to routing orders to an offshore affiliate that added an undisclosed mark-up or mark-down on the price of the security.<sup>18</sup> The SEC also obtained an admission of culpability from Scottrade in the January 2014 settlement over missing blue sheet data discussed above.<sup>19</sup> Interestingly, most of these admissions cases did not involve charges that could create a private right of action, and this may have been a factor in the SEC’s decision to demand the admission.

### Technology Tools

Several speakers, including Chair White and Jina Choi, Regional Director of the San Francisco Regional Office, highlighted the SEC’s use of technology tools to identify potential fraudulent conduct that could harm investors. For example, the agency is employing MIDAS and NEAT, two programs that allow the SEC to search, collate, and analyze large amounts of market data. MIDAS (Market Information Data Analytics System) is one of the SEC’s latest technological tools, which permits the agency to sort through massive amounts of trading data across markets in a matter of minutes. NEAT (National Exams Analytics Tool) is a tool utilized by the National Exam Program to search for evidence of insider trading by reviewing the trading patterns of registrants for any suspicious activity. Before these tools were developed, searches and analysis of market data took up to several weeks. These technological tools permit the SEC to be more efficient and more focused in spotting market trends and irregularities.

### Cooperation Program

Choi also noted the Commission’s commitment to, and achievements in, encouraging meaningful

cooperation by giving those with knowledge of misconduct an incentive to cooperate. She cited the Commission's April 2013 non-prosecution agreement with a company in an FCPA case as a reward for its cooperation (which we discuss further below). Choi also cited the SEC's first-ever deferred prosecution agreement (DPA) with an individual, entered into with a former hedge fund administrator, Scott Herckis, who cooperated with the SEC in its investigation of a hedge fund manager, Berton M. Hochfeld, who stole investor assets.<sup>20</sup> Herckis provided the SEC with "voluminous documents and help[ed] the SEC understand how Hochfeld was able to perpetrate his fraud."<sup>21</sup> The DPA prohibits Herckis from working as a fund administrator for a period of five years and he cannot associate with any broker, dealer, investment adviser, or registered investment company.<sup>22</sup>

## Whistleblower Program

Choi also cited the Commission's Whistleblower program as an important cooperation tool that she said was "huge" last year. As we have written elsewhere,<sup>23</sup> the program continues to see about 3,000 tips per year but has so far resulted in only six awards; although one of these was very substantial – \$14 million – the other five were quite small and totaled only approximately \$800,000. Moreover, the SEC has failed to shed any light on its thought process in making these awards, and has provided no insight regarding how it is applying the highly nuanced factors applicable to award decisions. Still, Choi and other speakers pointed to the whistleblower program as a significant driver of enforcement efforts.

## Microcap Fraud Task Force

The Co-Chairs of the Microcap Fraud Task Force, Elisa Frank and Michael Paley, stated that the task force is run out of Miami and New York, and consists of 19 lawyers and 26 staff focused on preventing fraud in the over-the-counter (OTC) market for securities, known as the microcap market. In aiming to prevent fraud among the more than 10,000 companies whose shares trade on the OTC market's two inter-dealer quotations systems (*i.e.*, companies with small amounts of assets and low stock prices),

the task force is currently focusing on repeat players, gatekeepers, such as attorneys and transfer agents, and shell companies.

Under a microcap fraud-fighting initiative begun in 2012, known as Operation Shell-Expel, the Commission has been scrutinizing penny stocks nationwide and identifying clearly inactive companies. The SEC has proactively suspended trading in several hundred dormant shell companies before they can be manipulated in pump-and-dump schemes involving the manipulative promotion of thinly traded microcap stock.

## Specialized Units

### Asset Management Unit

Marshall Sprung, the Co-Chief of the Asset Management Unit (AMU), highlighted the unit's focus on the investment advisory contract renewal process and fee arrangements in the fund industry. Sprung cited the unit's May 2013 action against gatekeepers of the Northern Lights Fund Trust and Variable Trust in which the SEC charged the fund's trustees, chief compliance officer, and fund administrator with causing untrue or misleading disclosures about the factors they considered when approving or renewing investment advisory contracts on behalf of shareholders.<sup>24</sup> He also noted that, in the private fund space, AMU has been conducting an aberrational performance initiative, bringing eight actions against 10 individuals. Under the agency's Compliance Program Initiative, which targets firms that have been previously warned by SEC examiners about compliance deficiencies but failed to effectively act upon those warnings, the unit brought a case against Capital Advisers LLC and Equitas Partners for failing to adopt and implement written compliance policies and procedures reasonably designed to prevent securities law violations and failing to conduct annual compliance reviews, as required by the "Compliance Rule" (Rule 206(4)-7) of the Investment Advisers Act.<sup>25</sup>

### Complex Financial Instruments Unit

In a real sign that times and priorities have changed for the Enforcement Division, the new chief of

this unit, Michael Osnato, explained that it is a repackaging and repurposing of the prior “Structured and New Products” unit. Osnato explained that this refocusing had just occurred and that as such, he did not have any case developments to report. Indeed, it is not clear whether the prior Structured and New Products Unit brought any cases in Fiscal 2013, although the Complex Financial Instruments Unit assisted in an investigation that led to a December 2013 settlement with Merrill Lynch for making faulty disclosures about collateral selection for two collateralized debt obligations it marketed to investors.<sup>26</sup> In any event, Osnato explained that the unit’s mandate is now to “find the most complicated products in the most complicated markets” and bring cases. Osnato cited *JPMorgan*, discussed above, and the January 2013 case brought against a former executive at Jefferies & Company for fraudulently marking up the price of mortgage-backed securities sold from his firm’s inventory.<sup>27</sup> Osnato stated that going forward the OTC market will be the first priority of the Unit because it contains “complicated products in dark markets.” Osnato said future cases will likely involve self-dealing or mismarking valuations of securities held by a firm in its portfolio.

### **Market Abuse Unit**

Daniel Hawke, Chief of the Market Abuse Unit, highlighted several cases from the last year including *Knight Capital* and *Scottrade*, discussed above, and the \$10 million settlement with NASDAQ after flaws in the design of its systems and an improper response by exchange officials delayed trading in Facebook’s stock during its initial public offering and left brokers confused about whether they owned shares of the stock after trading commenced.<sup>28</sup>

### **Municipal Securities and Public Pensions Unit**

LeeAnn Gaunt, Chief of the Municipal Securities and Public Pensions Unit, which has a presence in 10 out of 12 regional offices, noted that they are working on a pay-to-play initiative using public sources listing campaign contributions to find links to investment advisers.

### **FCPA Unit**

FCPA Unit Chief Kara Brockmeyer commented on the SEC’s willingness to enter into a non-prosecution agreement with the Ralph Lauren Corporation (RLC) in April 2013, the SEC’s first non-prosecution agreement in an FCPA case, to resolve allegations that RLC’s subsidiary in Argentina made improper payments to customs officials. RLC was required to pay almost \$735,000 in disgorgement and prejudgment interest and commit to other undertakings.<sup>29</sup> Not surprisingly, RLC’s voluntary disclosure, significant cooperation with authorities, and proactive and effective compliance and remediation were factors that helped it qualify for a non-prosecution agreement. Brockmeyer noted, however, that the limitation of FCPA violations to RLC’s Argentinian subsidiary was also a significant factor, suggesting that it would be difficult for a company with pervasive FCPA issues to qualify for a non-prosecution agreement. Brockmeyer also touched on some other issues of continuing interest, including:

- The availability of “hybrid monitors” involving an independent compliance monitor followed by a term of self-reporting to the SEC post-settlement;
- The SEC’s use of informed whistleblower complaints as a source of leads into possible FCPA violations;
- The SEC’s scrutiny of business practices that present issues under the FCPA, specifically, relationships with third-party intermediaries, travel and entertainment expenses for employees of state-controlled entities, and charitable donations; and
- The SEC’s willingness to use the ALJ forum to enter into resolutions with corporations.

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2. Mary Jo White, Chair, U.S. Sec. and Exch. Comm'n, Remarks at the 5th Annual Judge Thomas A. Flannery Lecture, Washington, D.C. (Nov. 14, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370540374908>.
3. Mary Jo White, Chair, U.S. Sec. and Exch. Comm'n, Remarks at the Securities Enforcement Forum, Washington, D.C. (Oct. 9, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370539872100#.Uwt4rflidWSo>.
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5. Presentation, Paul Beswick, Chief Accountant, U.S. Sec. and Exch. Comm'n, Audit Committee: Back to Basics (Feb. 22, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370540846980>. All of the speakers prefaced their remarks with the standard disclaimer that they were expressing their own views and not necessarily the views of the Commission.
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9. U.S. Sec. and Exch. Comm'n, SEC Sanctions Colorado-Based Portfolio Manager for Forging Documents and Misleading Chief Compliance Officer, Press Release No. 2013-165 (Aug. 27, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539791420#.Uw1YGPldVPE>.
10. U.S. Sec. and Exch. Comm'n, SEC Files Charges Against Two Others in Northern California Fund Manager's \$60 Million Scheme, Litigation Release No. 22580 (Dec. 21, 2012), <http://www.sec.gov/litigation/litreleases/2012/lr22580.htm>.
11. See *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2300 (2011) ("For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.").
12. Section 20(b) of the Exchange Act, 15 U.S.C. §78t(b), provides as follows: "It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person."
13. *SEC v. Contorinis*, 12-1723-CV, 2014 WL 593484 at \*9 (2d Cir. Feb. 18, 2014).
14. *Id.* at \*6-7. Cf. *id.* at 10 (Chin, J., dissenting).
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21. *Id.*
22. *Id.* at ¶ 7.
23. Christian R. Bartholomew and Brianna Benfield Ripa, *SEC's Second Annual Report Summarizing Whistleblower Program Shows Little Change*, WEIL NEWSLETTERS (Securities Enforcement and Litigation Alert), Dec. 3, 2013, <http://www.weil.com/news/pubdetail.aspx?pub=12350>.
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26. U.S. Sec. and Exch. Comm'n, SEC Charges Merrill Lynch with Misleading Investors in CDOs, Press Release No. 2013-261 (Dec. 12, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540492377#.UyC01YXgevU>.
27. U.S. Sec. and Exch. Comm'n, SEC Charges Former Jefferies Executive with Defrauding Investors in Mortgage-Backed Securities, Press Release No. 2013-12 (Jan. 28, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513874>.
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