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Top SEC Enforcement Issues for Public Companies - 2012

The 30th Annual

Federal Securities Institute

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SEC ENFORCEMENT TRENDS IN FY 2011

- Shift by SEC to high-profile cases against financial institutions for sales practices, as well as insider-trading and Ponzi scheme matters
- Financial statement and accounting cases decreased significantly
- Continued focus on FCPA (2 of largest 10 settlements obtained in fiscal year 2011 were FCPA matters)
- SEC focusing considerable resources on not missing the next Ponzi scheme
- SEC enforcement statistics for fiscal year 2011[1]
  - Record year for the SEC – 735 enforcement actions filed and more than $2.8 billion in disgorgement and penalties ordered
  - 682 settled matters (almost same as 680 in fiscal year 2010)
  - 42% of cases were financial institution sales practice cases and Ponzi scheme cases (as opposed to 23% average for these cases in 2003 through 2008)

FINANCIAL STATEMENT AND ACCOUNTING FRAUD CASES

- Financial statement/accounting cases represented only 10.4% of all SEC enforcement efforts in fiscal year 2011
  - this is the lowest level since before Sarbanes-Oxley Act went into effect
  - and less than half of the high of 23% in 2007 (71 settled cases in fiscal year 2011 versus 170 in fiscal year 2007)
- Amount of settlements extremely low
  - none of the 10 largest settlements in fiscal year 2011 involved a public company as a defendant
  - only 6 involved monetary sanction; highest settlement was $10 million (Satyam, see discussion below) but settlements averaged $1 million
- Commission adamant that this remains area of focus, but many believe SEC shifting emphasis
  - Five specialized units created by SEC in 2010 did not include unit devoted to financial statement or accounting cases[2]
- Still, reasons to remain ever vigilant:
  - new SEC whistleblower rules, discussed below, create enormous incentives for people deep in the organization who know about bad things to come forward

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[1] The SEC's enforcement statistics for Fiscal Year 2011 (Oct. 1, 2010–September 30, 2011) are available at Select SEC and Market Data Fiscal 2011, www.sec.gov/about/secstats2011.pdf; *see also* SEC Settlement Trends: 2H11 Update, NERA Economic Consulting (Jan. 23, 2012), *available at* http://www.nera.com/nera-files/PUB_SEC_Trends_2H11_01_12.pdf (a number of the statistics in this outline are derived from this publication).

[2] The five specialized units are: Asset Management; Market Abuse; Structured and New Products; Foreign Corrupt Practices; and Municipal Securities and Public Pensions.

- Dodd-Frank gave SEC significant new enforcement powers, particularly viz. public companies (see discussions below)
  - lowering of aiding-and-abetting standard to recklessness
  - ability to pursue companies in administrative proceedings and get full relief, penalties etc.
  - compensation clawback
- And there were some notable cases in fiscal year 2011 and already several in fiscal year 2012:
  - *SEC v. Satyam Computer Services Limited d/b/a Mahindra Satyam*, No. 1:11-cv-00672 (D.D.C. Apr. 5, 2011), Lit. Rel. No. 21915 (Apr. 5, 2011)
    - Satyam settled charges alleging it fraudulently overstated its revenue, income, and cash balances over a five-year period to make it appear more profitable to investors
    - complaint alleges Satyam accomplished the fraud by creating false invoices and forging bank statements to overstate its cash balances by more than $1 billion
    - Satyam paid a $10 million penalty and agreed to conduct training, improve internal audit functions, and hire an independent consultant to evaluate the adopted internal controls
    - five India-based affiliates of Price WaterhouseCoopers (PWC) settled with the SEC for $6 million, the SEC's largest settlement to date with a foreign-based accounting firm, for quality control failures uncovered during the Satyam investigation
  - *SEC v. DHB Industries, Inc. n/k/a Point Blank Solutions, Inc*, Lit. Release No. 21867 (Feb. 28, 2011)
    - DHB settled charges alleging it engaged in a pervasive accounting and disclosure fraud and misappropriation of company assets, resulting in false and misleading SEC filings
    - complaint alleged that DHB's lack of internal accounting and financial reporting controls allowed the CEO, CFO and CCO to manipulate the company's financials and to loot company assets
    - SEC also secured sanctions against three former independent directors of DHB's Audit and Compensation Committees for willfully ignoring red flags regarding senior management's conduct; court issued permanent injunctions, officer and director bars, and ordered the directors to pay penalties and disgorgement (*see SEC v. Jerome Krantz, Cary Chasin, and Gary Nadelman*, No. 0:11-cv-60431 (S.D. Fla. Nov. 11, 2011))
      - SEC's complaint alleged, among other things, that directors were friends and neighbors of the CEO and other executives; deeply under CEO's sway in terms of benefits, stock, etc; knew funds were being used for improper purposes (i.e. prostitutes); ignored numerous red flags, including multiple auditors issuing material weakness reports and raising other significant concerns; law firm that investigated significant allegation of related party transactions resigned; new controller told the Audit Committee that the company systematically overstated inventory, and controller was subsequently fired; and ignored SEC's subpoenas
      - in announcing the action against the directors, Robert Khuzami, head of the Division of Enforcement, remarked "[w]e will not second-guess the good-faith efforts of

directors. But in stark contrast, Krantz, Chasin, and Nadelman were directors and audit committee members who repeatedly turned a blind eye to warning signs of fraud and other misconduct by company officers." (*See SEC Charges Military Body Armor Supplier and Former Outside Directors With Accounting Fraud*, Rel. No. 2011-52 (Feb. 28, 2011))[1]

    - DHB's former CEO, CCO, and CFO were previously charged; CEO and CCO were convicted and CFO pled guilty; they are currently awaiting sentencing
    - DHB was not required to pay a fine; SEC took into account DHB's remedial measures and noted that it was in bankruptcy
- SEC has already brought several large accounting fraud actions in 2012:
  - *SEC v. Life Partners Holdings, Inc., Brian D. Pardo, R. Scott Peden, and David M. Martin*, No. 6:12-cv-00002 (W.D. Tex. Jan. 3, 2012)
    - following the close of its fiscal year 2011, the SEC filed an action against Life Partners, its Chairman and CEO (Pardo), president and general counsel (Peden), and CFO (Martin)
    - allege company and officers misled shareholders by failing to disclose that company was underestimating life expectancy estimates used to price transactions in order to artificially inflate revenues and profit margins
    - Life Partners had previously settled an action for $12.8 million with the Colorado Securities Commission for failing to disclose the "high frequency rate" that investors were outliving their life expectancies, of which the CEO and general counsel were well aware, yet continued to misrepresent this risk in SEC filings; the general counsel also allegedly misrepresented that the methodology of calculating life expectancy used by the company was industry practice when he knew that it was not
    - the CEO and general counsel were also charged with insider trading for selling shares of company stock at inflated prices while in possession of non-public information about this practice
    - litigation ongoing
  - *SEC v. Symmetry Medical Inc.*, Admin. Proc. No. 3-14723 (Jan. 30, 2012) (and related actions)
    - SEC recently settled actions with Symmetry, two executives, and two accountants, and filed charges against four additional executives
    - allege that four executives at Symmetry's England-based subsidiary of Symmetry systematically understated expenses and overstated assets and revenues at the subsidiary, which caused Symmetry to file misleading financial statements for a three-year period

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[1] While cases against independent directors are rare, this was one of several cases brought in 2011. The Commission also brought a case against Rajat Gupta, former independent director of The Goldman Sachs Group, Inc. and Proctor & Gamble Co., and a former Siemens board member alleging he violated the FCPA (see discussions below).

    - allege several of the executives involved in the scheme falsely certified the accuracy of financial information, lied to the company's auditors, and sold stock when they knew it was at inflated prices
    - two U.K. accountants from Ernst & Young also settled with the SEC for failing to properly audit the subsidiary, agreeing to suspensions from appearing or practicing before the SEC
    - CEO and CFO, who were not involved in or aware of the fraud, also agreed to reimburse the company for $450,000 and $210,000 under Sarbanes Oxley's clawback provision (see discussion below)
    - Symmetry was not required to pay a penalty, but agreed to a cease-and-desist order
  - and JDA Software Group Inc. recently announced that the SEC is investigating it for revenue recognition and other accounting and financial reporting matters

SEC WHISTLEBLOWER PROGRAM

- SEC implemented whistleblower rules in August 2011 after considerable public comment; rules provide for very large bounties for whistleblowers in broad range of securities cases
- Can recover 10% to 30% of any monetary sanctions over $1 million collected in any SEC or SEC-related (i.e., DOJ) securities matter, including, for example, FCPA, fraudulent financial reporting, manipulation, etc.—no longer limited to insider-trading matters
- Whistleblower must *voluntarily* provide *original information* about violation of federal securities laws that has occurred, is ongoing or is about to occur that leads to *successful enforcement action* in which the SEC recovers *$1 million or more in sanctions*
  - whistleblowers can be third-parties, non-employees, vendors, etc., but compliance personnel, internal auditors, and outside accountants cannot be whistleblowers unless:
    - ongoing conduct likely to cause substantial financial injury or impede investigation (*e.g.*, destroying documents); or 121 days after reporting to Audit Committee, CLO, chief compliance officer; or where Audit Committee, CLO or CCO already aware of information
    - attorneys can only be whistleblowers in the first two instances
- Internal reporting is *not* required, but SEC attempted to create incentives for whistleblowers to report internally first
  - whistleblower's "place in line" for award preserved for 120 days from date of complaint
  - attribute to whistleblower information company subsequently uncovers in internal investigation
  - give whistleblower "credit" for internal reporting in determining award
- 120-day look-back increases pressure on companies to investigate quickly—may also change and complicate self-reporting calculus
  - although SEC has said that new rules should not be read "to suggest that an internal investigation should in all cases be completed before an entity elects to self-report violations, or that 120 days is intended as an implicit 'deadline' for such an investigation"

(Adopting Release at 77), reality is that 120-day clock starts ticking upon receipt of the complaint, given whistleblower's incentive to save his place in line by reporting to the SEC on day 121

  - so, will need to have established, efficient and expedited procedures in place for internal whistleblower complaints—in most cases, assuming credible, meritorious complaint, self-reporting prior to day 121 seems prudent
  - may want to consider reporting to SEC prior to 121st day—should consider
    - gravity and materiality of initial allegation
    - whether senior management and/or board members are the subject of the allegation
    - degree to which the initial findings of the inquiry are problematic
- Rules have very strong anti-retaliation provisions
  - broader than bounty provisions: employee is protected even if complaint does not result in SEC enforcement action or if employee is not entitled to an award for other reasons; employee must have only a "reasonable belief" that a "possible violation" has occurred, is ongoing or is about to occur
- Thus far, SEC is not overwhelmed with tips; first report listed 334, not thousands as some had predicted
  - manipulation (16.4%); offering fraud (15.6%); corporate disclosure and financial statement (15.3%); less than 4% of tips involved FCPA; 23.7% categorized as "other"
  - no data on who these whistleblowers were, what percentage went directly to SEC versus reporting internally, how many were anonymous, etc.
- SEC officials have said that quality and source of tips has improved—getting detailed, brief-like submissions from persons with inside knowledge

INSIDER TRADING CASES

- SEC brought 57 insider trading actions in 2011; not substantially higher than prior years
- Continued focus on hedge funds and expert networks through parallel investigations with DOJ
- Cases brought against a wide-range of individuals, including a former NASDAQ managing director, former MLB player, and a FDA chemist
  - these cases signal ability to uncover insider trading in a variety of areas and by unsuspecting individuals
- *SEC v. Raj Rajaratnam*, No. 09-CIV-8811 (S.D.N.Y., filed Oct. 16, 2009); SEC Release No. 2011-233
  - SEC obtained final judgment of $92.8 million against Rajaratnam, the largest penalty to date in an insider trading case against an individual
  - Judge Rakoff, who handled civil matter, ordered defendants to turn over wiretapped conversations defendants received from prosecution in DOJ criminal matter pursuant to civil subpoena (see discussion below)

- Rajaratnam found guilty, sentenced to 11 year imprisonment, and ordered to pay $10 million in criminal fines and disgorge $53.8 million in parallel DOJ action
  - SEC filed 18 additional actions stemming from conduct discovered through the Rajaratnam investigation
  - include action alleging additional charges against Rajaratnam as well as charges against Rajat Gupta, former board member of Goldman Sachs and Proctor & Gamble, for allegedly providing information he learned as a board member to Rajaratnam (S*EC v. Rajat Gupta and Raj Rajaratnam*, No. 11-CV-7566 (S.D.N.Y., filed Oct. 26, 2011))

Use of Wiretaps in Insider Trading Cases

- Insider trading is not one of the enumerated offenses in which wiretapping is permitted under Title III of the U.S. Code
  - nonetheless, in Rajaratnam case, Judge Holwell of S.D.N.Y. admitted tapes in criminal matters, finding that where the government investigates insider trading for the purpose of prosecuting wire fraud, an enumerated offense, it can collect evidence of securities fraud that it learns of during the wiretaps
  - ruling has significant implications for SEC enforcement actions
    - in Rajaratnam case, Judge Rakoff of S.D.N.Y. ordered the tapes be produced, finding that the SEC's right to the wiretapped recordings far exceeded the defendant's privacy rights
- Wiretaps will make it more difficult for defendants to contest allegations, and easier for prosecutors to "flip" defendants involved in the calls to assist in unraveling the extent of the conduct
  - *e.g.*, Diamondback Capital Management (*SEC v. Adondakis*, 12-CIV-0409 (S.D.N.Y., filed Jan. 18, 2012); SEC Release 2012-16 (Jan. 23, 2012))
    - SEC brought action against Diamondback, two of its former employees, another hedge fund, and five additional individuals in connection with expert network investigation in which the DOJ was rumored to have used wiretaps
    - Diamondback quickly entered into a proposed settlement with the SEC and a non-prosecution agreement with the U.S. Attorney's Office whereby it would cooperate with the investigation against its employees, disgorge $6 million, and pay a $3 million penalty

FCPA CASES

- SEC brought 20 FCPA cases in 2011
- Specialized unit devoted to FCPA created in 2010
- Largest settlement in fiscal year 2011 was with Johnson & Johnson for $48.6 million, *see SEC v. Johnson & Johnson*, No. 1: 11-CV-00686 (D.D.C., filed Apr. 8, 2011)
  - Johnson & Johnson agreed to settle allegations that its subsidiaries bribed public doctors in several European countries and paid kickbacks to Iraqi officials to obtain contracts under the United Nations Oil for Food Program
    - settled with the SEC and DOJ for $48.6 million and $21.4 million, respectively.

- Following criticism that only corporation, and not the individuals actually responsible for making the bribe, were being charged, SEC recently announced two cases involving multiple individuals
  - *SEC v. Sharef*, No. 11-CIV-9073 (filed Dec. 18, 2011); SEC Release No. 2011-263
    - SEC filed charges against six Siemens executives and settled with a seventh executive who were involved in a bribing scheme to receive Argentinean contracts to produce identification cards for Argentine citizens
    - DOJ also brought charges against the same six executives as well as two intermediaries
    - executives charged include a former managing board member at Siemens, who allegedly met with intermediaries for the bribes and instructed an intermediary to issue false invoices to cover the bribes
    - this action come three years after Siemens paid a total of $1.6 billion to settle charges with the SEC, DOJ, and Prosecutor General in Munich; the matters against the individuals are ongoing
  - *SEC v. Magyar Telekom, PLC*, No. 11-CIV-9646 (S.D.N.Y., filed Dec. 29, 2011); *SEC v. Straub*, No. 11-CIV-9645 (S.D.N.Y., Dec. 29, 2011)
    - Magyar and its parent company, Deutche Telekom AG, paid combined penalties of $95 million to settle with the SEC and enter into deferred and non-prosecution agreements with the DOJ relating to allegations that it bribed officials in Macedonia and Montenegro to eliminate competition and to obtain business
    - SEC also charged Magyar's former Chairman and CEO and two other senior executives for, among other things, authorizing payments that they knew would be used to bribe and causing the company to enter into sham contracts to conceal the bribes; the case against the individuals is ongoing
- SEC also entered into its first ever deferred prosecution agreement in a matter involving violations of the FCPA with Tenaris (see discussion below)
  - it is yet to be seen whether deferred and non-prosecution agreements will become standard in SEC settlements involving FCPA violations as they are in DOJ settlements

COOPERATION AND DEFERRED AND NON-PROSECUTION AGREEMENTS

- SEC is continuing to move forward with cooperation initiative
  - following first non-prosecution agreement (NPA) in 2010 with Carter's, Inc., 2011 brought two more NPAs and first deferred prosecution agreement (DPA)
  - unlike Carter's NPA in 2010, 2011 agreements include detailed statements of fact
  - agreements permit parties to "neither admit nor deny" alleged facts
- First ever DPA with Tenaris S.A. (SEC Release 2011-112, May 17, 2011)
  - DPA alleges Tenaris violated the FCPA by bribing Uzbekistani officials in exchange for contracts to supply pipelines for transporting oil and natural gas; Tenaris precluded from contesting statement of facts in a subsequent SEC enforcement action if it breaches

- under terms of DPA, Tenaris required to disgorge $4.786 million in profits from the contracts and pay $641,900 in prejudgment interest; minimal undertakings and no independent monitor; Tenaris also entered into NPA with DOJ and agreed to pay $3.5 million to resolve the DOJ's parallel investigation
- Tenaris voluntarily reported to the SEC after uncovering the bribes during a worldwide internal review of its operations and controls, and SEC cited Tenaris's "immediate self-reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training" as factors for permitting DPA
- Tenaris agreed to annually review and update its Code of Conduct, to require director, officers, and management-level employees to certify compliance therewith, and to conduct FCPA training for certain employees; no independent monitor

- SEC NPAs with Fannie Mae and Freddie Mac (SEC Release 2011-267, Dec. 16, 2011)
  - NPAs allege companies materially underestimated risk exposure by misstating their holdings of subprime mortgage loans in Commission filings, public statements, investor calls and media interviews
    - press release accompanying NPA announced SEC actions against six senior executives at firms allegedly responsible for conduct
    - NPAs require Frannie and Freddie to cooperate in actions against senior executives, including, among other things, providing witnesses and documents to establish the facts set forth in the statement of facts and using best efforts to secure cooperation by firm executives and employees
  - in entering into agreement, SEC "recognize[d] the unique circumstances presented by the Respondent[s'] current status, including the financial support provided to the Respondent[s] by the U.S. Treasury, the role of another government agency (FHFA) as conservator, and the costs that may be imposed on U.S. taxpayers"
  - companies not required to pay fines or disgorgement (same as 2010 NPA)

CHALLENGES TO SEC "NEITHER ADMIT NOR DENY" POLICY

- Federal judges have recently challenged SEC's settlement policy that permits parties to "neither admit nor deny" the allegations against them
  - *SEC v. Citigroup Global Markets*, No. 11-civ-7387 (S.D.N.Y.) and No. 11-5227 (2nd Cir.)
    - Judge Rakoff rejected Citigroup $285 million settlement (Citigroup allegedly misled investors by failing to disclose that it had played a role in selecting underlying CDO assets while at the same time betting against those assets); Judge Rakoff criticized SEC's "no admit" policy as "depriv[ing] the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact."
    - SEC appealed Rakoff's decision to the Second Circuit, but the Second Circuit has yet to decide whether the SEC has a right to review of ruling
  - *SEC v. Koss Corp.*, No. 2:11-cv-00991 (E.D. Wis.)
    - following Rakoff's rejection of the Citigroup settlement, Wisconsin District Judge Randa declined to approve a settlement with Koss Corporation and its CEO until the SEC

provided "a written factual predicate" explaining why the proposed settlements "are fair, reasonable, adequate, and in the public interest." Judge Randa cited his concern that the proposed injunctions were vague and unlimited as to time, making them difficult to enforce, the lack of specifics on how the disgorgement amount was calculated, and concern that the proposed judgment is not in fact final

    - SEC response noted that courts need only find settlements "fair, adequate, and reasonable," and that Judge Rakoff had erred in adding the additional "public interest" requirement. The SEC nonetheless asserted that the settlement met this requirement, and further responded to the Judge's concerns. On February 1, Judge Randa issued a letter to the SEC stating its response "largely satisfies" his concerns and instructing the SEC to submit revised final judgments that include the consent provisions (rather than incorporating them by reference, as the prior judgment had)

- These cases do not mark the first time SEC settlements have been challenged by federal courts. *See, e.g.*, *SEC v. Citigroup, Inc.*, No. 10-cv-1277-ESH (D.D.C., Judge Huvelle) (requiring SEC to respond to inquiries regarding specifics of and appropriateness of proposed settlement); *SEC v. Bank of America*, No. 09-civ-6829, 10-civ-0215 (S.D.N.Y., Judge Rakoff) (requiring parties to restructure and increase size of settlement prior to approval)
- SEC announced in January 2012 that where a defendant makes admissions of conduct in a parallel criminal conviction, NPA, or DPA, the SEC will no longer permit that defendant to enter into a settlement with the SEC in which the defendant neither admits nor denies the same conduct
  - SEC officials insist change was "separate from and unrelated to" judicial scrutiny
  - will only affect a very small percentage of cases
- SEC unlikely to further modify policy of allowing defendants to neither admit nor deny, but will likely increase use of administrative settlements to avoid scrutiny (see discussion below)

SEC EXPANDED ENFORCEMENT POWERS UNDER DODD-FRANK[1]

Aiding-and-Abetting Liability

- Dodd-Frank extended SEC's authority to pursue aiding-and-abetting cases in two significant ways:
  - authorized SEC to prosecute aiders and abettors in actions brought under the Securities Act of 1933 and Investment Company Act of 1940
    - previously, such actions were only permitted under the Securities Exchange Act of 1934 and the Investment Advisors Act
  - amended prior statute and overturned numerous court rulings requiring aiders and abettors to "knowingly" provide substantial assistance

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[1] The full text of the Dodd-Frank Act is available at http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf.

    - now, can also be liable for aiding-and-abetting where "recklessly" provided substantial assistance
    - previously had to have a stronger case against aider and abettor than against primary violator, since the latter could violate many securities laws recklessly—including the fraud provisions—but the former could not
    - SEC has indeed begun adding allegations of "recklessness" in aiding-and abetting-actions
      - *see, e.g.*, *SEC v. Life Partners Holdings, Inc., Brian D. Pardo, R. Scott Peden, and David M. Martin* (charging Pardo, Peden, and Martin with aiding and abetting by "knowingly or with severe recklessness provid[ing] substantial assistance to Life Partners' violations")
    - this means that companies and employees must be careful not to ignore or turn a blind eye to wrongful conduct within the company and by counterparties
      - companies must be sure that they understand the effects of a transaction – whether it be a sale, loan, swap, or otherwise – not only upon their own financials but upon the counterparty's financials
    - it also means that public accounting firms, lawyers, investment bankers and other so-called "gatekeepers" are likely to be pursued more frequently by the SEC for "assisting" in a financial fraud

<u>Penalties Against Companies In Administrative Proceedings</u>

- Dodd-Frank gave SEC the ability to seek penalties and bars from public companies and their officers and directors in administrative cease-and-desist proceedings
  - previously, SEC could bring administrative action against public company and its unregistered individuals, but would have to bring related federal civil action in order to get penalty and bars
  - so, more often than not, SEC brought such cases in federal court in order to get full relief
- New ability to get total or near-total relief in administrative forum more beneficial to SEC and likely to result in more matters brought in this manner
  - administrative process is viewed as potentially less demanding/more friendly forum than federal action
    - this is particularly true in light of the additional scrutiny that SEC settlements received by federal judges in recent years, *e.g.*, Judge Rakoff in *Citibank* and *Bank of America* settlements (see discussion above)
    - administrative law judges are SEC employees deeply experienced in intricacies of securities law and SEC enforcement
  - administrative proceedings also provide more advantageous forum to SEC
    - limited discovery (no depositions)
    - lack of a jury trial

        - appellate review by SEC commissioners who approved the original filing of the complaint
- Despite this change, SEC has not brought settled or contested administrative proceedings against public company under this expanded power to date
- One contested administrative proceeding against independent director, which was subsequently dismissed and re-filed as a federal injunctive action (*see In re Rajat K. Gupta*, Admin. Proc. No. 3-14279) (Mar. 1, 2011))
- Nonetheless, expect SEC to start utilizing this forum soon

Executive Compensation Clawback Provisions

- Section 304 of the Sarbanes-Oxley Act of 2002 (SOX) requires CEO or CFO to return incentive-based compensation where financial misstatement or restatement occurs "as the result of misconduct"
- The precise meaning and interpretation of this statute has long been unclear, but since 2009, SEC has aggressively pursued SOX clawback claims even where there is no alleged misconduct by the CEO or CFO
- Trend of pursuing such cases continued in 2011
- *SEC v. Jenkins*, No. 09-cv-01510 (D. Ariz. filed Jul. 22, 2009); SEC Rel. No. 2011-243 (Nov. 15, 2011)
    - SEC settled clawback case brought against CEO for $2.8 million
        - notably, this was significantly less than $4 million the SEC originally sought to recover
    - no misconduct by CEO was alleged, and court had previously found in dismissing defendant's motion to dismiss that triggering event under Section 304 is misconduct by the issuer, not by the individual
- *SEC v. O'Leary*, No. 1:11-cv-2901 (N.D. Ga.), Lit. Rel. No. 22074 (Aug. 30, 2011); *SEC v. McCarthy*, 1:11-CV-667-CAP (N.D. Ga.), Lit. Rel. No. 21873 (Mar. 4, 2011)
        - settled clawback actions with former CEO and CFO of Beazer Homes
        - complaints contained no allegations of misconduct; in announcing settlement, SEC proclaimed that the reach of SOX's clawbacks provision "include[s] an individual who has not been personally charged with the underlying misconduct or alleged to have otherwise violated the federal securities laws"
        - O'Leary agreed to reimburse over $1.4 million and McCarthy agreed to reimburse over $6.4 million (representing bonuses, restricted stock, and stock sale profits)
- Dodd-Frank's new clawback provision requires reimbursement from a larger class of individuals and covers an expanded period of time
    - like SOX 304, requires recovery of compensation regardless of whether any misconduct is shown; only requires "material noncompliance . . . with any financial reporting requirements under the securities laws"
        - but, unlike the SOX provision, applies to ***all*** current and former executives, not just the CEO and CFO

    - and requires return of compensation for three-years preceding the misstatement, whereas SOX only covers 12-months
  - Dodd-Frank added Section 10D to the Exchange Act, requiring the Commission to enact rules directing national securities exchanges to prevent the listing of the securities of issuers that do not develop and implement policies regarding (i) disclosure of incentive-based compensation and (ii) mandating the recovery of performance-based incentive compensation from current or former executives paid during the three-year period prior to a financial restatement where the compensation would not have been provided under as-restated financials
- SEC expects to issue proposed rules between now and July 2012
  - can expect activity in this area in the near future – companies should began revising their policies and procedures accordingly

ENFORCEMENT ACTIONS POST-*JANUS*

- Recent Supreme Court decision limited private securities claims, and may change the landscape for SEC enforcement actions
- *Janus Capital Group, Inc. v. First Derivative Traders*, 113 S. Ct. 2296 (2011)
  - in private securities matter, Supreme Court addressed whether Janus Capital Markets, the investment advisor and administrator for, but separate legal entity of Janus Investment Fund, was liable under Rule 10b-5 of the Exchange Act for “making” false statements in prospectuses filed by Janus Investment Fund
  - Court found that maker of statement is one with ultimate authority and control over statement
    - Court analogized the relationship to that between a speechwriter and speaker; “Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. It is the speaker who takes credit—or blame—for what is ultimately said.” *Id.*
  - thus, even though Janus Capital Markets may have been involved in preparing the prospectuses, it did not “make” the statements as no statements were directly attributable to it and it was Janus Investment Funds that had the ultimate control over the content
  - in reaching this result, Court relied upon several principals unique to private securities litigation and not applicable to enforcement actions:
    - a broader reading of “make” would undermine its decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, which found that Rule 10b-5 did not afford private litigants a right of action for aiding and abetting, as giving “make” a broader meaning would permit individuals and entities who provided “substantial assistance” to a statement to be liable as primary violators even where they could not be liable as aiders and abettors
      - this reasoning is not applicable to enforcement cases, as the SEC can bring causes of action for aiding and abetting violations of Rule 10b-5

    - a different interpretation of "make" would undermine its decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* because there could be no "reliance" by investors on a statement made by Janus Capital Markets
    - while the Supreme Court had previously ruled that Rule 10b-5 creates a private right of action, judicial concerns about creating such a right counseled against its expansion
- Company executives and representatives must understand that they can be held liable for any documents that they sign or approve
  - post-*Janus*, courts consistently find that individuals who sign or approve documents (such as financial statements or press releases) "make" the statement. *See, e.g.*, *SEC v. Das*, 2011 U.S. Dist. LEXIS 106982, *18 (D. Ne. Sept. 20, 2011) (CFOs who signed and certified Forms 10-K and 10-Q were "makers" of statements therein); *SEC v. Carter*, 2011 U.S. Dist. LEXIS 136599 (N.D. Ill. Nov. 28, 2011) (CEO who approved press releases prior to their dissemination "made" statements under *Janus*, but corporate attorney and director who wrote releases at defendant's request would not be liable as "makers" of the statements)
- Extent to which *Janus* will apply to SEC enforcement cases uncertain at this point
  - To date, courts and SEC ALJ have required *Janus*'s "make" requirement be met in enforcement cases under Rule 10b-5
    - less clear how *Janus* will affect scheme liability under Rule 10b-5 (a) and (c) and claims under Section 17(a) of the Securities Act
  - at a recent small group meeting, Commission staff admitted that *Janus* has already affected the way the SEC is charging defendants
    - amending charges to replace or supplement primary violations with aiding-and-abetting or control person charges (see discussion supra). *See, e.g.*, *SEC v. Big Apple Consulting United States, Inc.*, 2011 U.S. Dist. LEXIS 95390 (M.D. Fla. Aug. 25, 2011) and *SEC v. Daifotis*, 2011 U.S. Dist. LEXIS 116631 (N.D. Cal. Oct. 7, 2011)
    - charging aiding-and-abetting and control person liability in lieu of primary violations, and where possible alleging scheme liability under sections (a) and (c) of Rule 10b-5
      - *see SEC v. Sells*, CV-11-4941-HLR (N.D. Cal. Oct. 6, 2011) (alleging these defendants violated Rule 10b-5(a) and (c) by "orchestrated a scheme to defraud the investors of Hansen Medical by using undisclosed trickery to make it appear that the company had successfully sold its most expensive product when it had not actually completed the sales.")
- *Janus* has not changed the requirements for scheme liability
  - before *Janus*, courts routinely found that scheme liability must be premised on more than merely false statements or omissions
  - post-*Janus* actions are consistent with this requirement.
    - *see SEC v. Kelly*, 2011 U.S. Dist. LEXIS 108805 (S.D.N.Y. Sept. 22, 2011) (dismissing securities fraud claims against AOL executives for failure to "make" a statement as required by *Janus* and declining to permit SEC to plead scheme liability as defendants' conduct was not inherently deceptive, but "became deceptive only through AOL's

misstatements in its public filings," and permitting the SEC to plead scheme liability based on false statements would render *Janus* meaningless)

- *see also SEC v. Mercury Interactive LLC*, 2011 U.S. Dist. LEXIS 134580 (N.D. Ca. Nov. 22, 2011) (in declining to reconsider motion to dismiss in light of Janus, court stated it was unnecessary to decide whether defendant was "maker" of statements since facts were sufficient to plead scheme liability); *SEC v. Boock*, 2011 U.S. Dist. LEXIS 129673, at *5-6 (S.D.N.Y. Nov. 9, 2011) (upholding scheme liability claim following *Janus* where allegations were not based on misstatements but on participation in fraudulent scheme); *SEC v. Landberg*, 2011 U.S. Dist. LEXIS 127827, *11-12 (S.D.N.Y. Oct. 26, 2011) (dismissal not required because complaint alleges conduct beyond making of statement)

- Courts are split over whether *Janus* applies to Section 17(a) claims
  - majority of courts find that *Janus*'s "make" requirement does not apply to Section 17(a) claims as the provision does not include the word "make"
    - *See, e.g.*, *SEC v. Mercury Interactive LLC*, 2011 U.S. Dist. LEXIS 134580 (N.D. Ca. Nov. 22, 2011); *Daifotis*, 2011 U.S. Dist. LEXIS 83872, at *14
  - nonetheless, SEC ALJ and S.D.N.Y. have found that *Janus* rule applies to statements under Section 17(a)
    - *In re Flannery*, SEC Admin. Proc. 3-14081 (Oct. 28, 2011) (finding that *Janus* test is the appropriate standard to apply in evaluating defendants' conduct under 10(b) and 17(a), and concluding that defendants did not have ultimate authority or responsibility for documents in which alleged misstatements were made)
    - *SEC v. Kelly*, 2011 U.S. Dist. LEXIS 108805, at *13-15 (applying *Janus* to Section 17(a) claims as the elements are essentially identical to a Rule 10b-5 claim and the only purpose in enacting Rule 10b-5 was to extend Section 17(a) liability to "purchasers" of securities)
- *Janus* likely makes it harder for SEC to prove primary liability, particularly in the case of parent, affiliate companies, or individuals who contributed but did not author documents. *See, e.g.*, *SEC v. Daifotis*, 2011 U.S. Dist. LEXIS 83872 (N.D. Cal. Aug. 1, 2011) (finding defendant did not "make" statements in advertisement that included his picture but was not otherwise attributed to him)
  - but unlike in private context, SEC can still pursue these individuals as secondary actors through aiding-and-abetting or control person theories
    - and because Dodd-Frank relaxed standard in aiding-and-abetting cases, end result is that SEC now need only show the secondary actor "recklessly provided substantial assistance"
- But *Janus* leaves many open issues, such as whether a parent corporation can have "ultimate authority" over a subsidiary's statements