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SEC Enforcement in the Second Term of the Obama Administration

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Editor's Note: This post comes to us from Erich T. Schwartz and Colleen P. Mahoney, partners at Skadden, Arps, Slate, Meagher & Flom, and is based on a Skadden memorandum by Mr. Schwartz.

At the beginning of the first Obama administration, the United States Securities and Exchange Commission (SEC or the Commission) was an agency on the ropes, with some knowledgeable observers even speculating that it might not survive the revision to the financial regulatory apparatus that was anticipated in the wake of the financial crisis. Although the agency has been the subject of fierce criticism and controversy regarding a variety of issues during the last four years, it has indeed survived and, by many measures, been reinvigorated. It announced that last year it brought 734 enforcement actions, nearly equaling the record number of 735 in 2011, and that it obtained more than $3 billion in financial remedies.

As the second term of the Obama administration begins, the SEC is experiencing a profound leadership transition, with the departures of agency Chair Mary Schapiro; Director of Enforcement Robert Khuzami; its general counsel; the director of Corporation Finance; and the director of Trading and Markets. Such widespread turnover at the Commission and among its senior staff will have a significant impact on the priorities and direction of the agency. Although eventually a new chair may be named to the Commission, for now Elisse Walter, who was elevated from commissioner to chair on Ms. Schapiro's departure, is moving forward to grapple with the pressing issues on the Commission's agenda. She also is re-populating the senior staff ranks, having recently named a new general counsel.

At this moment of transition, we assess several of the initiatives that marked Director Khuzami's tenure at the SEC and that are likely to continue to influence enforcement activity. We also reflect on several pressing issues that may be prominent on the SEC's enforcement agenda during the second Obama term.

1. Developments in the SEC's Whistleblower Program

Perhaps the most significant SEC enforcement component of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) was the authority granted to the SEC to pay whistleblowers for enforcement tips. Last year the agency made its first whistleblower award, paying the statutory maximum of 30 percent of the amount collected in the SEC enforcement action to an individual who exercised his statutory right to remain anonymous.

The seemingly slow start to what we anticipate will be a stream of awards under the program can be explained by the significant lead time that is inherent in the regulatory process. Statistics and our experience in enforcement activity suggest that the program is achieving its objectives: The SEC received more than 3,000 whistleblower tips in 2012, and the Commission has consistently lauded the quality of the tips it has received to date. Commission staff have noted that more complaints are coming from senior finance and other personnel who have detailed inside knowledge of a company's operations. The plaintiffs' bar is actively engaged with the program, suggesting that there will be aggressive advocacy before the Commission staff as to the merits of particular tips and the need for enforcement action. It is reasonable to anticipate that the number of whistleblower tips will hold steady or increase in 2013, particularly if the Commission makes additional (and large) whistleblower awards. This "payment for information flow" program has the prospect to affect significantly the direction and tempo of enforcement activity in the coming years.

In addition to more whistleblower tips, companies can expect more litigation by putative whistleblowers alleging retaliation. Several courts have adopted a broad construction of the term "whistleblower" for purposes of anti-retaliation claims under Dodd-Frank, and the SEC has held out the threat of enforcement action for violation of the retaliation rules. Specifically, courts have held that the anti-retaliation provisions protect individuals who make reports that are "required or protected" by other laws that are subject to the SEC's jurisdiction. This broad interpretation of the anti-retaliation provisions makes it easier to assert retaliation claims, which complicates personnel decisions involving persons styling themselves as whistleblowers.

2. Risk-Based Investigative Initiatives

The SEC's Enforcement Division currently is collaborating with other segments of the SEC staff on risk-based, analytic initiatives in search of the "holy grail" of securities enforcement: the ability to operate proactively to identify and address violative conduct that has not yet manifested itself.[1]

[1] See SEC Press Release No. 2011-252, SEC Charges Multiple Hedge Fund Managers With Fraud in Inquiry Targeting Suspicious Investment Returns (Dec. 1, 2011), http://www.sec.gov/news/press/2011/2011-252.htm.

These efforts include the Aberrational Performance Inquiry, which is an initiative to examine and investigate hedge fund advisers that demonstrate indications of aberrational performance returns. The Division of Risk, Strategy and Financial Innovation (RiskFin) and the Office of Compliance Inspections and Examinations (OCIE), together with the Enforcement Division, are using proprietary risk modules and technology to apply performance and volatility benchmarks to thousands of hedge fund advisers and flag outliers for follow-up examination or investigation.

To date, the SEC's Aberrational Performance Inquiry has resulted in seven public enforcement actions against hedge fund advisory firms and managers. Those actions involved various types of alleged misconduct, including fraudulent valuation of portfolio assets, overstatement of returns, misappropriation of assets, and misstatements regarding the safety and liquidity of portfolio investments, the longevity, size or investment strategy of hedge funds, or the credentials or conflicts of interest of advisers. At least one of the actions also involved criminal charges. In bringing the actions, the SEC trumpeted its ability to use risk-based analytics to achieve early detection and prevention of misconduct. The SEC also used information obtained through the Aberrational Performance Inquiry to refer "questionable behavior" by hedge fund advisers to regulators in at least 17 countries.

The apparent success of this novel effort is likely to encourage additional initiatives that make use of data mining and modeling techniques to direct enforcement efforts, as exemplified by an effort to examine private equity "zombie funds" — funds that delay liquidation of assets beyond their intended life. Although well-conceived efforts may yield successful enforcement actions, misfires can result in expensive dry holes. For parties that are subject to such inquiries, they can arrive like a bolt from the blue, with no indication of any apparent issue, and perhaps little clarity as to the staff's objective.

3. The Cooperation Initiative: Not a Game Changer Yet

Three years ago, the SEC announced a series of measures to foster cooperation with individuals and companies, including nonprosecution agreements (NPAs), deferred prosecution agreements (DPAs), and, in appropriate cases, declining to prosecute a cooperator. Robert Khuzami, director of the SEC's Division of Enforcement, described the so-called cooperation initiative at the time as "a game-changer."[2] He explained that "[f]or the first time, we will have a formal framework of

[2] Robert S. Khuzami, Dir., Div. of Enforcement, U.S. Sec. and Exch. Comm'n, Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders (Jan. 13, 2010), http://www.sec.gov/news/speech/2010/spch011310rsk.htm.

incentives — incentives to secure the cooperation of persons who saw, heard and witnessed securities fraud first-hand."[3]

Despite the optimism that accompanied the announcement of the cooperation initiative, the SEC does not appear to be using these new cooperation measures as readily and as often as may have been expected. Since January 2010, the SEC has reportedly entered into only three NPAs and two DPAs. In contrast, in 2012 alone, the United States Department of Justice (DOJ) reportedly has entered into 35 DPAs and NPAs.

Likewise, since 2010, the SEC has announced only one instance where it declined to prosecute a potential defendant pursuant to its cooperation initiative. In March 2012, the SEC announced that it had declined to bring an enforcement action against an AXA Rosenberg executive based on the executive's cooperation. Director Khuzami explained that the SEC's leniency demonstrates that it "fully recognizes the value of cooperation in SEC investigations, and will seek to reward such cooperation appropriately."[4]

An additional long-term challenge is the general lack of transparency with regard to the "credit" the SEC gives for self-reporting and other cooperation. The staff regularly announce publicly that companies and individuals will receive credit in settlements for cooperation, but it is often difficult to perceive the scope of that credit from the public disclosures concerning resolutions.

The decision of how to respond to an SEC investigation can be a difficult one and is informed by the facts and circumstances of each case. With so few examples of companies and individuals being rewarded for cooperation, it remains to be seen whether the cooperation initiative will be the "game changer" Director Khuzami envisioned.

4. Sustained Focus on Asset Managers

Another of the organizational innovations in the Division of Enforcement — the creation of a specialized Asset Management Unit as one of five special units within the division — has and will continue to place sustained enforcement emphasis on asset managers. The Asset Management Unit, comprised of 75 staff members across 11 SEC offices, focuses exclusively on investigating and bringing enforcement actions against investment advisers, investment companies, hedge funds, mutual funds and private equity funds. One of the SEC's objectives in creating its specialized units was to develop expertise and focus attention on areas seen as enforcement priorities. Statistics suggest this objective is being realized as to investment managers, as the

[3] Robert S. Khuzami, Dir., Div. of Enforcement, U.S. Sec. and Exch. Comm'n, Commission Credits Individual Under Cooperation Initiative (Mar. 19, 2012), http://www.sec.gov/news/speech/2012/spch031912rk.htm.
[4] Id.

SEC brought 147 enforcement actions in 2012 against investment advisers and investment companies, one more than the record number of such enforcement actions filed in 2011, with a significant focus on matters relating to asset valuation and conflicts of interest. We anticipate that the SEC's intense focus on this area will continue, particularly given the dramatic increase in advisers subject to SEC regulation since Congress' elimination of the so-called "private fund adviser exemption" in Dodd-Frank. Indeed, it is little surprise that the division's initial efforts at proactive enforcement through risk based enforcement initiatives involve investment managers and make use of enhanced access to information regarding newly registered advisers.

5. Insider Trading Will Remain a Focus in 2013

After a very successful 2012, we anticipate the SEC and DOJ will continue their aggressive pursuit of insider trading cases in 2013. Federal prosecutors won every insider trading case that went to trial last year, and prosecutors in the U.S. Attorney's Office for the Southern District of New York have obtained more than 70 guilty pleas and convictions since their expansive investigation of insider trading came to light in 2009. The SEC has filed more insider trading cases over the past three years than it has in any prior three-year period in its history. In its fiscal year 2012 alone, the SEC filed 58 cases against 131 individuals and entities.

One of the most notable cases in 2012 was the successful prosecution of Rajat Gupta, former head of McKinsey & Co. and a former director at Goldman Sachs and Procter & Gamble. Both the SEC and the DOJ filed charges against Gupta, who allegedly tipped inside information about Goldman to Raj Rajaratnam, founder of Galleon Management LP. The evidence against Gupta was largely circumstantial and included phone records showing a pattern of calls from Gupta to Rajaratnam and trades by Rajaratnam's fund minutes after those calls. The jury deliberated for only 10 hours before finding Gupta guilty. He was sentenced to two years in prison and is free on bail pending an appeal.

There is no question that prosecutors' willingness to employ aggressive investigative tactics, such as wiretaps and informants, has played a role in their success. Even in their prosecution of Gupta, where they lacked direct evidence of wrongdoing, prosecutors played wiretaps of Rajaratnam's conversations with his traders, including one where he referenced a source on the Goldman board. Given their success, we anticipate that prosecutors will continue to use these aggressive investigative tactics going forward.

Other trends and issues we expect to see in insider trading cases over the course of this year include: (i) a continued focus on hedge fund insiders, other market professionals and gatekeepers (e.g., lawyers and accountants) in investigations and prosecutions; (ii) a continued focus on corporate executives and whether they are trading (and/or tipping others to trade) ahead of market-moving corporate announcements and events; (iii) increased investigations and prosecutions arising from tips that the SEC receives from foreign regulators; and (iv) investigations and prosecutions of non-U.S. persons for participating in insider trading schemes that touch U.S. markets.

6. FCPA: SEC and DOJ Release Guidance and Continue to Focus on Health Care Industry

Enforcement of the U.S. Foreign Corrupt Practices Act (FCPA) remains a professed federal priority for both the SEC and the DOJ. Although the number and size of enforcement actions decreased from the prior year, the SEC and DOJ still recovered $260 million in FCPA settlements with 12 companies in 2012. The impact of the whistleblower program in this space remains to be seen. There has been an expectation, particularly given the enormous settlement figures in some FCPA cases, that the area would be particularly attractive to award-seeking whistleblowers. However, the statistics published by the SEC's whistleblower office do not seem to bear that out, with less than 4 percent of the tips received in that category. Accordingly, enforcement activity may continue to depend significantly on self-discovery and voluntary disclosure by companies.

The government's aggressive interpretation of provisions of the FCPA to support a focus on healthcare companies is particularly noteworthy. Half of the FCPA enforcement actions filed by the SEC and DOJ in 2012 involved allegations against health care companies. In these actions, the SEC took the position that health care professionals employed by government-run health care systems (e.g., physicians, nurses, etc.) are "foreign officials" within the purview of the FCPA. As a result, health care companies, including pharmaceutical and medical device manufacturers, must ensure that their compliance programs monitor relationships between their employees and health care professionals and implement effective compliance controls on all interactions with health care professionals outside the United States.

Late last year the SEC and DOJ jointly released the long-anticipated Resource Guide to the FCPA.[5] The resource guide tracks developments with respect to FCPA enforcement and interpretation and provides some insight into the government's perspective on a number of enforcement issues. Although the resource guide will serve as a good reference tool for FCPA practitioners and in-house lawyers, it did not announce new policies or provide guidance that has not been gleaned from existing cases, settlements and opinion letters. Certain of the positions taken in the resource guide, including with regard to jurisdiction and the statute of limitations, are being challenged in the courts, and the guide may not be the last word. It is clear from the

[5] The Resource Guide is available online to the public at http://www.justice.gov/criminal/fraud/fcpa and http://www.sec.gov/spotlight/fcpa.shtml.

resource guide, however, that vigilance, diligence and informed common sense are the principles to apply when evaluating whether a company's practices are compliant with the anti-bribery and accounting provisions of the FCPA.

The publication of the resource guide provides the impetus for companies to pursue self-assessment to ensure that their existing internal controls are robust, and that their policies conform to best practices. Although the resource guide did not provide the nuts and bolts for employing effective and sustainable compliance measures, it compiled case law and government guidance to benchmark the sufficiency of a company's controls and policies. In particular, the resource guide confirmed the elements the government considers to be essential to an effective compliance program and provides practical examples regarding travel, gifts, entertainment, and bona fide promotional and educational expenses. The guide also confirmed guidance regarding acquisition and investment due diligence.

7. High Frequency Trading

The rapid evolution of the structure of the securities markets and the fragmentation of trading venues has continued apace, and has continued to generate controversy both with regard to whether rulemaking is appropriate to direct that evolution in investor friendly ways, and with regard to whether the emerging new marketplace is adequately policed. The "flash crash" in May 2010 and an assortment of more limited but equally dramatic breakdowns associated with high frequency trading (HFT) galvanized the attention and the concern of investors, regulators and Congress alike. The public debate regarding the utility of HFT continues, with proponents citing the measurable benefits in the form of deeper liquidity and tighter spreads for all market participants, and opponents questioning the durability of that liquidity and worrying about risks created by the complexity of the structure and opportunities for abuse.

As the regulators struggle to catch up with evolving markets, we anticipate continued enforcement scrutiny of HFT. Recently, for example, the SEC turned its attention to a broad range of HFT-related issues, such as the structure of proprietary market data feeds, the adequacy of testing of automated trading algorithms, and the development of order types geared toward automated trading. The most prominent HFT-related enforcement action of the year was announced in September 2012, when the SEC levied a first-ever $5 million civil money penalty against the NYSE as part of a settlement of allegations that the exchange violated market regulations by providing customers of its proprietary data feed with access to market data faster than that provided to the public. There have also been public reports of ongoing, broad-based examinations of market structure issues involving a multitude of market participants, including exchange operators, self-regulatory organizations, broker-dealers and high-frequency traders.

Continued focus on HFT in the coming year is all but guaranteed. FINRA's CEO, Richard Ketchum, has publicly vowed to increase scrutiny of dark pools and alleged cross-market abuses by enhancing surveillance of HFT. The SEC too has plans to launch a trade monitoring system to better monitor HFT across markets. The debate on the benefits and detriments of HFT will continue, with the likely end result being additional regulatory actions in the form of market structure reforms through rule-making, as well as additional enforcement actions.

8. Solving the China Conundrum

The U.S. capital markets experienced great success in becoming the leading venue for financing the development of China-based companies. Over the past few years, allegations of accounting improprieties, fraud and other misconduct have cast a pall over that once-booming market. Moreover, fundamental questions of regulatory oversight have emerged, which must be resolved in a way that is satisfactory to all parties. This is a significant challenge, as failure here may threaten that entire market — an outcome that would be in no one's interest.

In 2010 and 2011, a number of Chinese issuers — in particular those that have used so-called "reverse mergers" to access U.S. capital markets — were alleged by short sellers to be fraudulent. The SEC and self-regulatory organizations suspended trading in the stocks of several Chinese issuers in 2011, and the SEC revoked the securities registrations of others. U.S.-listed Chinese companies also saw a wave of auditor resignations. The confluence of events depressed U.S. demand for Chinese issuers and led to shareholder litigation.

Regulatory scrutiny of Chinese issuers and their advisers increased in 2012. The SEC brought a number of enforcement actions against reverse merger companies and associated persons or investors, as well as their advisers and consultants, for alleged misconduct ranging from violations of securities and broker registration provisions to fraud, manipulation, insider trading and illegal short selling. The FBI also raided the offices of an advisory firm that specializes in reverse mergers by Chinese companies.

Repeated allegations of fraud and accounting improprieties by Chinese companies listed in the U.S. have elevated the significance of a long-running conflict between U.S. and Chinese regulatory authorities regarding the ability of the SEC and the Public Company Accounting Oversight Board (PCAOB) to obtain audit work papers and other documents from Chinese accounting firms, as well as the ability of the PCAOB to examine such firms. After years of resistance on the grounds that U.S. audit inspections implicate sovereignty concerns and could reveal state secrets, Chinese authorities only recently permitted the PCAOB to observe official audit inspections, a step that falls short of full PCAOB inspections of foreign registered public accounting firms. Likewise, citing state secrecy and sovereignty concerns, Chinese accounting firms insist they cannot provide the SEC with audit work papers relating to U.S.-listed companies they audit.

Three pending SEC enforcement actions against China-based accounting firms are poised to bring this diplomatic and regulatory conflict to a head. The SEC recently instituted administrative enforcement proceedings against the Chinese affiliates of five major global accounting firms for allegedly violating Section 106 of the Sarbanes-Oxley Act of 2002 by failing to produce audit work papers and other documents related to audit clients under SEC investigation. That enforcement action followed a similar Section 106 enforcement action against Deloitte Touche Tohmatsu CPA Ltd. (DTT). Separately, the SEC instituted a judicial action against DTT in 2011 to enforce an administrative subpoena for documents related to Longtop Financial Technologies Limited, a DTT audit client that is being investigated by the SEC for fraud. The judicial action against DTT was stayed in July 2012 to facilitate negotiations between the SEC and Chinese regulatory authorities regarding access to the requested documents. Those negotiations were unsuccessful, however, and the SEC recently moved to lift the stay. These three enforcement actions raise profound questions about the continued ability of accounting firms based in China to audit U.S. issuers. This, in turn, raises questions about the continued ability of Chinese companies to list on U.S. exchanges.

In light of heightened regulatory scrutiny and international regulatory conflict, as well as low investor confidence and weak demand, it is unsurprising that an increasing number of Chinese companies have fled the United States. The continued viability of U.S. capital markets for Chinese issuers depends on confidence in financial reporting and reasonable regulatory accommodation by all parties. Successful resolution of this issue will challenge all parties, including the SEC.

Conclusion

As the SEC enters the second Obama term, many of the program innovations and authority put into place during the first term seem likely to continue to bear fruit for the agency. To a great degree, the matters to which those tools will be applied will be the agency’s traditional diet of enforcement issues. However, the SEC also is facing new and important policy issues in which enforcement is likely to have a prominent role. It should make for an interesting term.