Chapter 14

SEC Investigations and Enforcement Actions

Marc J. Fagel, Barry R. Goldsmith & Mark K. Schonfeld*

* The authors of this chapter would like to acknowledge the contributions of John H. Sturc and Jonathan C. Dickey, retired former partners of Gibson, Dunn & Crutcher LLP, who were the original co-authors of this chapter.

§ 14:1 Introduction

The U.S. Securities and Exchange Commission (SEC or "Commission") is the federal government's principal regulatory and enforcement arm with respect to the securities activities of corporate America. This chapter provides an overview of SEC investigations and enforcement actions as they relate to public companies and their officers, directors, and employees, as well as third parties such as auditors, and suggests how these entities and affiliated persons may most effectively deal with SEC investigations and enforcement actions.

SEC enforcement actions involving public companies vary in several significant respects from private actions. Unlike class actions, SEC investigations are rarely triggered by an earnings disappointment or a merger announcement; rather, the SEC typically focuses on allegations of accounting improprieties and serious misrepresentations and omissions. And while the SEC, like private plaintiffs, usually

pursues fraud claims, the SEC has a much wider array of charges it can level, including allegations of failures to maintain accurate books and records and implement adequate internal controls.

Additionally, the SEC can seek broader and potentially more devastating remedies from both companies and individual officers, directors, and employees than may be obtained in private litigation. An enforcement action against a public company issuer may result in the assessment of large corporate penalties, elimination of the protections afforded by the "safe harbor" for forward-looking statements under the Private Securities Litigation Reform Act, and the imposition of restrictive corporate governance structures. With respect to individuals, the SEC may seek not just monetary relief in the form of disgorgement and penalties, but temporary or permanent restrictions on an individual's ability to serve as an officer or director of a public company. An enforcement action by the SEC may also have significant collateral effects. It may cast doubt on the reputation of the corporation and its management and board; it may lead to lawsuits by shareholders or other persons (who may in turn obtain access to the SEC's investigative record); and it may limit the company's access to financing (including the loss of the "well-known seasoned issuer" exemption from securities registration). And while the SEC itself is a civil agency that cannot seek criminal remedies, its investigations are sometimes referred to criminal authorities, such as the Department of Justice (DOJ), which has access to broader investigative powers (such as search warrants and wiretaps) and more daunting sanctions (including incarceration).

Even if the investigation is concluded without an enforcement action, the pendency of an investigation—sometimes lasting years—places a cloud over the corporation if the investigation is publicly disclosed, which can chill relationships with customers, lenders and shareholders, and distract and demoralize management and other corporate personnel.

How a corporation responds to an indication of misconduct is often as important to the future of the corporation as remediating the underlying conduct itself. Any business enterprise may have a rogue employee or officer who engages in misconduct either for personal benefit or because of a misguided belief that it will assist the corporation. In the eyes of the SEC and, in many instances, the DOJ, such conduct will not necessarily be attributed to the corporation, as the conduct may be inconsistent with the policies, values, and interests of the corporation. On the other hand, the failure to detect the misconduct may reflect upon the quality of the company's internal accounting and other controls. More important, the manner in which the company responds to indications of misconduct or to a government investigation will directly affect the SEC's views of the integrity

of the company and may have a significant impact on the outcome of an investigation.

§ 14:2 SEC Investigations

§ 14:2.1 *Investigation Participants*

SEC investigations are conducted by the Division of Enforcement (or "Enforcement Division"). Enforcement Division staff are located at the SEC's headquarters in Washington, D.C., as well as around the country in eleven regional offices. The Enforcement Division conducts investigations, recommends enforcement actions to the Commission, and negotiates settlements (subject to the Commission's approval). The Enforcement Division also litigates enforcement actions before SEC administrative law judges and in federal court.

SEC investigations are conducted by staff attorneys and, where appropriate, staff accountants. As part of their investigation, staff attorneys may collect and review documents, conduct interviews, and take sworn testimony. Investigations are supervised by assistant directors, each of whom manages several staff attorneys. These assistant director groups are in turn managed by associate directors in the regional offices and in Washington, D.C. At a high level, the enforcement program is overseen by the regional directors, unit chiefs (in the case of investigations handled by the specialized units described below), and ultimately the Director of the Enforcement Division in Washington, D.C.

§ 14:2.2 *Triggering Events*

[A] Generally

Nothing more than official curiosity is required for the SEC to start an investigation. This is not to say, however, that investigations are opened for no reason. Usually some event or market activity prompts the SEC to begin an inquiry, but it could be commenced based on any number of reasons, including:

1. Review of periodic filings and registration statements, as well as Forms 8-K, by the Division of Corporation Finance.
2. Referrals, particularly in the insider trading context, from self-regulatory organizations, such as the Financial Industry Regulatory Authority (FINRA), which carefully monitor securities trading activity.
3. Surveillance of newspaper and other media reports, industry publications, and stock-related websites and bulletin boards by Enforcement Division staff.

4. Tips from self-appointed corporate watchdogs (including professional short-sellers).
5. Complaints from investors, including formal "whistleblowers" seeking cash rewards pursuant to recently enacted SEC regulations (described below).
6. Complaints from competitors who may believe they are competing against a company that has been falsely stating its performance or which improperly secured business through a bribe to a foreign official.
7. Complaints from class action plaintiffs' counsel who hope to benefit from the fruits of an SEC investigation or the filing of an SEC enforcement action.

In addition, many SEC investigations of public companies originate from the self-reporting of potential irregularities by the issuer itself (through counsel). As discussed in section 14:3.4 below, the SEC expects, and may credit, cooperation by public companies, and thus it is often in the best interest of the company to inform the Enforcement Division of a potential violation of the federal securities laws identified internally before it becomes public or is shared by a whistleblower.

Given the tremendous volume of tips, complaints, and referrals that reach the SEC, as well as the increased resources the SEC is devoting to its own surveillance programs, the SEC enforcement staff has endeavored to evaluate such complaints with a critical eye, and in recent years has designed sophisticated systems and procedures to help evaluate and prioritize the information it receives. These reforms became an agency imperative in the wake of the Bernard Madoff scandal, in which the SEC was criticized for apparent failures to timely pursue tips suggesting Madoff may have been running a Ponzi scheme. Hence, the Enforcement Division established the Office of Market Intelligence, which serves as a central office for handling all such information.[1] Similar concerns led Congress to incentivize whistleblowers to come forward and report fraud, as described below.

[B] Whistleblowers

The Dodd-Frank Wall Street Reform and Consumer Protection Act,[2] passed in 2010, provides for the payment of cash awards to

---

1. *See* Mary L. Schapiro, Chairman, SEC, Testimony Before the Subcommittee on Financial Services and General Government, U.S. Senate Committee on Appropriations (Apr. 28, 2010), www.sec.gov/news/testimony/2010/ts042810mls.htm.
2. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

whistleblowers. Under Dodd-Frank, whistleblowers who voluntarily provide original information that leads to a successful enforcement action and imposition of monetary sanctions of over $1 million may be entitled to between 10% and 30% of the funds ultimately recovered by the SEC.[3] The whistleblower program went into effect on August 12, 2011. According to the SEC's 2017 Annual Financial Report, the SEC ordered over $50 million in payments to whistleblowers in fiscal year 2017.[4] In the 2017 Annual Report to Congress on the Dodd-Frank Whistleblower Program, the Whistleblower Office reported receiving over 4,400 tips in fiscal year 2017.[5] This is an increase of nearly 50% since the first full year of reporting in 2012.[6] The single largest category of tips, representing about 19% of those reported to the agency, was corporate disclosures and financials, followed closely by offering frauds (that is, Ponzi schemes) and market manipulation.[7] Other categories included the Foreign Corrupt Practices Act and insider trading.

As of April 2018, the SEC has publicly announced awards to more than fifty-five whistleblowers, ranging from hundreds of thousands of dollars to tens of millions.[8] In September 2014, the SEC awarded more than $30 million to a foreign citizen (while noting that the award would have been even higher if the whistleblower had not unreasonably delayed reporting the matter to the authorities).[9] In June 2016, the SEC awarded $17 million to a former company employee whose tip "substantially advanced the agency's investigation and ultimate enforcement action."[10] And in August 2016, the SEC awarded $22 million to a company insider who assisted the SEC with uncovering

---

3. *Id.* § 922; *see also* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules to Establish Whistleblower Program (May 25, 2011), www.sec.gov/news/press/2011/2011-116.htm.
4. U.S. SEC. & EXCH. COMM'N, FISCAL YEAR 2017 AGENCY FINANCIAL REPORT 16 (Nov. 2017) [hereinafter AGENCY FINANCIAL REPORT 2017], www.sec.gov/files/sec-2017-agency-financial-report.pdf.
5. U.S. SEC. & EXCH. COMM'N, 2017 ANNUAL REPORT TO CONGRESS ON THE DODD-FRANK WHISTLEBLOWER PROGRAM 1 (Nov. 2017) [hereinafter DODD-FRANK WHISTLEBLOWER REPORT 2017], www.sec.gov/files/sec-2017-annual-report-whistleblower-program.pdf.
6. *Id.*
7. *Id.* at 24.
8. Press Release No. 2018-64, U.S. Sec. & Exch. Comm'n, SEC Awards Whistleblower More Than $2.1 Million (Apr. 12, 2018), www.sec.gov/news/press-release/2018-64.
9. Press Release No. 2014-206, U.S. Sec. & Exch. Comm'n, SEC Announces Largest-Ever Whistleblower Award (Sept. 22, 2014), www.sec.gov/News/PressRelease/Detail/PressRelease/1370543011290.
10. Press Release No. 2016-114, U.S. Sec. & Exch. Comm'n, SEC Issues $17 Million Whistleblower Award (June 9, 2016), www.sec.gov/news/pressrelease/2016-114.html.

fraudulent activity.[11] The highest-ever award generated from a single SEC enforcement action was announced in March 2018, with two whistleblowers sharing nearly $50 million and a third whistleblower receiving over $33 million.[12]

Because of the confidentiality requirements of Dodd-Frank, the SEC has provided only limited information about the cases in which it has paid out whistleblower awards, and it is unclear the extent to which whistleblower awards have arisen from cases involving public companies. However, in 2015, the SEC announced an award of around a half million dollars to "a former company officer." The SEC explained that while officers who learn of fraud through another employee are typically excluded from the whistleblower provisions, they may recover where, as in this case, they first report the information to compliance personnel who fail to take appropriate action.[13] Along similar lines, the SEC has paid several awards to compliance persons who have reported the fraud to the government after the company failed to take action.[14] In April 2018, the SEC paid its first award to a whistleblower who first reported the information to another federal agency.[15] The award was paid under the "safe harbor" rule, which provides whistleblowers with a 120-day safe harbor period to also report their information to the SEC even if the federal agency has already referred the matter to the SEC.

---

11. Press Release No. 2016-172, U.S. Sec. & Exch. Comm'n, $22 Million Whistleblower Award for Company Insider Who Helped Uncover Fraud (Aug. 30, 2016), www.sec.gov/news/pressrelease/2016-172.html.
12. Press Release No. 2018-44, U.S. Sec. & Exch. Comm'n, SEC Announces Its Largest-Ever Whistleblower Awards (Mar. 19, 2018), www.sec.gov/news/press-release/2018-44.
13. Press Release No. 2015-45, *supra* note 8. *See generally* Exchange Act Rule 240.21F-4(b)(4)(v), providing for recovery by officers, directors, compliance personnel, accountants, and certain others who report to the SEC more than 120 days after sharing the information with appropriate company officials, or where they reasonably believe reporting is necessary to prevent substantial injury or that the company is impeding an investigation of the misconduct.
14. *See* Press Release No. 2015-73, U.S. Sec. & Exch. Comm'n, SEC Announces Million-Dollar Whistleblower Award to Compliance Officer (Apr. 22, 2015), www.sec.gov/news/pressrelease/2015-73.html; Press Release No. 2014-180, U.S. Sec. & Exch. Comm'n, SEC Announces $300,000 Whistleblower Award to Audit and Compliance Professional Who Reported Company's Wrongdoing (Aug. 29, 2014), www.sec.gov/News/PressRelease/Detail/PressRelease/1370542799812.
15. Press Release No. 2018-58, U.S. Sec. & Exch. Comm'n, SEC Awards More Than $2.2 Million to Whistleblower Who First Reported Information to Another Federal Agency Before SEC (Apr. 5, 2018), www.sec.gov/news/press-release/2018-58.

A much-debated aspect of the SEC's whistleblower rules is the extent to which the financial incentives could undermine corporate compliance programs by leading employees to bypass internal reporting mechanisms in favor of reporting directly to the SEC. In promulgating the regulations under Dodd-Frank, the SEC rejected recommendations that the rules require corporate whistleblowers to first report their concerns internally to allow the company to investigate the allegations before triggering a government investigation. Instead, the SEC's rules do not require an employee to report a complaint internally in order to be eligible for a reward; however, the rules provide that the amount of the reward may be higher if the employee reports the complaint internally first, and that the effective date of the complaint will be deemed to have been the date the information was reported to the company (as long as the information is then reported to the SEC within 120 days).[16]

Dodd-Frank further provides for anti-retaliation provisions to protect lawful whistleblowers.[17] Critically, an employee must report alleged misconduct to the SEC to be afforded anti-retaliation protection under Dodd-Frank.[18] The Supreme Court has refused to extend protections to individuals who only make allegations internally and some district courts have refused to protect employees who only report to other entities since the objective of the Dodd-Frank whistleblower program is to "motivate people who know of securities law violations to *tell the SEC*."[19] Employees may still find some anti-retaliation protections under Sarbanes-Oxley, which covers employees who report to the SEC, to another federal agency, to Congress, or to a supervisor.[20]

The SEC has indicated it would take an aggressive position in response to allegations that companies retaliated against whistleblowers or took steps to prevent them from reporting to the regulators. In June 2014, the SEC brought its first action in which it alleged that, among other things, a hedge fund advisor had retaliated against an

---

16. *See* Exchange Act Rules 240.21F-6(a)(4) and 240.21F-4(b)(7), respectively, www.sec.gov/about/offices/owb/reg-21f.pdf.
17. *See* 15 U.S.C. § 78u-6(h).
18. Dig. Realty Tr., Inc. v. Somers, 138 S. Ct. 767, 200 L. Ed. 2d 15 (2018).
19. *Id*. at 771 (employee who did not report any securities-law violations to SEC did not qualify as whistleblower); *see also* Price v. UBS Fin. Servs., Inc., 2018 WL 1885669, at *2 (D.N.J. 2018) (reporting to Financial Industry Regulatory Authority does not entitle individual to anti-retaliation whistleblower protection under Dodd-Frank).
20. 18 U.S.C. § 1514A(a)(1).

employee who had reported improper conduct to the SEC.[21] In April 2015, the whistleblower in connection with the SEC's first retaliation case received over $600,000 for providing the information.[22] And in December 2016, the SEC for the first time charged a company for retaliating against an internal whistleblower; the company agreed to pay a penalty of $1.4 million without admitting the SEC's allegations.[23]

Even short of evidence of a company's outright retaliation against a whistleblower, the SEC has indicated that the company's response to an internal whistleblower complaint will be scrutinized by the enforcement staff. In a 2016 accounting fraud action, the SEC's settled order instituting proceedings faulted the company for its alleged failure to adequately address an internal whistleblower complaint.[24] The SEC noted that, while the company investigated the complaint, the investigation failed to seek legal or accounting opinions sufficient to evaluate its merits.

Beginning in 2015, the SEC filed a handful of enforcement actions alleging that language in corporate confidentiality and severance agreements interfered with an employee's right to report securities law violations to the SEC in violation of Rule 21F-17 of the Securities Exchange Act of 1934 (the "Exchange Act", which prohibits impeding individuals from reporting violations to the SEC.[25] Among other things, the SEC has brought settled actions against companies whose employment agreements required personnel to first notify the legal department before sharing confidential information with the government, prohibited personnel from disparaging the company in communications with the government, or required employees to waive their ability to obtain whistleblower awards.[26] Notably, in these cases,

---

21. Press Release No. 2014-118, U.S. Sec. & Exch. Comm'n, SEC Charges Hedge Fund Adviser with Conducting Conflicted Transactions and Retaliating Against Whistleblower (June 16, 2014), www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307.
22. Press Release No. 2015-75, U.S. Sec. & Exch. Comm'n, SEC Announces Award to Whistleblower in First Retaliation Case (Apr. 28, 2015), www.sec.gov/news/pressrelease/2015-75.html.
23. Press Release No. 2016-270, U.S. Sec. & Exch. Comm'n, Company Settles Charges in Whistleblower Retaliation Case (Dec. 20, 2016), www.sec.gov/news/pressrelease/2016-270.html.
24. Order Instituting Cease-and-Desist Proceedings, *In re* ModusLink Glob. Sols., Inc., Admin. Proc. Rel. No. 3-17171 (Mar. 15, 2016), www.sec.gov/litigation/admin/2016/33-10055.pdf.
25. 17 C.F.R. § 240.17F.
26. Press Release No. 2015-54, U.S. Sec. & Exch. Comm'n, SEC: Companies Cannot Stifle Whistleblowers in Confidentiality Agreements (Apr. 1, 2015), www.sec.gov/news/pressrelease/2015-54.html; Press Release No. 2016-268, U.S. Sec. & Exch. Comm'n, Company Violated Rule Aimed

the SEC penalized the companies even though there was no finding that any whistleblowers had been deterred from contacting the SEC or that the employment agreements had been enforced.

§ 14:2.3 Phases of SEC Investigations

[A] Informal Inquiry

An SEC investigation typically begins with the staff member opening a matter under inquiry (referred to by the staff as a "MUI"). As noted above, there is a very low threshold for doing so, and opening the MUI can be done at the staff level with management approval; authorization by the Commission is not required.

During this stage, the staff may request documents from individuals and companies, and may seek witness statements in the form of interviews or sworn testimony, but only on a voluntary basis. (There is an exception for certain entities regulated by the SEC, such as investment advisers and broker-dealers, who are obligated to share many records with the SEC. Hence, the SEC may obtain an individual's securities trading records from a broker without resorting to a subpoena.) The staff may also solicit information through witness proffers, in which the staff agrees that the witness's statements may not be used against him or her in an enforcement proceeding.[27]

While the SEC cannot compel the production of documents or witness testimony at this stage and a corporation and its employees are under no obligation to comply with such a request, it is usually in the company's interest to do so. First, voluntary cooperation will put the company in a more positive light in the staff's consideration of

---

at Protecting Potential Whistleblowers (Dec. 19, 2016), www.sec.gov/news/pressrelease/2016-268.html; Press Release No. 2017-14, U.S. Sec. & Exch. Comm'n, BlackRock Charged with Removing Whistleblower Incentives in Separation Agreements (Jan. 17, 2017), www.sec.gov/news/pressrelease/2017-14.html; *See also* Press Release No. 2017-24, U.S. Sec. & Exch. Comm'n, Financial Company Charged with Improper Accounting and Impeding Whistleblowers (Jan. 19, 2017), www.sec.gov/news/pressrelease/2017-24.html.

27. *See* SEC. & EXCH. COMM'N, DIV. OF ENF'T, ENFORCEMENT MANUAL § 3.3.7 (June 4, 2015) [hereinafter SEC ENFORCEMENT MANUAL], www.sec.gov/divisions/enforce/enforcementmanual.pdf ("A proffer agreement is a written agreement providing that any statements made by a person, on a specific date, may not be used against that individual in subsequent proceedings, except that the Commission may use statements made during the proffer session as a source of leads to discover additional evidence and for impeachment or rebuttal purposes if the person testifies or argues inconsistently in a subsequent proceeding.").

the issues posed by the investigation. Second, voluntary cooperation may encourage the SEC staff not to issue a formal order of private investigation, which could implicate disclosure obligations or suggest that the matter has reached a more serious level of scrutiny by the SEC. Third, voluntary cooperation gives the company some greater degree of control over the scope of the investigation and the amount and type of information that must be produced.

In any event, whether the company chooses to cooperate or not, once it is advised of an informal inquiry, it should preserve relevant documents. The destruction of relevant documents in these circumstances could lead to charges of obstruction of justice.[28] In determining which materials it is obliged to preserve or disclose in an informal inquiry, the company should consider the potential relevance of the materials to the matters under inquiry, not the informal or formal nature of the inquiry.

[B] Formal Investigation

In order for the staff conducting the investigation to issue subpoenas and compel witnesses to produce documents or appear for testimony under oath, the Commission must first issue a "formal order of investigation." A formal order is not a finding of fact or a form of adjudication, but rather asserts the possibility of a violation of delineated provisions of the federal securities laws by certain entities and/or individuals.[29] Formal orders tend to be very general in nature, with only a bare-bones recitation of the facts which form the factual predicate for issuing the order and the statutory and regulatory provisions that may have been violated; the staff will often broaden the scope of an investigation, or revise its theory of the case, as the evidence develops.[30]

Until recently, formal orders were subject to full review at a meeting of all five commissioners, the same process used by the staff when recommending that an enforcement action be commenced or settled. While the Commission would rarely deny this authority to the staff, the process by which the proposed formal order was reviewed

---

28. *See* 18 U.S.C. §§ 1505, 1512.
29. *See* SEC ENFORCEMENT MANUAL, *supra* note 27, § 2.3.3.
30. Somewhat confusingly, the Enforcement Division also uses the term "investigation" more broadly to define an inquiry that has reached a more advanced state—that is, where the staff has reason to believe that the matter justifies the resources needed to proceed further. The staff is advised to convert a MUI to an investigation within sixty days of opening, and in some cases may open the matter directly as an investigation. *See* SEC ENFORCEMENT MANUAL, *supra* note 27, § 2.3.2. However, and most significantly, it is not a *formal* investigation, and no subpoenas may be used by the staff, until the formal order has been issued.

by other divisions of the SEC and considered by the commissioners could take several weeks (or even months).[31] In 2010, the SEC delegated the authority to issue formal orders directly to senior staff of the Enforcement Division "so investigations can be launched without the prior—and time-consuming—approval of the Commission."[32] This had the effect of allowing the Enforcement staff to obtain formal orders much more quickly and, not surprisingly, precipitated a sharp rise in the number of formal orders—from 272 in 2005 to 611 in 2017.[33] More recently, the SEC rolled back this delegated authority somewhat, maintaining delegated authority for the Director of Enforcement but not for other members of the senior Enforcement staff.[34]

The staff may have various reasons for obtaining a formal order. A witness may be non-cooperative and refuse to provide documents or testify voluntarily, in which case the staff will need subpoenas to compel the production or testimony (and to create the mechanism by which it may ultimately seek federal court intervention to enforce the subpoena if the witness fails to comply).

In addition, the staff will typically need to obtain information from various third parties. Some institutions, such as banks and Internet service providers, can only produce records to the government pursuant to a subpoena.[35] In cases where such information is needed, the staff will have to obtain a formal order, regardless of how cooperative the company or individual witnesses may be.

In other instances, certain third parties, even if not precluded by statute from providing the information voluntarily, might be reluctant to provide information to the government absent a subpoena

---

31. *See Speech by SEC Chairman: Address to Practising Law Institute's "SEC Speaks in 2009" Program*, U.S. SEC. & EXCH. COMM'N (Feb. 6, 2009), www.sec.gov/news/speech/2009/spch020609mls.htm.

32. Testimony Before the Subcommittee on Financial Services and General Government, U.S. SEC. & EXCH. COMM'N (Apr. 28, 2010), www.sec.gov/news/testimony/2010/ts042810mls.htm; *see also* SEC Delegation of Authority to Director of Division of Enforcement, 17 C.F.R. § 200.30-4 (2009); SEC ENFORCEMENT MANUAL, *supra* note 27, § 2.3.3.

33. *Compare* U.S. Sec. & Exch. Comm'n, Select SEC and Market Data: Fiscal 2017, www.sec.gov/files/enforcement-annual-report-2017-addendum-061918.pdf (June 2018) [hereinafter Select SEC and Market Data: Fiscal 2017], *with* U.S. Sec. & Exch. Comm'n, Select SEC and Market Data: Fiscal 2005, www.sec.gov/about/secstats2005.pdf.

34. *See* S. Lynch, *SEC's Acting Chair Scales Back Enforcement Unit's Subpoena Powers*, REUTERS (Feb. 16, 2017).

35. *See, e.g.*, SEC ENFORCEMENT MANUAL, *supra* note 27, § 4.5 (production of bank records under the Right to Financial Privacy Act of 1978); *id.* § 4.6 (production of account identifying information from ISP's under the Electronic Communications Privacy Act of 1986).

requiring them to do so. For example, in the typical financial disclosure case, the staff may seek information from the company's auditors, customers, vendors, lenders, or business partners, depending on the nature of the issues. These persons or entities may be (or believe themselves to be) limited in their ability to share information voluntarily, either because of contractual duties or simply to preserve business relationships, and the staff will thus frequently obtain a formal order as the investigation proceeds.

The order itself is kept confidential by the SEC during the investigation, though there are mechanisms for individual witnesses to request a copy.[36] There is no specific requirement that a public company disclose a formal investigation to investors. Nonetheless, companies continue to struggle with whether a formal investigation rises to the level of materiality warranting disclosure. Item 103 of Regulation S-K requires only that companies disclose "legal proceedings," and the mere initiation of a formal investigation by the SEC staff would not appear to constitute such a proceeding. The fact that a formal order has been issued is not in and of itself indicative that an enforcement action is likely. Indeed, as noted above, there are sometimes reasons to issue subpoenas that have no bearing on the seriousness of the investigation or the likelihood that it will result in an enforcement action. At least one district court has held that a public company does not have a duty to disclose a formal order of investigation.[37] Yet the issue is not free from doubt: There remains a perception that once the staff begins issuing subpoenas, some determination has been made by managers in the Enforcement Division that the matter warrants further scrutiny and has advanced into a more serious stage, and companies need to give consideration as to whether the investigation, or the allegations giving rise to the investigation, should be disclosed to investors. Companies should also consider whether disclosure will trigger an ongoing obligation to update the disclosure as the investigation proceeds, sometimes with unintended consequences.

[C] "Wells" Notices and the Process to Authorize the Filing of an Enforcement Action

After completing its investigation, the staff will make a decision as to whether it will recommend to the five-member Commission that a particular company or individual should be charged with a violation of the federal securities laws, which laws are believed to have been

---

36. *See id*. § 2.3.4.2.
37. *In re* Lions Gate Entm't Corp. Sec. Litig., 2016 WL 297722 (S.D.N.Y. Jan. 22, 2016); *see also In re* Inv. Tech. Grp., Inc. Sec. Litig., 2017 WL 1498055 (S.D.N.Y. Apr. 26, 2017).

violated, and the nature of the relief to be sought. In virtually every case other than those requiring emergency relief, the staff will contact counsel for the prospective defendant, state its conclusion, and summarize the basis for that conclusion. This is known as a "Wells" notice. Counsel then has a time-limited opportunity to make a Wells submission—essentially a brief setting forth factual, legal, and policy arguments why an enforcement action is not appropriate (or at least why certain charges or remedies are unwarranted). Before making a Wells submission, the prospective defendant and counsel generally have an opportunity to meet with the staff to discuss the basis for its conclusion. Such a meeting can be a helpful means to obtain greater insight into the evidence the staff believes supports its theories. The staff has the discretion, upon request, to allow the prospective defendant and counsel to review non-privileged portions of the investigative file.[38] Viewing such information may allow counsel to more intelligently respond to the staff and assess the risks of litigation. It should be noted, however, that the staff has no obligation to share any detailed information, and may decline to open its investigative file prior to initiating litigation proceedings (particularly when the staff believes the prospectivedefendant has not been cooperative during the investigation or that sharing such information is unlikely to lead to settlement).

Meetings with and Wells submissions to the staff are sometimes fruitful. Often counsel or the company can inform the staff of significant factual and legal defenses that may change its recommendation, or correct inaccuracies in the staff's understanding of the underlying facts. Moreover, even if the staff decides to go forward with an enforcement recommendation to the Commission, counsel and the company may be successful in persuading the staff that some defendants should be excluded altogether, or that the severity of charges should be reduced, or that the penalties or other remedial relief being sought should be reconsidered.

Although there are substantial benefits that may result from a Wells submission, there are also possible tactical disadvantages to submitting one. To begin with, Wells submissions are commonly sought, and sometimes considered discoverable, in private civil litigation, even if information that has been provided to the SEC was pursuant to an agreement that the provision of such information does not waive the producing party's attorney-client or work product privileges.[39] In addition, the SEC considers Wells submissions to be

---

38. *See id.* § 2.4.

39. *See, e.g.*, Salomon Bros. Treasury Litig. v. Steinhardt Partners, 9 F.3d 230 (2d Cir. 1993) (holding voluntary provision of Wells submission to SEC waived work product protection for the document); *In re* Initial Pub.

party admissions, which may be used by the SEC in any enforcement action it brings against the person making the submission (and, in appropriate circumstances, perhaps the corporation for whom the person was or is employed).[40] A Wells submission may also provide the SEC with a "roadmap" to the defense in the event of litigation. In addition, federal prosecutors may obtain Wells submissions from the SEC and, in turn, make use of the Wells submission in a parallel criminal proceeding. Thus, counsel must weigh carefully the benefits and pitfalls of making a Wells submission and, if one is made, give careful consideration to the content of the submission.

If the investigating staff decides to go forward and recommend an action, it sends its recommendation to the Commission in the form of an "action memo," together with any Wells submissions. Before the recommendation is considered by the Commission, it will face several levels of internal review. Senior personnel within the Enforcement Division (including the division director) will review the matter. The memo and Wells submissions will also be reviewed by the appropriate policy-making divisions within the agency. (For example, in a financial disclosure case, the Division of Corporation Finance and the Office of the Chief Accountant will have an opportunity to review the matter and provide input to the commissioners.) In addition, all recommendations are reviewed for consistency and for compliance with Commission policy and applicable law by the Office of the General Counsel.

Finally, following a process that can take several months from the date of the initial Wells notice, the commissioners will review the recommendation in a meeting open to the staff but not to the public or to the prospective defendants. The commissioners will vote on the recommendation, and assuming it is approved (as the vast majority are), the staff will file the action shortly thereafter.

Offering Sec. Litig., 64 Fed. R. Evid. Serv. 420 (S.D.N.Y. Dec. 24, 2003) (Wells submission discoverable even though it included settlement offer); *see also* SEC ENFORCEMENT MANUAL, *supra* note 27, § 2.4 (written Wells notice or written confirmation of an oral Wells notice should, among other things, "[i]nform the recipient that any Wells submission . . . may be discoverable by third parties in accordance with applicable law").

40. *See* SEC ENFORCEMENT MANUAL, *supra* note 27, § 2.4 (written Wells notice or written confirmation of an oral Wells notice should, among other things, "[i]nform the recipient that any Wells submission may be used by the Commission in any action or proceeding that it brings," and attach a copy of SEC Form 1662); *see also id.* ("The staff may reject a submission if the person making the submission seeks to limit its admissibility under Federal Rule of Evidence 408 or the Commission's ability to use the submission for the purposes described in Form 1662").

Under Dodd-Frank, the SEC staff, within 180 days of issuing a Wells notice, is required to either file the enforcement action or notify the director of the Enforcement Division of its intent not to do so.[41] Although the statute includes mechanisms for the granting of extensions beyond the 180-day period for actions deemed "sufficiently complex," SEC leadership may be concerned about the optics of freely granting such extensions, placing some pressure on the staff to proceed quickly and push back on requests from defense counsel for additional time to prepare a Wells submission or negotiate settlement terms. While six months would seem like more than adequate time for the staff to prepare and file an enforcement proceeding, complex investigations often involve numerous potential parties, the involvement of multiple civil and criminal authorities, protracted settlement discussions, and difficult questions of law and policy to be evaluated by the SEC's divisions and commissioners, and thus it is not uncommon for significant time to pass before the case is actually filed.[42]

In some cases, it is possible to engage with the staff in a "pre-Wells" process in which counsel may make a submission akin to a Wells submission and engage in a dialogue with the staff, but without the receipt of a formal Wells notice.[43] This can potentially alleviate the company's disclosure obligations,[44] while possibly reducing the pressure on the staff to move forward quickly with an enforcement action in order to avoid running afoul of the Dodd-Frank 180-day rule.

[D] Resolving Enforcement Actions

If a prospective defendant is unsuccessful in persuading the staff to forgo an enforcement action during the Wells process, meeting with the staff may also provide an opportunity for companies and individuals to explore settlement options with the SEC. If the party

---

41. Dodd-Frank § 929U(a), 124 Stat. 1376, 1867.
42. In several cases, defendants have attempted to challenge SEC actions filed more than 180 days after the Wells notice was issued as untimely. However, the courts have so far declined to hold the Dodd-Frank 180-day rule to be a statute of limitations and have rejected such challenges. *See, e.g.*, Montford & Co. v. SEC, 793 F.3d 76, 81–83 (D.C. Cir. 2015).
43. *See* SEC ENFORCEMENT MANUAL, *supra* note 27, § 2.4 ("If the staff intends to provide a written Wells notice, the staff may give advance notice of the intention to the recipient or his or her counsel . . . .").
44. As with formal orders, it is unclear whether the receipt of a Wells notice is material for disclosure purposes. However, several private class action decisions have held to the contrary. *See In re* Lions Gate Entm't Corp. Sec. Litig., No. 14-cv-5197, 2016 WL 297722 (S.D.N.Y. Jan. 22, 2016); Richman v. Goldman Sachs Grp., Inc., 868 F. Supp. 2d 261, 276 (S.D.N.Y. 2012).

seeks to avoid trial and resolve the matter, there may be advantages to reaching settlement with the SEC before the enforcement action is filed. Although the remedies the SEC seeks in settlement may not be dramatically different from what it seeks in litigation (including injunctive relief, monetary payments, and potential ancillary relief such as suspensions or bars, as described below), there may be more room to negotiate less onerous allegations in the pleadings and reduced charges before the case has been filed. In a litigated action, the staff will typically include more detailed allegations (among other things, to avoid a motion to dismiss based on a failure to plead with particularity) and more charges (such as both scienter- and non-scienter-based causes of action, to provide more options for the finder of fact), and more aggressive characterizations of the alleged wrongdoing. Resolving the matter in advance of filing also provides an opportunity for the party to seek the inclusion of mitigating language in the SEC's press release announcing the action, including references to the company's cooperation or remedial efforts.

One additional benefit to settling parties has been the SEC's historical practice of settling matters on a "neither admit nor deny" basis. By not admitting wrongdoing, the party avoids some of the serious collateral consequences of a finding of liability, which can be used against the party in a related class action or derivative lawsuit, or by another state or federal regulator in a separate proceeding. At the same time, SEC settlements prohibit settling parties or their representatives from publicly denying the allegations (although parties retain the right to defend themselves in matters in which the SEC is not a party).

Notably, in recent years the SEC's "neither admit nor deny" policy has come under fire in some quarters for failing to provide sufficient corporate accountability. Several courts have rejected SEC settlements, holding that the defendant's failure to admit the allegations prevented the court from assessing the adequacy of the settlement terms. Most notably, Judge Rakoff of the Southern District of New York in November 2011 rejected a proposed $285 million settlement between the SEC and Citigroup.[45] Judge Rakoff held that the absence of a party admission "deprives the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact."[46]

Both Citigroup and the SEC moved for interlocutory appeal. In a June 4, 2014, opinion, the Second Circuit vacated Judge Rakoff's

---

45. *See* SEC v. Citigroup Glob. Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011).
46. *Id*. at 332.

ruling and remanded the case for further proceedings, reaffirming the SEC's discretionary authority to enter into settlements under its "neither admit nor deny" policy.[47] During the pendency of the appeal, several other courts rejected or at least criticized SEC settlements due to the absence of admissions.[48]

In response to such criticism, the SEC revisited its policy of neither-admit-nor-deny settlements, publicly announcing in 2013 that, in certain cases, the agency would require parties to admit wrongdoing as a term of the settlement.[49] And while the vast majority of SEC enforcement actions continue to be settled on a standard neither-admit-nor-deny basis, one study found that the SEC obtained admissions in about 100 settlements from fiscal years 2013 through 2017, with slightly less than half coming from individuals and the remainder from entities.[50] Notably, while the SEC initially pledged to limit the admissions requirement to only the most egregious cases, some settlements including party admissions have charged more technical violations that do not appear to involve serious fraud. It remains to be seen whether the SEC will continue to demand admissions under the new leadership that replaced Chair White in early 2017.

Even beyond the admissions issue, SEC settlements have faced greater scrutiny in the courts in recent years. Judge Rakoff, in addition to challenging the SEC's neither admit nor deny policy in *Citigroup*, has also challenged the SEC's penalty assessments. In 2010, Judge Rakoff rejected the SEC's $33 million settlement with Bank of America, finding the settlement unfair and unreasonable.[51] Several months later, after the parties submitted additional evidence supporting the settlement and the bank agreed to pay a $150 million penalty and

---

47. *See* SEC v. Citigroup Glob. Mkts., Inc., 752 F.3d 285 (2d Cir. June 4, 2014).

48. *See, e.g.*, Order Denying Entry of Final Judgments, SEC v. Bridge Premium Fin., LLC, No. 1:12-CV-02131-JLK (D. Colo. Jan. 17, 2013) ("I refuse to approve penalties against a defendant who remains defiantly mute as to the veracity of the allegations against him. A defendant's options in this regard are binary: He may admit the allegation or he may go to trial.").

49. *See* Andrew Ceresney, Co-Director of Div. of Enforcement, Address Before American Law Institute: Financial Reporting and Accounting Fraud (Sept. 19, 2013), www.sec.gov/News/Speech/Detail/Speech/1370539845772.

50. V. Winship & J. Robbennolt, NYU School of Law Program on Corporate Compliance and Enforcement, Admitting Wrongdoing to the SEC: An Empirical Study of Admissions in SEC Settlements (Oct. 24, 2017), https://wp.nyu.edu/compliance_enforcement/2017/10/24/admitting-wrongdoing-to-the-sec-an-empirical-study-of-admissions-in-sec-settlements/.

51. SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507 (S.D.N.Y. 2010).

implement certain remedial measures, the court reluctantly accepted the settlement.[52]

In all events, any settlement offers submitted to the staff, as with all litigated enforcement actions, must be authorized by Commission vote. On occasion, a party may reach an agreement in principle with the staff, only to have the commissioners reject the agreement or demand material changes to the settlement agreement before accepting it. Hence, public companies disclosing a settlement in principle with the staff must be cautious in describing the tentative nature of the agreement until it has been formally authorized by the Commission.

[E] Closing Investigations

When a determination has been made not to pursue an enforcement action, the Enforcement Division's policy is to send a termination letter "at the earliest opportunity" after such decision has been reached.[53] The policy provides that such a letter may be sent by the staff even where the investigation is ongoing as to other potential defendants; however, as a practical matter, the staff will usually wait until the entire investigation has been closed (or at least until an enforcement action has been filed against certain parties). The policy further provides that letters should be sent to, among others, anyone who received a Wells notice or otherwise "reasonably believes that the staff was considering recommending an enforcement action against them."[54] Of course, in a broad investigation involving a large number of witnesses, not everyone involved in the investigation may be notified when the matter has been closed, and an individual or entity unsure about the status of the matter may contact the staff and request a termination letter.

Termination letters expressly provide that they "must in no way be construed as indicating that the party has been exonerated or that no action may ultimately result from the staff's investigation of that particular matter."[55] Nonetheless, while it is possible that a decision not to pursue charges at that time may be revisited by the staff if new evidence comes to light, a termination letter at least provides some comfort, particularly where an individual or company has been placed under a cloud due to publicity surrounding the investigation.

---

52. SEC v. Bank of Am. Corp., 2010 WL 624581 (S.D.N.Y.Feb. 22, 2010).
53. *See* SEC ENFORCEMENT MANUAL, *supra* note 27, § 2.6.2.
54. *Id*.
55. *Id*.

§ 14:3 SEC Enforcement Actions

§ 14:3.1 SEC Enforcement Areas

The SEC's Enforcement Division investigates cases in a wide range of subject matter areas. Classifications of SEC actions include:

- issuer reporting and disclosure;
- securities offerings;
- insider trading;
- investment advisers and investment companies;
- broker-dealers;
- market manipulation; and
- municipal securities and public pensions.

The SEC files several hundred enforcement actions per year. In fiscal year 2017, for example, the SEC filed a total of 754 actions.[56] Of those actions, 446 were independent "stand-alone" actions with the remainder constituting more routine administrative actions against issuers for delinquent filings or follow-on administrative proceedings seeking to suspend or bar individuals based on criminal convictions, civil injunctions, or other orders. In addition, hundreds of investigations are conducted by the staff but do not actually culminate in the filing of an enforcement action. For fiscal year 2017, the SEC reported that it had opened 965 investigations, closed 989, and had 1,695 ongoing investigations.[57]

Historically, financial reporting and disclosure cases have represented one of the largest components of the Division of Enforcement's case load, typically accounting for a quarter or more of all enforcement actions filed each year.[58] Such cases dropped off somewhat in the late 2000s and early 2010s. In 2013, for example, this category represented only 10% of SEC enforcement actions.[59] This decline may have reflected improvements in public company accounting and

---

56. SEC Division of Enforcement 2017 Annual Report, www.sec.gov/files/enforcement-annual-report-2017.pdf.
57. Select SEC and Market Data: Fiscal 2017, *supra* note 33.
58. In 2007, for example, issuer reporting and disclosure cases constituted 33% of the SEC's total actions filed. U.S. Sec. & Exch. Comm'n, Select SEC and Market Data: Fiscal 2007, www.sec.gov/about/secstats2007.pdf.
59. U.S. Sec. & Exch. Comm'n, Select SEC and Market Data: Fiscal 2013, www.sec.gov/about/secstats2013.pdf.

internal controls in the wake of the Sarbanes-Oxley Act of 2002[60] and the various high-profile financial fraud cases of the early 2000s. It also reflected a dramatic shift of SEC enforcement resources into other areas, with a significant increase in the number of enforcement actions focused on investment advisers (including private fund managers) and broker-dealers. Finally, some of the shift in priorities is undoubtedly cyclical, such as the expenditure of significant enforcement resources on investigations of large financial institutions in the wake of the financial crisis of the late 2000s. Indeed, by fiscal 2017, the number of financial reporting cases had rebounded somewhat, comprising about 21% of the stand-alone enforcement actions filed by the SEC.[61]

One subset of financial reporting fraud, and the focus of its own specialized investigative unit, is the Foreign Corrupt Practices Act (FCPA), which bars corrupt payments to foreign officials to obtain or keep business. For decades, the SEC seldom used its authority, shared with the DOJ, to enforce this statute. But recent years have seen the number of FCPA cases increase dramatically. Indeed, in 2011, when it brought twenty FCPA actions, the SEC began reporting FCPA cases as a separate category in its public reports, rather than including those cases in its tabulation of issuer reporting matters.[62]

The number of FCPA cases has held relatively steady in recent years, with thirteen new FCPA actions filed by the SEC in fiscal 2017.[63] Nonetheless, notwithstanding their relative rarity among SEC enforcement actions, an FCPA investigation can take a significant toll on a company. The disgorgement and penalty assessments in these matters can be quite large, often in the tens or hundreds of millions of dollars. Recent actions of note have included cases against Panasonic Corp. ($143 million settlement), Telia ($965 million settlement), Braskem S.A. ($957 million settlement), Teva Pharmaceuticals ($519 million settlement), and VimpelCom ($795 million settlement).[64] These figures represent only SEC settlements; FCPA cases are also typically accompanied by criminal penalties of a comparable magnitude.

---

60. Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), Pub. L. No. 107-204, 116 Stat. 745.
61. SEC Division of Enforcement 2017 Annual Report, *supra* note 56.
62. U.S. Sec. & Exch. Comm'n, Select SEC and Market Data: Fiscal 2011, www.sec.gov/about/secstats2011.pdf.
63. SEC Division of Enforcement 2017 Annual Report, supra note 56.
64. U.S. Sec. & Exch. Comm'n, SEC Enforcement Actions: FCPA Cases (May 14, 2018), www.sec.gov/spotlight/fcpa/fcpa-cases.shtml.

In addition, because of their cross-border nature, as well as the involvement of the DOJ and foreign authorities, these investigations can be unusually protracted. For instance, the above-referenced matter against Telia was filed in September 2017, but involved alleged conduct alleged to have occurred between 2007 and 2010.[65]

§ 14:3.2 SEC Causes of Action

The SEC has a far broader array of statutes and regulations it may charge through an enforcement action than are available as private rights of action in class-action litigation. As with class actions, SEC enforcement actions against public companies and their officers and directors will frequently allege fraud in violation of section 10(b) of the Exchange Act and Rule 10b-5 thereunder. However, SEC financial reporting actions typically also include allegations concerning the integrity of the company's books and records and internal controls, among other charges. Many of these statutes and regulations do not require a showing of scienter (i.e., intent or recklessness) and thus present a significantly lower burden for the SEC to meet; at the same time, these charges are perceived publicly as far less severe than a fraud charge and may have less onerous collateral consequences.

[A] Fraud

- *Section 10(b) of the Exchange Act*. As addressed more fully elsewhere in this volume, section 10(b) and Rule 10b-5 thereunder prohibit persons from employing any device, scheme, or artifice to defraud, making a material misstatement or omission, or engaging in any course of business which would operate as a fraud or deceit, in connection with the purchase or sale of any security. Scienter is required to establish a violation.[66] The SEC may maintain section 10(b) charges against both companies and individuals.
- *Section 17(a) of the Securities Act*. Section 17(a)(1) of the Securities Act of 1933 (the "Securities Act") prohibits the use of interstate commerce to employ any device, scheme, or artifice to defraud. As with section 10(b) of the Exchange Act, the SEC may bring such charges against both companies and individuals,

65. *See* Order Instituting Cease-and-Desist Proceedings, *In re* Telia Co. AB, Admin. Proc. File No. 3-18195 (SEC Sept. 21, 2017), www.sec.gov/litigation/admin/2017/34-81669.pdf.

66. *See* Aaron v. SEC, 446 U.S. 680, 691 (1980) ("scienter is an element of a violation of § 10(b) and Rule 10b–5, regardless of the identity of the plaintiff or the nature of the relief sought").

and scienter is required to establish a violation.[67] Additionally, section 17(a)(2) prohibits the use of interstate commerce to obtain money or property by means of a material misstatement or omission, and section 17(a)(3) prohibits the use of interstate commerce to engage in any course of business which would operate as a fraud or deceit upon a purchaser. However, unlike section 17(a)(1), these provisions do not require scienter.[68] As a result, the SEC will often pursue these latter provisions where evidence of scienter is lacking, and will sometimes negotiate settlements under sections 17(a)(2) and (3) where the conduct is viewed as less egregious. Notably, because section 17(a) is part of the Securities Act, the SEC may only maintain such charges where the fraud is alleged to have been conducted during an ongoing offering of securities.[69]

[B] Reporting, Books and Records, and Internal Controls

- *Section 13(a).* Section 13(a) of the Exchange Act requires issuers to file periodic filings in accordance with SEC rules and regulations. Rules 13a-1, 13a-11, and 13a-13 under this statute provide for the filing of annual reports on Form 10-K, current reports on Form 8-K, and quarterly reports on Form 10-Q, respectively, while Rule 12b-20 requires the inclusion of any information necessary to make such reports not materially misleading. Scienter is not required to violate section 13(a) and the regulations thereunder[70]; the SEC will typically include charges under one or more of these provisions either as an accompaniment to fraud charges or as stand-alone violations in the absence of scienter. Issuers violate section 13(a) directly, while individuals can be charged with aiding and abetting or causing the issuer's violation.
- *Section 13(b)(2).* Section 13(b)(2)(A) of the Exchange Act requires issuers to maintain books and records which accurately and

---

67. *See* Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979), *cert. granted* 446 U.S. 917, *aff'd*, 450 U.S. 91, 67 ("Scienter is an element of a violation of subsection 17(a)(1) of the Securities Act").
68. *See Steadman*, 603 F.2d at 1133 ("we hold that scienter need not be proved to establish violations of subsections 17(a)(2) and (3)").
69. *See* SEC v. Brown, 740 F. Supp. 2d 148, 163–64 (D.D.C. 2010) (dismissing a section 17(a) claim for failure to allege that an offer or sale of securities occurred).
70. *See* S.E.C. v. Espuelas, 698 F. Supp. 2d 415 (S.D.N.Y. 2010) (holding scienter is not an element of civil liability regarding filings with the SEC).

fairly reflect the issuer's transactions and assets, while section 13(b)(2)(B) requires issuers to maintain an adequate internal control system to detect and prevent improper transactions. Rule 13b2-1 prohibits the falsification of accounting records subject to section 13(b)(2)(A). Scienter is not required for violations of these provisions.[71] Issuers can violate section 13(b)(2)(A) and (B) directly, while individuals can only aid and abet or cause a violation; both issuers and individuals may be charged with direct violations of Rule 13b2-1.

- *Section 13(b)(5)*. Section 13(b)(5) of the Exchange Act prohibits knowingly circumventing or failing to implement a system of internal accounting controls or knowingly falsifying any book or record. Notwithstanding the reference to "knowing" circumvention, there is some uncertainty as to whether scienter is required or if negligence will suffice.[72] Both issuers and individuals can directly violate section 13(b)(5).
- *Rule 13b2-2*. Rule 13b2-2 prohibits a director or officer of an issuer from making a material misstatement or omission to an accountant in connection with an audit. There is a circuit split regarding whether scienter is required for Rule 13b2-2 liability, though most courts have found that it is not.[73] Because this rule is specific to directors or officers, only individuals may violate the rule.

§ 14:3.3 Civil Remedies

The typical SEC enforcement action filed in federal court against a public company and related persons will seek several categories of relief: an injunctive order prohibiting future legal violations; disgorgement of any ill-gotten gains; monetary penalties; and, where appropriate, ancillary relief, such as an order barring an individual from serving as an officer or director of a public company. Some amalgam of these remedies will generally be sought by the SEC either from the court in a litigated action, or from the parties as part of a negotiated settlement.

---

71. *See* S.E.C. v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998) (holding that section 13(b) does not have a scienter requirement).
72. *See* SEC v. Das, 723 F.3d 943 (8th Cir. 2013).
73. *See* McConville v. SEC, 465 F.3d 780, 789 (7th Cir. 2006) ("there is no scienter requirement in SEC Rule 13b2-1 because § 13(b) of the 1934 Securities Exchange Act contains no words indicating that Congress intended to impose a scienter requirement"); *but see* SEC v. Todd, 642 F.3d 1207 (9th Cir. 2011) (holding that the district court had properly applied a "knowing" standard to Rule 13b2-2).

[A] Civil Injunctions

The SEC may obtain a civil injunction prohibiting any person or entity from future violations of the federal securities laws based upon a showing that the person or enterprise has violated or is about to violate the federal securities laws. Injunctions are issued by a federal district judge after commencement of a lawsuit by the SEC, either following a successful trial by the SEC or pursuant to a settlement in which the defendant stipulates to entry of the proposed injunction by the court. The standard for issuing an injunction requires that the SEC show a reasonable likelihood of future violations. Courts usually look to factors that include:

(1) the egregiousness of the conduct;

(2) the isolated or recurring nature of the conduct;

(3) the degree of scienter involved;

(4) the defendant's opportunity to engage in future violations; and

(5) the degree to which the defendant has recognized the wrongfulness of his conduct.[74]

In both the litigated and settled context, the SEC typically seeks to have the court impose general injunctions under which the defendant is enjoined from violations of the provisions of the federal securities laws deemed by the SEC (or found by the court) to have been violated. Such injunctions provide a basis for the SEC to charge individuals with contempt of court in the event of future violations; more generally, injunctions provide a mechanism for the SEC to explain how the alleged misconduct ran afoul of the law. Notably, in recent years several courts have pushed back on broad "obey the law" injunctions as lacking sufficient specificity to guide a defendant's future conduct.[75] In response, the SEC has begun, in some cases, to seek more targeted "conduct-based" injunctions that prohibit the defendant from engaging in the specific activities that led to the violation (even though such activities may in and of themselves be legal).[76]

---

74. *See, e.g.*, SEC v. Sierra Brokerage Servs., Inc., 712 F.3d 321, 332–33 (6th Cir. 2013); SEC v. Calvo, 378 F.3d 1211, 1216 (11th Cir. 2004); SEC v. Fehn, 97 F.3d 1276, 1295–96 (9th Cir. 1996).

75. For example, in SEC v. Goble, 682 F.3d 934 (11th Cir. 2012), the Eleventh Circuit vacated the generic "obey the law" injunctions issued by the district court after trial, holding that they violated Rule 65(d)(1) of the Federal Rules of Civil Procedure by failing to describe in sufficient detail the acts sought to be restrained.

76. *See, e.g.*, SEC Litigation Release No. 22,494, Former "Teach Me To Trade" Salesman Agrees to Settle Securities Fraud Charges and Pay a $200,000

The SEC is also able to obtain temporary equitable relief—such as an asset freeze or receivership—under emergency circumstances. The SEC generally seeks such relief when there is an ongoing fraud (such as a Ponzi scheme), or significant reason to believe that a defendant might destroy evidence or move assets outside the SEC's jurisdiction. For example, in several recent insider trading cases, the SEC has sought and obtained emergency orders freezing brokerage accounts controlled by foreign traders following suspiciously timed trading, even before it had evidence establishing the source of the inside information ostensibly being traded upon[77]—or, in some cases, before it had even identified the trader who owned the brokerage account.[78]

[B] Monetary Sanctions

[B][1] Disgorgement

In most enforcement actions, the SEC will seek to have the defendant "disgorge," or repay, money obtained as a result of alleged violations of the federal securities laws. Such improper gains may include, for example, profits from insider trading; proceeds obtained from unregistered or fraudulent securities offerings; bonuses and stock sale proceeds obtained by an executive during a period in which the company's stock price was artificially inflated due to the alleged fraud; and any assets misappropriated by the defendant. The SEC will seek prejudgment interest on these sums as well.

[B][2] Civil Penalties

As a result of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990,[79] the SEC also has the authority to obtain civil money penalties from issuers of securities and persons associated with issuers. The amounts of such penalties are based upon the nature of the violation and whether the defendant is an individual or

---

Penalty (Sept. 26, 2012), www.sec.gov/litigation/litreleases/2012/lr22494.htm (in case alleging fraud in connection with sales of seminars and software purportedly teaching how to profitably sell securities, defendants enjoined from participating in the development, marketing, or sale of any classes, workshops or seminars concerning securities trading).

77. Press Release No. 2013-102, U.S. Sec. & Exch. Comm'n, SEC Freezes Assets of Thailand-Based Trader for Insider Trading Ahead of Smithfield Foods Acquisition Announcement (June 6, 2013), www.sec.gov/news/press/2013/2013-102.htm.

78. *See* SEC v. Certain Unknown Traders in Sec. of H.J. Heinz Co., 2013 WL 1174139 (S.D.N.Y. Feb. 25, 2013).

79. Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act), Pub. L. No. 101-429, 104 Stat. 931 (codified in scattered sections of 15 U.S.C.).

an organization. Note that a separate statute provides for penalties in insider-trading cases; these penalties can reach three times the total profits gained (or losses avoided) through the unlawful trading.[80]

Historically, penalties recovered by the SEC would be paid into the U.S. Treasury. However, the Sarbanes-Oxley Act permitted the SEC to add the amount of any civil penalties it recovers to any disgorgement fund established for the benefit of victims of the securities law violation. This "Fair Funds" provision in section 308 arguably increases the SEC's ability to make victims whole when the amount of disgorgement otherwise obtainable from wrongdoing officers and directors is insufficient, whether due to the limited assets of the individuals, or other factors mitigating against the imposition of a more severe disgorgement amount. The "Fair Funds" provision correspondingly increased the SEC's incentive to seek penalties, and in larger amounts, as seen by a series of significant penalties paid by public companies over the past decade.

Notwithstanding the SEC's expanded statutory authority to seek penalties from public company issuers, these settlements remain somewhat controversial, insofar as extracting penalties from public companies can be viewed as penalizing the company's shareholders, rather than the individual officers or directors responsible for the underlying misconduct. In an effort to bring more predictability to its assessments of corporate penalties, in 2006 the Commission issued a "Statement Concerning Financial Penalties,"[81] in which it said that the appropriateness of seeking penalties from a corporation in a particular case turns principally on two factors: (1) the presence or absence of a direct benefit to the corporation as a result of the violation, and (2) the degree to which the penalty will recompense or further harm the injured shareholders. In addition, the SEC noted other subsidiary factors, which included the extent of cooperation exhibited by the company in connection with any SEC investigation. On that issue, the 2006 statement said that "the degree to which a corporation has self reported an offense, or otherwise cooperated with the investigation and remediation of the offense, is a factor that the Commission will consider."[82] The stated purpose of the guidelines was to provide "clarity, consistency, and predictability."[83] Since that time, the composition

---

80. *See* 15 U.S.C. § 78u-1(a)(2), (a)(3).
81. Press Release No. 2006-4, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), www.sec.gov/news/press/2006-4.htm.
82. *Id*.
83. Testimony Concerning Strengthening the SEC's Vital Enforcement Responsibilities, U.S. SEC. & EXCH. COMM'N (May 7, 2009), www.sec.gov/news/testimony/2009/ts050709rsk.htm.

of the Commission, as well as the leadership of the Enforcement Division, has undergone significant changes, raising questions as to the continuing viability of the 2006 penalty guidance; however, at this time, there has been no formal revision or revocation of the policy.

[B][3] Clawback of Executive Compensation

Section 304 of the Sarbanes-Oxley Act provides that, if an issuer "is required to prepare an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," the CEO and CFO shall reimburse the issuer for any bonus or other incentive-based or equity-based compensation received, and any profits realized from the sale of the securities of the issuer, during the year following issuance of the original financial report.[84] The statute does not specify whose "misconduct" is required in order to trigger the remedy. In the years immediately after the enactment of the Sarbanes-Oxley Act, the SEC only asserted section 304 claims against CEOs and CFOs who were also alleged to have been personally involved in wrongdoing leading to the restatement. For example, several early cases involved CEOs or CFOs named as defendants in cases alleging improper backdating of stock options.[85] Another case involved an officer who allegedly participated in an accounting fraud and misappropriated company funds.[86]

In 2009, the SEC for the first time used section 304 in an action seeking to "claw back" bonuses and proceeds of stock sales from an officer who was not accused of personally violating the securities laws. The SEC filed a stand-alone enforcement action against the CEO of CSK Auto Corporation, alleging only that he had earned (and failed to reimburse the company for) $4 million in bonuses and stock sale profits while the company was engaged in an accounting fraud that had resulted in a financial restatement.[87] The CEO moved to dismiss, but the district court denied the motion, finding that section 304 does not require personal misconduct by the defendant.[88] Later courts

---

84. Section 304 of the Sarbanes-Oxley Act is codified at 15 U.S.C. § 7243.
85. SEC v. William W. McGuire, SEC Litigation Release No. 20,387 (Dec. 6, 2007), www.sec.gov/litigation/litreleases/2007/lr20387.htm.
86. SEC v. David H. Brooks, SEC Litigation Release No. 20,345 (Oct. 25, 2007), www.sec.gov/litigation/litreleases/2007/lr20345.htm.
87. SEC Seeks Return of $4 Million in Bonuses and Stock Sale Profits from Former CEO of CSK Auto Corp., SEC Litigation Release No. 21,149 (July 23, 2009), www.sec.gov/litigation/litreleases/2009/lr21149a.htm.
88. SEC v. Jenkins, 718 F. Supp. 2d 1070, 1074 (D. Ariz. 2010) ("the text and structure of Section 304 require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer's CEO or CFO"). Jenkins subsequently settled with the SEC and agreed to pay

similarly endorsed this interpretation of section 304 and upheld the SEC's ability to bring stand-alone clawback actions.[89] Since CSK, the SEC has increasingly brought settled proceedings against corporate executives solely under section 304 without alleging any personal wrongdoing.[90] And in August 2016, the U.S. Court of Appeals for the Ninth Circuit held that under the plain language of the statute, the SEC could seek a clawback from the CEO or CFO even if the restatement did not result from that individual's misconduct.[91]

A second provision of the Sarbanes-Oxley Act similarly expanded the ability of the SEC to limit the ability of executives to profit from alleged financial misconduct. Section 1103 of the Sarbanes-Oxley Act authorizes the SEC to obtain an order temporarily freezing assets of an individual accused of a securities law violation where it is "likely" that the issuer will make "extraordinary payments" to an officer suspected of violating the federal securities laws. The freeze order can extend to payments in the form of compensation "or otherwise," and requires the issuer to escrow such funds for a period of up to forty-five days, presumably to permit the SEC to then seek additional relief to prohibit the movement of funds. However, this statute has been only rarely invoked by the agency.[92]

---

back the incentive payments. Press Release No. 2011-243, U.S. Sec. & Exch. Comm'n, Former CEO to Return $2.8 Million in Bonuses and Stock Profits (Nov. 15, 2011), www.sec.gov/news/press/2011/2011-243.htm.

89. *See* SEC v. Baker, 2012 WL 5499497, at *6 (W.D. Tex. Nov. 13, 2012) ("The absence of any requirement of personal misconduct . . . ensures corporate officers cannot simply keep their own hands clean, but must instead be vigilant in ensuring there are adequate controls to prevent misdeeds by underlings."); SEC v. Microtune, Inc., 783 F. Supp. 2d 867, 886 (N.D. Tex. 2011) ("Section 304 contains no *personal* wrongdoing element, in contrast to disgorgement, that would require scienter or misconduct on behalf of the officers in order to trigger reimbursement.").

90. *See, e.g.*, *In re* ModusLink Glob. Sols., Inc., Admin Proc. Rel. No. 3-17171 (Mar. 15, 2016), www.sec.gov/litigation/admin/2016/33-10055.pdf; Press Release No. 2014-214, U.S. Sec. & Exch. Comm'n, SEC Charges Software Company in Silicon Valley and Two Former Executives Behind Fraudulent Accounting Scheme (Sept. 24, 2014), www.sec.gov/News/PressRelease/Detail/PressRelease/1370543035992; Press Release No. 2011-172, U.S. Sec. & Exch. Comm'n, SEC Recovers CFO's Bonus and Stock Sale Profits Received During Beazer Homes Accounting Fraud (Aug. 30, 2011), www.sec.gov/news/press/2011/2011-172.htm.

91. SEC v. Jensen, 835 F.3d 1100 (9th Cir. 2016).

92. *See* SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1045 (9th Cir. 2005) (defining "extraordinary payments" as a "payment that would not typically be made by a company in its customary course of business" and stating the "nexus between the suspected wrongdoing and the

[C] Ancillary Relief

[C][1] Officer and Director Bar

The Remedies Act expressly authorized the SEC to obtain an order from a district court prohibiting an individual from serving in the future as an officer or director of a public company. Such orders could be obtained where the SEC charged the individual with scienter-based fraud (that is, section 10(b) of the Exchange Act or section 17(a)(1) of the Securities Act), and where the SEC made a showing that the defendant was "substantially unfit" to serve as an officer or director.[93] While the courts had the ability to impose this relief under their general equitable powers even before 1990, the remedy had been sought relatively infrequently until recent years.[94]

In 2002, the Sarbanes-Oxley Act reduced the threshold for the imposition of a bar, substituting the less rigorous standard of mere "unfitness" (rather than "substantial unfitness").[95] In 2013, the Second Circuit in *SEC v. Bankosky* held that the legislative history of section 305(a) "demonstrates that Congress's intent was to lower the threshold of misconduct for which courts may impose director and officer bans," referencing the 2002 Senate Report that stated that the "substantial unfitness' standard . . . [was] inordinately high, causing courts to refrain from imposing bars even in cases of egregious misconduct."[96]

The SEC has the ability to seek either a permanent or a time-limited bar. In settled cases, the SEC staff will frequently be willing to negotiate a five-year or ten-year bar (or occasionally less), depending on the egregiousness of the allegations and the risks of litigating the case to trial.

---

payment itself may further demonstrate that the payment is extraordinary, although such a connection is not required").

93. *See* Remedies Act § 201, 104 Stat. 931, 935.

94. *See Speech by SEC Staff: Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute*, U.S. SEC. & EXCH. COMM'N (Feb. 15, 2002), www.sec.gov/news/speech/spch538.htm (noting the SEC obtained bars from a total of about 100 individuals prior to 1990); *cf*. Select SEC and Market Data: Fiscal Year 2017, *supra* note 33 (the SEC sought orders barring 100 defendants from serving as officers or directors of public companies in fiscal 2017 alone).

95. Sarbanes-Oxley Act § 305, 116 Stat. 745, 778.

96. SEC v. Bankosky, 716 F.3d 45, 48 (2d Cir. 2013) (but continuing to apply same factors for assessing "unfitness" as the courts had applied before Sarbanes-Oxley).

[C][2] Corporate Governance Changes

On occasion, the SEC will seek an order requiring a structural change in a business, such as the adoption of internal controls, the establishment of an audit committee or other committees, or, in extreme cases, the appointment of a receiver to take control of the enterprise. In actions brought under the FCPA alleging improper payments to foreign officials, it is not unusual for the SEC's settlement with the company—like the parallel DOJ agreement—to require that extensive compliance procedures be implemented.[97]

§ 14:3.4 Administrative Remedies

[A] Cease-and-Desist Proceedings

Before 1990, the SEC had relatively little jurisdiction in administrative proceedings over public companies and their officers. Such actions were generally limited to charges against financial services providers regulated by the SEC—investment advisers, broker-dealers, and mutual funds, among others.

In 1990, as part of the Remedies Act, Congress gave the SEC the authority to seek cease-and-desist orders against public companies and their officers. The Remedies Act authorized the SEC to issue its own orders against persons who have directly violated the securities laws or who are found to be "a cause" of another person's violation. For example, a cease-and-desist order may compel an issuer to maintain its books and records in accordance with the federal securities laws and forbid the CFO from being a "cause" of the issuer's violation.

Since 1990, hundreds of cease-and-desist orders have been obtained. The SEC contends that it may obtain an order upon a lesser showing than a "reasonable likelihood of future violation" as is required for civil injunctions. In *KPMG, LLP v. SEC*, the District of Columbia Circuit held that the SEC could use a negligence standard as the basis for obtaining a cease-and-desist order.[98]

Cease-and-desist proceedings are tried before an administrative law judge, a full-time Commission employee, with a right of appeal to the Commission and from there to a U.S. court of appeals. There is no right to a jury, very limited discovery, and limited applicability of the rules of evidence.[99] Moreover, in contrast to a federal court action,

---

97. *See, e.g.*, Order Instituting Cease-and-Desist Proceedings, *In re* Total, S.A., Exchange Act Release No. 69,654 (May 29, 2013), www.sec.gov/litigation/admin/2013/34-69654.pdf (requiring company to engage an independent compliance consultant subject to multiple provisions).
98. KPMG, LLP v. SEC, 289 F.3d 109, 118–20 (D.C. Cir. 2002).
99. *See* SEC Rules of Practice, 17 C.F.R. § 201.110, .111, .232–.234, .320, .321.

which can take several years to reach a trial, an administrative law judge is required to issue his or her initial decision, following a hearing, no more than 120, 210, or 300 days from the date the initial order instituting the proceedings was served (depending on the complexity of the case).[100]

Notably, while the SEC could obtain disgorgement in a cease-and-desist proceeding, the Remedies Act did not provide for the recovery of penalties (except against regulated persons) or the issuance of officer and director bars. As a result, for many years most cases against public companies and their executives continued to be filed primarily in federal court. In contrast, the SEC has long been able to obtain penalties and bars in administrative proceedings against regulated persons and entities, and thus until recently most administrative actions filed by the SEC involved investment advisers and brokers.

Subsequent legal developments have expanded the ability of the SEC to obtain additional remedies in administrative cease-and-desist proceedings. The Sarbanes-Oxley Act authorized the SEC to obtain officer and director bars administratively. And Dodd-Frank authorized the SEC to seek civil monetary penalties ranging from $7,500 to $150,000 for individuals, and $75,000 to $725,000 for companies and other entities.[101]

In the years since Dodd-Frank, the SEC has increasingly brought litigated enforcement actions in the administrative forum. Indeed, in a 2014 speech, the SEC's Enforcement Division Director acknowledged the Division's increased reliance on such proceedings, and defended their fairness in the face of significant public criticism.[102] As the number of cases litigated in the SEC's administrative forum rose, a number of respondents have leveled constitutional challenges against such proceedings. These challenges came to a head in 2018, when the Supreme Court ruled that the manner in which the SEC appointed its administrative law judges violated the Appointments Clause of the Constitution.[103]

While this decision resolved one of the key controversies that had arisen in the wake of the SEC's increased use of litigated administrative proceedings, questions remain about the legitimacy and appropriateness of the administrative forum for certain matters. Although the SEC continues to litigate matters in its administrative

---

100. *Id.* § 201.360.
101. Dodd-Frank § 929P, 124 Stat. 1376, 1862.
102. *Remarks to the American Bar Association's Business Law Section Fall Meeting*, U.S. SEC. & EXCH. COMM'N (Nov. 21, 2014), www.sec.gov/News/Speech/Detail/Speech/1370543515297 (remarks of Andrew Ceresney, Dir. Div. of Enforcement).
103. Lucia v. SEC, 585 U.S. __ (2018).

forum—particularly those involving registered entities like brokers and investment advisers—the trend towards a greater number of litigated actions in administrative proceedings rather than in federal court appears to have reversed. (That said, the SEC frequently files *settled* actions as administrative proceedings.)

In response to some of the criticism of the expanded use of administrative proceedings, the Division of Enforcement in May 2015 issued guidance with respect to how it decides whether to bring an administrative proceeding or to file in federal district court. While careful to caution that there is "no rigid formula dictating the choice of forum," the Division provided some broad factors that it considers in its forum-selection decision, including:

(a) the availability of the desired claims, legal theories, and forms of relief in each forum;

(b) whether any charged party is a registered entity or an individual associated with a registered entity;

(c) the cost-, resource-, and time-effectiveness of litigation in each forum; and

(d) fair, consistent, and effective resolution of securities law issues and matters.[104]

Additionally, in 2015 the SEC proposed amendments to its Rules of Practice governing administrative proceedings.[105] The proposed amendments, among other things, expanded the discovery rights of respondents (including the right to take a limited number of depositions) and slightly expanded the time frame for hearings. The SEC adopted the proposed rule changes in July 2016.[106]

[B] Professional Discipline

In addition to injunctive actions and administrative proceedings seeking a cease-and-desist order, the SEC may also take action against professionals. These actions traditionally have arisen under Rule 102(e) of the SEC's Rules of Practice, which permits the Commission to limit the ability of a professional who has engaged in improper

---

104. *Division of Enforcement Approach to Forum Selection in Contested Actions*, U.S. SEC. & EXCH. COMM'N, www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf.

105. Press Release No. 2015-209, U.S. Sec. & Exch. Comm'n, SEC Proposes to Amend Rules Governing Administrative Proceedings (Sept. 24, 2015), www.sec.gov/news/pressrelease/2015-209.html.

106. Press Release No. 2016-142, U.S. Sec. & Exch. Comm'n, SEC Adopts Amendments to Rules of Practice for Administrative Proceedings (July 13, 2016), www.sec.gov/news/pressrelease/2016-142.html.

professional conduct or who has violated the federal securities laws to practice and appear before the Commission. Rule 102(e) proceedings are brought before an administrative law judge. Section 602 of the Sarbanes-Oxley Act amendments to the Exchange Act codified Rule 102(e) of the SEC's Rules of Practice.[107]

Rule 102(e) proceedings clearly extend to outside professionals, such as accountants and lawyers. Rule 102(e) proceedings in this context commonly consider whether previously issued financial statements were audited in accordance with generally accepted auditing standards or whether professionals, such as lawyers, violated the federal securities laws in connection with the preparation of prospectuses, registration statements, or other disclosure documents, or acted improperly in the course of representing a client in an SEC investigation.

The Commission also has taken the position that Rule 102(e) extends to management professionals within a corporation, such as chief financial officers, controllers, and in-house counsel. Thus, an order prohibiting a professional from practicing and appearing before the SEC may preclude a professional from assisting in the preparation of financial statements to be filed with the SEC, even if the professional is not associated with an outside firm.

The Sarbanes-Oxley Act added provisions specifically regulating the practice of attorneys before the Commission. In section 307, Congress reacted to the widespread perception that in scandals such as Enron and WorldCom, lawyers had failed in their role as gatekeepers and otherwise permitted unlawful conduct to take place.[108] Accordingly, Congress imposed a "reporting up" provision, requiring that if a lawyer becomes aware of evidence of a "material violation of securities law, or breach of fiduciary duty or similar violation," the lawyer must report it to the chief legal officer or chief executive officer. Second, if the lawyer is not satisfied that an appropriate response to the evidence has been made, the lawyer must escalate his or her concerns to the audit committee or other committee of the board. In 2003, the Commission adopted detailed rules implementing section 307.[109] The SEC's rules under section 307 empower the SEC to bar an attorney from practicing before the Commission in the event of a section 307 violation.[110]

---

107. *See* 15 U.S.C. § 78d-3.

108. Section 307 of the Sarbanes-Oxley Act is codified at 15 U.S.C. § 7245.

109. 17 C.F.R. § 205 *et seq.*

110. Acting under authority granted by section 307 of the Sarbanes-Oxley Act, the Commission promulgated rules setting forth minimum standards for attorneys appearing before the Commission on behalf of issuers. *See* 17 C.F.R. §§ 205.1–205.7 (2003).

§ 14:3.5 The Role of Cooperation

[A] The Seaboard Report

In the past decade, the SEC has become increasingly vocal about the role of cooperation in deciding the severity of punishment it will seek against a corporation whose employees are believed to have been involved in violations of the federal securities laws. The trend began in 2001 with the so-called Seaboard Report,[111] in which the SEC laid out the factors that are considered in determining whether a company should receive credit for good cooperation. The release stressed four key concepts—self-policing, self-reporting, cooperation with law enforcement authorities, and remediation—and listed a detailed set of factors the SEC may consider when bringing an enforcement action. The Seaboard factors continue to be assessed in the SEC's charging decisions and are incorporated in the SEC Enforcement Manual.[112]

The Seaboard Report concerned credit for cooperation by corporations, not individuals. In January 2010, the Enforcement Division amended its Enforcement Manual to add new provisions designed to foster cooperation by individuals. The new provisions offer guidance for evaluating an individual's cooperation and authorize new cooperation tools, including cooperation agreements, deferred prosecution agreements, and non-prosecution agreements.[113]

In evaluating an individual's cooperation, the Enforcement Division will consider:

(a) assistance provided by the individual;

(b) importance of the underlying matter;

(c) interest in holding the individual accountable; and

(d) profile of the individual.

The standards track the typical DOJ considerations for evaluating cooperation.

Once the Enforcement Division determines that an individual should be given credit for cooperation, the Enforcement Manual provides the Division and the Commission with a nonexclusive list of tools to encourage and facilitate such cooperation.

---

111. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (Oct. 23, 2001).

112. SEC ENFORCEMENT MANUAL, *supra* note 27, § 6.1.2.

113. *Id.* § 6.

(1) *Cooperation agreements.* The Enforcement Division may agree to recommend to the Commission that the individual or company receives credit for giving substantial assistance. The Enforcement Division may also make specific enforcement recommendations to the Commission where appropriate. In return, the individual or company agrees, among other things, to cooperate fully and truthfully, and waive applicable statutes of limitations.

(2) *Deferred prosecution agreements.* The Commission may forgo an enforcement action against an individual if the individual agrees to cooperate fully and truthfully, to waive applicable statutes of limitations, to comply with prohibitions and undertakings, to pay any agreed disgorgement or penalty amounts, and to admit or agree not to contest the relevant facts underlying the alleged offenses. Deferred prosecution agreements are for a set amount of time that cannot exceed five years, after which the Commission may agree not to pursue any further enforcement action if the individual adheres to the terms of the agreement.

(3) *Non-prosecution agreements.* The Commission may agree not to pursue an enforcement action if the individual agrees to cooperate fully and truthfully, comply with express undertakings, and pay any agreed disgorgement or penalty amounts. The guidelines make clear that these should generally be used in limited circumstances and that other forms of obtaining cooperation should be considered first.

(4) *Expedited immunity requests.* The Director of Enforcement may now submit expedited immunity requests to the DOJ in to provide a cooperator with protection against criminal prosecution. Approval of the Commission is no longer required for such requests.

(5) *Proffer agreements.* Statements made by an individual in an investigation may not be used against that individual in subsequent proceedings except as a source of investigative leads or for impeachment or rebuttal if the person testifies inconsistently in a subsequent proceeding.

(6) *Oral assurances.* Assistant directors may give assurances to individuals that based on currently available evidence the Enforcement Division does not currently anticipate recommending an enforcement action against an individual or a company.

In 2012, the SEC publicly announced for the first time that it credited the substantial cooperation of a former senior executive of an investment adviser by declining to take enforcement action against him.[114] The executive's cooperation assisted in the settled enforcement action against an institutional money manager, where, without admitting or denying wrongdoing, the firm agreed to pay $217 million to clients plus a $25 million penalty.[115] The Commission issued a corresponding litigation release where it analyzed the former executive's cooperation by applying it to the four factors outlined in the Commission's Cooperation Policy Statement:

(1) *Assistance provided*. The executive possessed intimate knowledge relating to the investment adviser and provided his assistance to the SEC without conditions, which bolstered his credibility.

(2) *Importance of the underlying matter*. The SEC was able to return to clients their alleged losses, and the firm agreed to pay a penalty totaling $25 million.

(3) *Interest in holding the senior executive accountable*. The cooperating executive played a limited role in the alleged conduct at issue, and his cooperation maximized the SEC's law enforcement interests by efficiently and successfully resolving the issues against the firm.

(4) *The executive's profile*. The executive, who had no prior disciplinary history, was not an associated person of any regulated entity, a fiduciary for other individuals or entities regarding financial matters, or an officer or director of a public company.[116]

In addition, in November 2013, the SEC announced it had entered into a deferred prosecution agreement with a former hedge fund administrator whose "voluntary and significant cooperation" enabled the SEC to file an emergency enforcement action alleging that the fund's founder and manager had misappropriated more than $1.5 million

---

114. SEC Credits Former AXA Rosenberg Executive for Substantial Cooperation During Investigation, SEC Litigation Release No. 22,298 (Mar. 19, 2012), www.sec.gov/litigation/litreleases/2012/lr22298.htm.

115. *See* Press Release No. 2011-37, U.S. Sec. & Exch. Comm'n, SEC Charges AXA Rosenberg Entities for Concealing Error in Quantitative Investment Model (Feb. 3, 2011), www.sec.gov/news/press/2011/2011-37.htm.

116. SEC Credits Former AXA Rosenberg Executive for Substantial Cooperation During Investigation, SEC Litigation Release No. 22,298 (Mar. 19, 2012), www.sec.gov/litigation/litreleases/2012/lr22298.htm.

from the hedge fund and overstated its performance to investors.[117] As a part of the deferred prosecution agreement, the individual defendant admitted that he aided and abetted violations of the securities laws and, as a result, he cannot serve as a fund administrator or associate with any broker, dealer, investment adviser, or registered investment company for a period of five years, and was forced to disgorge approximately $50,000 in fees that he received for serving as the fund administrator. While still infrequent, the SEC has continued to periodically disclose its use of deferred prosecution agreements with individuals.[118]

Notably, while the SEC has typically recognized cooperation by corporate entities by applying the Seaboard factors during settlement, the agency has also used the more formal cooperation agreements described above for companies. In 2010, the SEC entered into its first non-prosecution agreement with a corporation.[119] In resolving the alleged accounting fraud, the corporate defendant did not have to pay a monetary penalty, but agreed to cooperate in the SEC's investigation for an unlimited period of time and to forgo raising a statute-of-limitations defense if it were to violate the agreement.[120] And in 2011, the SEC entered into its first deferred prosecution agreement with a company. To resolve alleged FCPA violations, the agreement required the corporate defendant to pay disgorgement and to toll the statute

---

117. Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces First Deferred Prosecution Agreement with Individual (Nov. 12, 2013), www.sec.gov/News/PressRelease/Detail/PressRelease/1370540345373.

118. *See, e.g.*, Press Release No. 2016-45, U.S. Sec. & Exch. Comm'n, Tech Company Misled Investors About Key Product (Mar. 9, 2016), www.sec.gov/news/pressrelease/2016-45.html (deferred prosecution agreement with former board chairman); Press Release No. 2016-29, U.S. Sec. & Exch. Comm'n, Tech Company Bribed Chinese Officials (Feb. 16, 2016), www.sec.gov/news/pressrelease/2016-29.html (deferred prosecution agreement with former employee in an FCPA case).

119. Non-Prosecution Agreement Between Carter's, Inc. and Securities and Exchange Commission (Dec. 17, 2010), www.sec.gov/litigation/cooperation/2010/carters1210.pdf.

120. As another example, in April 2013, the SEC announced a non-prosecution agreement with Ralph Lauren after it agreed to disgorge some $700,000 obtained through alleged bribes to Argentine officials. The SEC decided not to charge the company with FCPA violations "due to the company's prompt reporting of the violations on its own initiative, the completeness of the information it provided, and its extensive, thorough, and real-time cooperation with the SEC's investigation [including flying in witness and translating and summarizing documents]." *See* Press Release No. 2013-65, U.S. Sec. & Exch. Comm'n, SEC Announces Non-Prosecution Agreement with Ralph Lauren Corporation Involving FCPA Misconduct (Apr. 22, 2013), www.sec.gov/news/press/2013/2013-65.htm.

of limitations during the three-year agreement period.[121] As with its cooperation agreements with individuals, the SEC has continued to use such agreements with companies on an intermittent basis.[122]

[B] Privilege Waivers As an Element of Cooperation

While the Enforcement Manual generally defines cooperation as "providing the Commission staff with all the information relevant to underlying violations and the company's remedial efforts,"[123] the Seaboard Report itself specifically referenced the fact that the company provided to the SEC staff "notes and transcripts of interviews" and "did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation."[124] In light of the Seaboard Report and subsequent SEC enforcement actions in which large penalties have been imposed for alleged non-cooperation, a particular concern has arisen over the question of whether companies must waive their attorney-client privileges in order to garner greater credit for cooperation.

Some companies and commentators have raised concerns that a new "culture of waiver" had arisen that threatened the very fabric of the attorney-client privilege. Moreover, companies that waived their privileges in connection with an SEC investigation have been exposed to the additional risk that such privileges also were deemed waived in connection with any parallel private class action litigation. Indeed, in a number of prominent cases, district courts ordered companies to produce otherwise privileged documents to the civil class action plaintiffs' lawyers, based upon the fact that the companies previously had produced those same documents to the SEC or other government agencies.[125]

Responding to these concerns, the Enforcement Manual provides that the staff should not ask a party to waive the attorney-client or

---

121. Deferred Prosecution Agreement, Tenaris S.A. & SEC (May 17, 2011), www.sec.gov/news/press/2011/2011-112-dpa.pdf.

122. *See, e.g.*, Press Release No. 2016-109, U.S. Sec. & Exch. Comm'n, SEC Announces Two Non-Prosecution Agreements in FCPA Cases (June 7, 2016), www.sec.gov/news/pressrelease/2016-109.html.

123. *See* SEC ENFORCEMENT MANUAL, *supra* note 27, § 6.1.2.

124. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, SEC Accounting and Auditing Enforcement Release No. 1470 (Oct. 23, 2001), www.sec.gov/litigation/investreport/34-44969.htm.

125. *See In re* Qwest Sec. Litig., 450 F.3d 1179 (10th Cir.), *cert. denied*, 549 U.S. 1031 (2006).

work-product privilege, and it is not directed to do so.[126] The manual further provides that voluntary disclosure need not include a waiver of privilege to be an effective form of cooperation, as long as all relevant facts are disclosed.[127] There are no hard statistics available to gauge whether and to what extent the staff has universally acceded to the Enforcement Manual's directives in this regard; on the contrary, there is anecdotal evidence that requests for privilege waivers are still being made. In some cases, the parties "split the baby," with company counsel offering to share privileged information pursuant to a "non-waiver" agreement. It should be noted, however, that the majority of court decisions hold that such non-waiver agreements do *not* protect the company from losing its privileges in parallel civil litigation or regulatory proceedings.[128]

§ 14:3.6 Parallel Criminal Cases

The SEC does not have independent authority to prosecute criminal cases. However, any willful violation of the federal securities laws can be prosecuted as a crime. Thus, the SEC maintains a close working relationship with federal prosecutors and frequently refers more egregious violations of the federal securities laws to them. According to the SEC, in fiscal year 2017 prosecutors filed 128 indictments, informations, or contempts relating to SEC actions.[129]

[A] Common Grounds for Prosecution

In recent years, federal criminal authorities have been most visibly active in insider trading matters. Particularly newsworthy were multiple civil and criminal cases filed involving the improper sharing of information among corporate employees and executives, hedge funds, and "expert networks." Criminal authorities also frequently prosecute matters involving financial reporting by public companies, FCPA violations, and Ponzi schemes.

In addition to securities law violations, prosecutors frequently will charge the following:

(1) mail and wire fraud;

(2) money laundering; and

(3) RICO violations.

---

126. *See* SEC ENFORCEMENT MANUAL, *supra* note 27, § 4.3.
127. *Id.*
128. *See, e.g.*, *Qwest Commc'ns*, 450 F.3d at 1179 (rejecting selective waiver notwithstanding agreements with SEC and DOJ).
129. Select SEC and Market Data: Fiscal 2017 (June 19, 2018), www.sec.gov/files/enforcement-annual-report-2017-addendum-061918.pdf.

In addition to investigating and prosecuting the underlying securities law violations, the criminal authorities frequently pursue claims that a witness interfered with the SEC investigation by falsifying or destroying evidence or providing false testimony to the SEC staff, invoking either 18 U.S.C. § 1505 (obstruction of agency proceedings) or 18 U.S.C. § 1001 (making false statements to the government). As a civil agency, the SEC itself does not have authority to file charges under these statutes, and thus relies on criminal referrals to protect its processes. Notably, it is often easier for the prosecutors to prove obstruction than it is to prove the underlying securities fraud, and thus an SEC enforcement action may sometimes be accompanied by a stand-alone criminal obstruction case.

The Sarbanes-Oxley Act added a number of new sanctions to the criminal enforcement arsenal, including:

- section 802, prohibiting the alteration or destruction of documents in connection with a federal investigation, and section 1102, prohibiting such conduct in connection with any "official proceeding"—both statutes authorize fines and prison terms of up to twenty years;
- section 807, authorizing a prison term of up to twenty-five years for criminal securities fraud;
- section 902, expanding the criminal remedies for persons found guilty of an "attempt" to commit a securities law violation, and now subjecting persons guilty of an "attempt" to the same penalties as those prescribed for the offense that was the object of the attempt;
- sections 903 and 904, authorizing greater prison time—twenty years instead of five—for acts of mail fraud and wire fraud, and increasing the fines for violations of the Employee Retirement Income Security Act (ERISA);
- section 906(c), authorizing fines and prison terms for the filing of false certifications by the company's CEO and CFO that the company's financial statements are sound—fines for "willfully" false certifications may be as high as $5 million, and the prison term as high as twenty years;
- section 1106, amending the criminal sanctions under section 32(a) of the Exchange Act, increasing the fines from $1 million to $5 million, and increasing the prison time from ten years to twenty years.

[B] Cooperation Between SEC and DOJ

The SEC and DOJ (including local U.S. attorneys' offices) frequently conduct parallel investigations. In some cases, the investigations may be closely (and visibly) aligned, with SEC staff attorneys, FBI agents, and assistant U.S. attorneys conducting joint proffers with witnesses. In others, the criminal investigators may play a more passive role, waiting for the SEC investigation to become sufficiently advanced before the criminal authorities determine whether the case warrants criminal investigation and prosecution.

For the most part, the federal securities laws permit the SEC to share virtually all information gathered during its investigation, including documents and testimony transcripts, with other government agencies. The SEC's Form 1662, a disclosure form shared with all witnesses asked to provide documents or testimony to the staff, expressly advises witnesses of the SEC's "Routine Uses of Information," including the potential sharing with criminal authorities. That said, the SEC staff will not generally advise witnesses whether there is a related criminal investigation beyond this general disclosure, though in some instances, depending on the criminal prosecutor involved, more information may be shared.

In contrast, the criminal authorities are not as free to share information with the SEC. Documents and information obtained through grand jury subpoenas are subject to strict privacy requirements and, with some exceptions, may not be shared with the SEC. Information obtained outside of the grand jury—such as through the execution of a search warrant or an FBI interview—is not subject to grand jury secrecy, however. In light of these limitations, the SEC will often take the lead in developing evidence where parallel investigations are underway.

Coordinated law enforcement efforts have not gone unchallenged. In *United States v. Stringer*, the defendant in a financial reporting case argued that his due process rights were violated because the SEC did not expressly warn him that the agency was sharing information with the FBI and U.S. attorney's office.[130] The district court agreed and, in a stinging rebuke of the government, held that dismissal of the indictment was warranted because the government misconduct was "shocking" and "egregious."[131] The Ninth Circuit ultimately reversed, holding that the Form 1662 had put the defendant on sufficient notice that information he had provided could be shared with the criminal authorities.[132] Though ultimately affirming the ability of the SEC and

130. United States v. Stringer, 408 F. Supp. 2d 1083 (D. Or. 2006).
131. *Id*. at 1089.
132. United States v. Stringer, 535 F.3d 929 (9th Cir. 2008).

DOJ to conduct parallel investigations, the case did serve as a wake-up call to potential pitfalls for the government when conducting parallel investigations.[133]

The SEC Enforcement Manual provides direct guidance to the staff in the area of parallel proceedings that largely follows the prescription for proper coordinated law enforcement investigations set forth by the courts. First, the manual provides that a civil investigation should have "its own independent civil investigative purpose" and should not be initiated solely for the benefit of or to obtain evidence for a criminal investigation. Second, the staff should make its own independent decisions regarding investigative strategy, such as what documents to request, what testimony to take, what questions to ask, and where testimony should be taken. Third, if asked by individuals or their counsel whether there is a parallel criminal investigation, the manual advises the staff to direct the individual or their counsel to a section in SEC Form 1662 that provides that the "Commission often makes its files available to other government agencies, particularly the United States Attorneys and state prosecutors." Fourth, the staff is directed to have supervisors involved "in all significant discussions and written communications with criminal authorities." In addition, the manual provides that sharing information with criminal prosecutors is generally permissible to assist a criminal prosecution, and in certain circumstances, it is permissible for the staff and criminal prosecutors to advise each other to refrain from taking certain actions that may harm their respective investigations.[134]

§ 14:4 Insider Trading Cases

Insider trading has been a fairly consistent component of the SEC's enforcement program, typically accounting for about 5%–10% of the agency's annual case filings. Though historically focused on individual traders and tippers, the government (including the DOJ) has grown increasingly sophisticated in its ability to ferret out large-scale trading schemes, ranging from far-reaching conspiracies among institutional investors and securities professionals to international data harvesting incidents.

The coordinated focus of the SEC and DOJ on large-scale insider trading cases achieved significant national attention in 2009, with

---

133. *See also* United States v. Scrushy, 366 F. Supp. 2d 1134, 1139 (N.D. Ala. 2005) (in criminal securities fraud case, suppressing SEC testimony and dismissing related charges where SEC agreed to DOJ request to move location of testimony to ensure jurisdiction over potential perjury charge).

134. SEC ENFORCEMENT MANUAL, *supra* note 27, § 5.2.1.

the initiation of a series of cases centered on trading by hedge fund manager Raj Rajaratnam and his firm Galleon Management.[135] The criminal case culminated in May 2011 when Rajaratnam was found guilty of all fourteen conspiracy and securities fraud charges brought against him.[136] The criminal interest in the scheme was perhaps most noteworthy because it involved the government's use of wiretaps to collect evidence, a tool not part of the SEC's arsenal. In subsequent court rulings, the U.S. Court of Appeals for the Second Circuit upheld the criminal prosecutors' use of wiretaps,[137] as well as the SEC's ability to get access to the wiretaps from the defendant.[138]

Over the past few years, the SEC has continued to file enforcement actions alleging large and highly lucrative insider schemes, including cases involving "expert networks" providing confidential information about clinical trials to hedge funds;[139] cases alleging trading rings centered around investment bankers;[140] and cases alleging long-running insider trading schemes involving corporate attorneys and Wall Street traders.[141] More recently, the SEC has brought actions involving "political intelligence firms" providing confidential information about government regulatory action to traders.[142] And evidencing the growing sophistication of both insider trading schemes and the SEC's ability

---

135. Press Release No. 2009-221, U.S. Sec. & Exch. Comm'n, SEC Charges Billionaire Hedge Fund Manager Raj Rajaratnam with Insider Trading (Oct. 16, 2009), www.sec.gov/news/press/2009/2009-221.htm.

136. *See Graphic: The Rajaratnam Verdict*, N.Y. TIMES: DEALBOOK (May 11, 2011), dealbook.nytimes.com/2011/05/11/the-verdict-on-raj-rajaratnam/.

137. United States v. Rajaratnam, 719 F.3d 139 (2d Cir. 2013).

138. SEC v. Rajaratnam, 622 F.3d 159 (2d Cir. 2010). The court found, however, that the district court failed to properly balance the SEC's right of access to the materials with the defendant's privacy interests. Following remand, the lower court found the SEC's right to the wiretaps to outweigh the defendant's privacy interests and ordered the wiretaps to be produced. SEC v. Galleon Mgmt., LP, 274 F.R.D. 120 (S.D.N.Y. 2011).

139. Press Release No. 2012-237, U.S. Sec. & Exch. Comm'n, SEC Charges Hedge Fun Firm CR Intrinsic and Two Others in $276 Million Insider Trading Scheme Involving Alzheimer's Drug (Nov. 20, 2012), www.sec.gov/news/press/2012/2012-237.htm.

140. Press Release No. 2012-225, U.S. Sec. & Exch. Comm'n, SEC Charges 10 in Insider Trading Ring Around Investment Banker's Illegal Tips on Impending Mergers (Dec. 5, 2012), www.sec.gov/news/press/2012/2012-255.htm.

141. Press Release No. 2011-85, U.S. Sec. & Exch. Comm'n, SEC Charges Corporate Attorney and Wall Street Trader in $32 Million Insider Trading Ring (Apr. 6, 2011), www.sec.gov/news/press/2011/2011-85.htm.

142. *See, e.g.*, Press Release No. 2015-266, U.S. Sec. & Exch. Comm'n, SEC Charges Political Intelligence Firm (Nov. 24, 2015), www.sec.gov/news/pressrelease/2015-266.html; Press Release No. 2017-109, U.S. Sec. & Exch. Comm'n, SEC Files Charges in Trading Scheme Involving

to pursue them, the SEC in 2015 obtained an asset freeze against more than thirty defendants for their alleged involvement in an "unprecedented" insider trading scheme facilitated by hacking.[143]

§ 14:4.1 "Classical Theory" of Insider Trading

Insider trading is prohibited by SEC Rules 10b-5 and 14e-3. Rule 10b-5, promulgated under section 10(b) of the Exchange Act, provides that

> [i]t shall be unlawful for any person . . . [t]o employ any device, scheme, or artifice to defraud [or] . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

Rule 14e-3 prohibits similar activities in connection with a tender offer.

Insider trading liability under Rule 10b-5 originally required a fiduciary relationship between the insider and the person with whom the insider traded. This is because the fraud occurs not by virtue of the possession of material, nonpublic information alone, but rather by the trader's failure to disclose such information where the trader has a duty to do so. Typically, a trader has no duty to disclose the information upon which he or she bases his or her stock transactions, and it is expected that investors trade on the basis of unequal (although equally available) information.

Instead, under the "classical theory" of insider trading, only certain persons—corporate executives and directors, as well as other persons associated with the corporation who have access to material, nonpublic information, such as certain key employees and the corporation's accountants, lawyers, and investment bankers (and individuals who obtain information from any of these persons)—can be held liable for insider trading. It is the relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their relation to that corporation (or to a person who has such a relation) that gives rise to the duty to disclose the confidential information at the time of the trade or to abstain from trading. In short, the classical theory

---

Confidential Government Information (May 24, 2017), www.sec.gov/news/press-release/2017-109.

143. Press Release No. 2015-163, U.S. Sec. & Exch. Comm'n, SEC Charges 32 Defendants in Scheme to Trade on Hacked News Releases (Aug. 11, 2015), www.sec.gov/news/pressrelease/2015-163.html.

of insider trading holds that a corporate insider should not use corporate information to take unfair advantage of the corporation's own shareholders in the securities markets.

§ 14:4.2 "Misappropriation Theory" of Insider Trading

In 1997, the U.S. Supreme Court, in *United States v. O'Hagan*, adopted the "misappropriation theory" of insider trading.[144] Although the misappropriation theory had been adopted by five of the twelve U.S. courts of appeals, its validity had come into doubt because two other courts of appeals—the Fourth and the Eighth Circuits—had rejected misappropriation of material nonpublic information as a basis for insider trading liability.

In contrast to the classical theory of insider trading, the misappropriation theory holds that a person commits fraud "in connection with" a securities transaction for purposes of Rule 10b-5 when he misappropriates and trades on the basis of confidential information in a breach of a duty owed to the source of the information. As stated by the Supreme Court, "[i]n lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[145] Thus, according to the Supreme Court, "[t]he two theories are complimentary" in that the original theory "targets a corporate insider's breach of duty to shareholders with whom the insider transacts," and the misappropriation theory "outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information."[146]

In practice, the *O'Hagan* case is used in training and educating company employees not to divulge sensitive information to third parties. Corporate compliance policies also should be clear that employees are prohibited from trading on the basis of material, nonpublic information obtained in the course of their duties as employees, including information concerning companies with which the employer conducts business or from which the company otherwise receives confidential information.

One district court case has moved in the direction of limiting the reach of the misappropriation theory of insider training, although it was overruled on appeal.[147] In July 2009, the district court granted a

---

144. United States v. O'Hagan, 521 U.S. 642 (1997).
145. *Id*. at 652.
146. *Id*. at 652–53.
147. *See* SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated and remanded*, 620 F.3d 551 (5th Cir. 2010).

defendant's motion to dismiss allegations of insider trading on the grounds that, absent a fiduciary relationship, an agreement to keep information confidential did not itself create an obligation not to trade based upon that information. In the case, the SEC's complaint alleged that the CEO of a corporation reached a verbal agreement with the defendant that the defendant would keep the divulged information confidential. The defendant thereafter used the information to sell his stock in advance of the public announcement of the information. On appeal, the Fifth Circuit held that the district court erred in that the pleaded misappropriation theory was sufficient to survive the motion to dismiss and reinstated the charges against defendant.

Conversely, a recent Second Circuit case appears to have expanded the reach of the misappropriation theory. In *SEC v. Obus*, the court held that actual knowledge of the fiduciary breach is not required and that tippee liability may be established where the tippee knew or should have known that the information was improperly disclosed.[148] While the Circuit Courts appear willing to grant the SEC a wide degree of latitude in prosecuting the misappropriation theory, this attitude has not been shared by juries. In each of the above cases, the Circuit Court's ruling resulted in the case going to trial, and in both instances the defendants were found not liable.

§ 14:4.3 "Use" Versus "Possession"

For many years, debate raged over whether an insider trading claim could be based upon the fact that a person merely was in possession of material nonpublic information at the time of a trade, regardless of whether the person actually used such information as the basis for the decision to trade. To provide the Enforcement Division with a more liberal standard upon which to base future insider trading cases, the SEC promulgated SEC Rule 10b5-1, which expressly states that a person trades "on the basis of" material nonpublic information when the person "was aware of" the material nonpublic information when the person made the purchase or sale. In other words, mere possession of the information—not just use of the information—suffices. The same rule, however, permits individuals to create so-called 10b5-1 plans that allow the person to buy or sell on a pre-established basis, pursuant to a written plan for the trading of such securities. The contract instruction or plan must specify the amount of securities to be sold, the formula for any such sales, or other indicia that the person has been divested of discretion to exercise any subsequent influence over how, when, or whether any securities were to be purchased or sold.

---

148. SEC v. Obus, 693 F.3d 276 (2d Cir. 2012).

§ 14:4.4 Tipper/Tippee Liability

In *Dirks v. SEC*, the U.S. Supreme Court held that insiders who tip material non-public information to others are liable only where they breach a fiduciary duty to the company's shareholders.[149] The test for whether the tipper breached his fiduciary duty is "whether the insider personally will benefit, directly or indirectly, from his disclosure." The Court further held that a tippee's duty to disclose or abstain from trading on material, nonpublic information is derivative of the tipper's duty—meaning that where a tipper breaches his duty to company shareholders by tipping insider information in exchange for a personal benefit, the recipient of the information (the tippee) similarly breaches a duty to the shareholders by trading on the inside information without disclosure.

In late 2014, the U.S. Court of Appeals for the Second Circuit issued its decision in *United States v. Newman*, vacating the insider trading convictions of two hedge fund managers and narrowing the scope of tippee liability.[150] In the years since *Dirks*, the government has taken a broad view of what could constitute a "personal benefit" to the trader, such as simply maintaining a friendship. The *Newman* decision held that mere friendship was insufficient and that the government must prove a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Though the tipper's gain "need not be immediately pecuniary," it must be "of some consequence."

The following year, the Ninth Circuit declined to follow *Newman*, holding in *United States v. Salman*, "To the extent *Newman* can be read to go so far [as to hold that evidence of a friendship or familial relationship . . . standing alone, is insufficient to demonstrate that the tipper received a benefit], we decline to follow it. Doing so would require us to depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an 'insider makes a gift of confidential information to a trading relative or friend.'"[151] In late 2016, the Supreme Court resolved this circuit split, affirming *Salman* and rejecting *Newman*'s requirement that some pecuniary gain was required to establish tippee liability.[152]

---

149. Dirks v. SEC, 463 U.S. 646 (1983).
150. United States v. Newman, 773 F.3d 438 (2d Cir. 2014).
151. United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015).
152. Salman v. United States, 137 S. Ct. 420 (2016).

§ 14:5 Role of Directors

Outside directors have a critical role to play in preventing the adverse events that may lead to SEC investigations, mitigating the effects of any wrongdoing, and managing a company's response to an SEC investigation to prevent it from going out of control. Plainly, outside directors cannot and should not try to micromanage an enterprise. On the other hand, by setting standards for corporate behavior, they may help a corporation prevent or ameliorate the effects of a government investigation. Several beneficial measures are discussed below.

§ 14:5.1 Corporate Codes of Conduct and Compliance Policies

Many corporations now have codes of conduct and compliance policies and procedures that set forth legal and ethical standards for officers and employees. Codes of conduct establish the corporation's values and put employees on notice of behavior that may result in termination of employment even prior to the commencement of regulatory action. Codes of conduct enable a corporation to demonstrate to the government that misconduct by an employee was contrary to the interest of the corporation and may also provide a basis for terminating an errant employee who refuses to cooperate with an internal investigation.

Similarly, properly done compliance policies should help to prevent violations. Even when they are not fully effective, compliance policies demonstrate the corporation's good faith.

§ 14:5.2 Internal Controls

Probably the most effective measure to prevent employee or officer misconduct is the presence of strong internal accounting and operational controls. The spate of high-profile financial reporting cases brought by the SEC (and the DOJ) in the early 2000s, including Enron, WorldCom, Adelphia, and HealthSouth, have been attributed in part to the lack of strong internal controls. Thus, outside directors can play a critical role in reviewing existing controls and insisting that they be enhanced where appropriate.

§ 14:5.3 Dealing with Potential Illegal Acts

Section 10A of the Private Securities Litigation Reform Act of 1995[153] requires that the auditor of a company whose stock is registered

153. Private Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (1995).

pursuant to section 12 of the Exchange Act include in its annual audit, among other things, procedures regarding the detection of illegal acts. Where material illegal acts are detected, section 10A requires the auditor to report its finding directly to the SEC if the issuer fails to do so.

Nothing in PSLRA section 10A or the regulations promulgated pursuant to it requires a company's management or audit committee to undertake any additional duties or responsibilities to implement section 10A's fraud detection and disclosure standards. But the potential for an auditor's whistleblowing to the SEC in connection with the reporting of suspected illegal acts should provide added incentive for the audit committee and the board to strengthen their oversight of the company's compliance programs, and to take appropriate remedial steps when illegal acts are suspected. Indeed, section 10A requires the auditor to seek to have appropriate remedial measures taken by the audit committee and the board, and to report violations to the SEC only when the auditor is not satisfied with the remedial actions taken. As well, the audit committee may be called upon to engage in more extensive oversight depending on the existence of fraud "risk factors."[154]

In light of these standards, and as a minimum step toward monitoring accounting controls, the audit committee should consider the following:

- Evaluate, in conjunction with management, each of the risk factors identified in SAS 82 in order to judge whether any particular risk factors, alone or in combination with others, indicate that the company's current environment may foster fraud. The audit committee should recommend that appropriate actions be taken to mitigate these perceived risks, and expand the scope of the internal audit function to better detect fraud.
- Familiarize itself with the audit procedures to be implemented by the outside auditors, and understand to what extent the outside auditors believe that material fraud risk factors exist within the company.
- Consider, or reconsider, how the audit committee monitors corporate activities and what company-wide information and reporting systems exist for the detection of fraud and illegal acts.

154. Am. Inst. of Certified Pub. Accountants, AU § 316, Consideration of Fraud in a Financial Statement Audit (Dec. 2012).

Moreover, where fraud or other illegal acts are suspected, the audit committee's counsel could independently investigate the suspected wrongdoing and advise the committee as to its obligations.

§ 14:5.4 Supervising Internal Investigations and the Corporation's Response to the SEC

Outside directors also should play a useful role in supervising internal investigations of potential misconduct and overseeing a corporation's response to the government. Supervision of an internal investigation is helpful because it provides the corporation and third parties the assurance that evaluations of employee conduct have been independently made by persons who do not have as vested an interest in the outcome as does management. This independence is essential if the investigation implicates senior management, or if the effects of the misconduct are so severe as to warrant changes in senior management. Independence is just as important even if management changes are not warranted, as the independent determination by outside directors provides managers with the assurance that they will continue to be supported by the board during the investigation and may also enable the corporation to remove a political cloud over the managers at an early stage.

The board also should monitor pending government inquiries. Wishful thinking is an all-too-common human trait; thus, management may not fully appreciate the significance of a government investigation. The independent assessment that a board can provide allows a corporation to take appropriate remedial measures before it is too late.

§ 14:5.5 Audit Committee Oversight

Partly due to the enhanced duties imposed on audit committees under the Sarbanes-Oxley Act, the SEC has focused particular attention in recent years on the oversight responsibilities of audit committees, and in some cases the Enforcement Division staff has targeted audit committee members. In March 2014, the SEC initiated a pair of enforcement actions against the respective audit committee chairs of two companies headquartered in the United States with operations in China. In each case, the SEC alleged that the audit committee chair had actual knowledge of unreported fraud.[155]

---

155. *See* Press Release No. 2014-59, U.S. Sec. & Exch. Comm'n, SEC Announces Fraud Charges Against Coal Company and CEO for False Disclosures About Management (Mar. 27, 2014), www.sec.gov/News/PressRelease/Detail/PressRelease/1370541317697; Press Release No.

In the first of these cases, the SEC permanently barred the former audit committee chair from signing public filings. According to the SEC, the company's CEO falsely represented in SEC filings that a person served as the company's acting CFO who in fact never did. The SEC alleged that when the former audit committee chair learned of this accusation, she merely inquired of the CEO, was told the accusation was false, and "contacted no one else, including anyone at the company or the company's external auditors, to investigate." The SEC further alleged that after the CEO later admitted the fraud to the audit committee chair, she nonetheless signed a false Sarbanes-Oxley certification.

In the second matter, the SEC alleged that when pervasive fraud was brought to the attention of the audit committee chair, he ignored advice to conduct an independent investigation under the guidance of legal counsel, and instead merely directed members of management and a consulting firm to investigate, and then largely ignored the results of those investigations. According to the SEC, when presented with evidence that the company systematically had reported fictitious revenues, maintained a second set of books, and engaged in extensive cover-up efforts, the audit committee chair failed to disclose the information to the company's outside auditor or outside disclosure counsel and "failed to conduct further meaningful inquiries into the fraud even as additional red flags arose."

In an earlier case, the SEC had filed a complaint against three former independent directors and audit committee members of DHB Industries, Inc.[156] According to the SEC, from 2003 to 2006 the directors permitted the company to report misleading financials, allowed the CEO to divert $10 million from the company, and oversaw payment of the CEO's personal expenses. The SEC alleged that the directors "willfully ignored significant red flags," including material weakness letters from and resignation of outside auditors, concerns raised by the company's comptroller, and the resignation of outside counsel. The SEC alleged that the directors were not independent due to their business and decades-long personal relationships with the CEO, but also "made little or no effort even to understand their Audit Committee responsibilities."

2014-47, U.S. Sec. & Exch. Comm'n, SEC Charges Animal Feed Company and Top Executives in China and U.S. with Accounting Fraud (Mar. 11, 2014), www.sec.gov/News/PressRelease/Detail/PressRelease/1370541102314.

156. SEC v. Krantz, No. 11-cv-60432 (S.D. Fla. Feb. 28, 2011). Consent judgments were ultimately entered in this matter. SEC v. Krantz, No. 11-cv-60432 (S.D. Fla. Nov. 10, 2011).

Another example is a 2006 enforcement action against the former audit committee chair of Spiegel, Inc.,[157] in which the SEC alleged the director, through his position as audit committee chair, recommended that the Spiegel board withhold filing the company's financial statements until the auditor provided an unqualified opinion after the audit firm first threatened a "going concern" qualification.[158] And more recently, in 2015 the SEC instituted settled proceedings against the former audit committee chair of a sports nutrition company in a case alleging that the company failed to disclose executive perks in its financial statements. According to the SEC, the former chair "substituted his wrong interpretation of SEC rules for the views of experts the company had hired, resulting in an incorrect disclosure."[159]

It is still relatively rare for the SEC to pursue claims against audit committee members for a breach of their duty of oversight. Nevertheless, audit committee members should be mindful that, unlike the private securities litigation arena, where there is no private right of action for "aiding and abetting," the SEC has plenary powers to pursue enforcement actions against aiders and abettors, including audit committee members. Thus, audit committee members should be mindful that some of the same principles that apply to them under state law fiduciary duty standards may apply to them under the federal securities laws.

§ 14:6 Role of Counsel

In recent years, the SEC has frequently spoken of the role of counsel in preventing fraud and has identified in-house and outside counsel as among the most important "gatekeepers" who are expected to play a role in guarding against misconduct.

In years past, in-house counsel were rarely sued in enforcement actions. That has changed over the past decade, with an increasing number of enforcement actions naming attorneys as defendants or respondents. In bringing such actions, SEC officials have often taken

---

157. *In re* Horst Hansen, 2006 WL 3095646 (SEC Nov. 2, 2006).

158. Other recent SEC cases against audit committee members have involved more traditional antifraud issues such as insider trading, rather than any violation based on a breach of a duty of oversight. *See, e.g.*, SEC v. Erickson, No. 3-07-CV-0254-N (N.D. Tex. Feb. 7, 2007), Litigation Release No. 19,992 (Feb. 7, 2007); SEC v. Gad, 07-CV-8385 (GEL) (S.D.N.Y. Sept. 27, 2007), Litigation Release No. 20,577 (May 15, 2008).

159. Press Release No. 2015-179, U.S. Sec. & Exch. Comm'n, SEC Charges Sports Nutrition Company with Failing to Properly Disclose Perks for Executives (Sept. 8, 2015), www.sec.gov/news/pressrelease/2015-179.html.

pains to point out that it was focusing on attorneys who engaged in improper conduct, not who merely gave bad advice to clients.[160] Similarly, in an SEC opinion involving charges against a broker-dealer's general counsel, the Commission referenced "the Commission's traditional reluctance to bring an administrative action against a lawyer for the negligent rendering of non-public advice to his or her own client."[161] This is not to say that the SEC has not brought cases that sound in negligence and may appear to blur the lines between advice and conduct.[162] However, most enforcement actions seem to identify significant conduct by counsel that went beyond the rendering of legal advice.

For example, in the mid 2000s, the Enforcement Division brought a number of cases against in-house general counsel for their alleged roles in connection with the improper backdating of stock options, including actions against the in-house counsel of Symbol Technologies, Comverse Technology, Apple Computer, McAfee, Mercury Interactive, CNET, Monster Worldwide and Boston Communications, KLA-Tencor, and Juniper Networks.[163] In several of these cases, the DOJ also brought parallel criminal actions. In general, these cases turned on specific allegations that the in-house lawyers were active participants in knowing misconduct and, in most cases, were alleged to have personally benefited from the alleged misconduct.

Similarly, the SEC has filed multiple actions against counsel based on their alleged involvement in penny stock schemes. For example, in 2007, the SEC filed suit against two attorneys, David Stocker and Phillip Offill, for their respective roles in a "pump and dump" scheme, whereby they facilitated the issuance of millions of shares of stock to companies they controlled, then transferred the shares back to the company principals, who in turn dumped them into the market.[164]

---

160. *See Christopher Cox, Chairman, Speech by SEC Chairman: Address to the 2007 Corporate Counsel Institute*, U.S. SEC. & EXCH. COMM'N (Mar. 8, 2007), www.sec.gov/news/speech/2007/spch030807cc.htm.

161. Opinion of the Commission, *In re* Scott Monson, Investment Company Act Release No. 28,323 (June 30, 2008), www.sec.gov/litigation/opinions/2008/ic-28323.pdf (finding attorney did not act negligently).

162. *See, e.g., In re* Google, Inc. & David C. Drummond, Securities Act Release No. 8523 (Jan. 13, 2005), www.sec.gov/litigation/admin/33-8523.htm.

163. An extensive review of these cases is found in Dickey, *Litigation Against Accountants and Lawyers: The Year of Living Dangerously* (West Legal Works 17th Annual Litigation and Resolution of Complex Class Actions Workshop, Nov. 1–2, 2007).

164. SEC Charges Securities Attorneys in Penny Stock Scam, Litigation Release No. 20,154 (June 14, 2007), www.sec.gov/litigation/litreleases/2007/lr20154.htm.

The DOJ filed criminal charges against the pair; Offill was sentenced to eight years in prison after a jury trial, and Stocker was sentenced to thirty-three months in prison after pleading guilty.[165]

SEC enforcement actions have also been based on attorney conduct during SEC proceedings. In 2008, the general counsel of the SEC instituted Rule 102(e) proceedings against Steven Altman, alleging that he had called counsel for the respondents in an SEC administrative proceeding and offered to have his client provide false testimony to the SEC in exchange for certain financial consideration.[166] Following a hearing at which the administrative law judge found in favor of the SEC, the Commission issued an opinion ordering Altman permanently barred from appearing before the agency as an attorney.[167]

Not all such SEC actions have been as successful for the agency. In a highly publicized case, the SEC brought charges against the general counsel of a registered brokerage firm, claiming that he failed reasonably to supervise an individual stock broker who allegedly manipulated a publicly traded stock and who also allegedly engaged in sales practice violations with respect to the accounts of several of his customers.[168] After years of heavy litigation, Chief Administrative Law Judge Brenda J. Murray issued an opinion recommending dismissal of the case, concluding that the general counsel acted reasonably. The Division of Enforcement appealed. The Commission dismissed the proceeding on a 1-1 vote (with other commissioners recusing themselves from the decision), leaving unresolved the legal issues presented—namely, when, if ever, a general counsel is a supervisor, and what constitutes a reasonable response to indicia of misconduct.[169] Nevertheless, the recent history of enforcement actions against in-house counsel provides a sober reminder that counsel may be subject to SEC scrutiny.

---

165. Attorneys Sentenced in Stock Manipulation Scheme, Litigation Release No. 21,508 (Apr. 28, 2010), www.sec.gov/litigation/litreleases/2010/lr21508.htm.

166. *In re* Steven Altman, Esq., Exchange Act Release No. 57,240 (Jan. 30, 2008), www.sec.gov/litigation/admin/2008/34-57240.pdf.

167. *In re* Steven Altman, Esq., Exchange Act Release No. 63,306 (Nov. 10, 2010), www.sec.gov/litigation/opinions/2010/34-63306.pdf (*petition denied*, Altman v. SEC, No. 11-1067 (D.C. Cir. Dec. 16, 2011)).

168. *See* Initial Decision, *In re Urban*, Admin. Proc. File No. 3-13655 (Sept. 8, 2010), Initial Decision Release No. 402, www.sec.gov/litigation/aljdec/2010/id402bpm.pdf.

169. *See* Order Dismissing Proceeding, *In re* Urban, Admin. Proc. File No. 3-13655 (Jan. 26, 2012), www.sec.gov/litigation/admin/2012/34-66259.pdf.

§ 14:7 Role of Auditors

The other significant "gatekeepers" about which the Enforcement Division has frequently spoken in recent years are the outside audit firms for public registrants. Over the past decade, a number of enforcement actions have been brought against major accounting firms and individual audit partners. In recent years, the SEC stepped up its enforcement efforts against individual audit partners. In addition to cases brought by the Division of Enforcement, proceedings may also be initiated by the Public Company Accounting Oversight Board (PCAOB) pursuant to its own independent enforcement powers over audit firms and audit partners. In 2003, the PCAOB, established by Congress as part of the Sarbanes-Oxley Act, adopted rules that govern its investigations and adjudications, and since then the PCAOB has slowly built up its enforcement resources. Today, the PCAOB is fully staffed to conduct inspections of audit firms and, where appropriate, initiate disciplinary proceedings.

With the combined oversight of the SEC and the PCAOB, auditors are acutely aware of their roles and responsibilities as gatekeepers and of their obligation to discharge their duties as independent auditors with ever-increasing vigilance. Even before passage of the Sarbanes-Oxley Act, federal statutes imposed significant obligations on audit firms to take prompt remedial actions in the event of detection of illegal acts. For example, Exchange Act section 10A sets forth detailed statutory requirements auditors must follow in the event they detect an illegal act, including the ultimate obligation to report to the SEC if, after detection of such an illegal act, the company's management or board of directors fails to take "timely and appropriate remedial actions with respect to the illegal act." The obligation to report to the SEC provides a powerful inducement to public companies to respond promptly and substantively to the audit firm's concerns during the course of an audit. In practice, the duty to report has resulted in significant cooperation between companies and auditors to address suspected wrongdoing in a prompt and decisive fashion.

The Sarbanes-Oxley Act further enhanced the standards applicable to audit firms in the performance of their audit duties, including new independence standards and new obligations imposed on public companies with regard to their financial statements, including the requirement that the chief executive officer and chief financial officer sign "certifications" of the financial statements, that the company certify as to the sufficiency of its internal controls, and that the company's management avoid any improper influence on the conduct of the external audit. All of these provisions have caused audit firms to

perform more rigorous annual audit and quarterly reviews, and management to implement more rigorous internal policies and practices associated with the preparation and disclosure of the company's financial statements.

The auditor's role continues to be critical to the effective implementation of all these systems. While the fair presentation of the company's financial statements is the responsibility of management, auditors nevertheless have generally taken proactive steps in recent years in at least the following areas:

- ensuring their own independence, consistent with independence standards promulgated by the FASB, the PCAOB, and other standards-setting organizations;
- designing audit procedures that are reasonably likely to detect fraud;
- evaluating the company's business risks, credit risks, and financial statement risks, and incorporating those risks into the development of the audit plan;
- regularly and effectively communicating with the audit committee; and
- evaluating the integrity of management and the effectiveness of the company's system of internal controls.

These and other steps have become "best practice" for most public company audits and are key areas that the SEC Enforcement Division staff will focus on in the event that it decides to investigate a possible fraud. The SEC will expect to find documentation showing that the audit firm carefully designed its audit and that, if a fraud occurred, it was not for lack of audit procedures that were reasonably designed to detect fraud. In that respect, and in light of the major financial frauds of the last decade, more is expected of audit firms by the SEC than ever before.

Not surprisingly, as the SEC has revamped its scrutiny of public company reporting in the mid-2010s, it has likewise taken an increasingly aggressive stance toward public company audits. In a pair of cases involving large national audit firms filed in 2015, the SEC brought charges against not just individual audit partners, but the firms themselves. Moreover, as part of the settlements, the SEC required the firms to admit their wrongdoing—which, as discussed above, is still a relatively infrequent component of SEC settlements. In one case, the SEC alleged that partners at the firm had ignored red flags and fraud risks while auditing two public companies that were charged

with accounting fraud by the SEC.[170] In the other, the SEC alleged that a number of the firm's partners (including the concurring partner and the regional and national practice directors) had similarly dismissed red flags in connection with the audit of a company sued for fraud by the SEC.[171]

One of the more significant emerging issues facing auditors and the SEC relates to the discoverability of work papers from foreign accounting firms performing audits of companies trading in the U.S. markets. With the increased globalization of U.S.-listed companies, conflicts have arisen between the SEC's requests for offshore audit work and limitations on the ability of these firms to produce the materials under the law of the foreign jurisdiction. Section 106 of the Sarbanes-Oxley Act expressly requires foreign firms issuing opinions relied upon by domestic firms registered with the PCAOB to produce work papers to the SEC or PCAOB.

This statute was put to the test in a series of recent actions by the SEC. In late 2012, the SEC filed administrative proceedings against foreign affiliates of five accounting firms (including all of the "Big Four") for their failure to produce documents prepared in connection with their audits of ten China-based companies.[172] In January 2014, Administrative Law Judge Cameron Elliot issued an initial decision barring each Big Four affiliate from SEC practice for six months, finding that the firms had "willfully refused to comply" with section 106 because they had "chose[n] not to comply with at least one Sarbanes-Oxley 106 request after receiving at least constructive notice of it."[173] Notably, the ALJ found the firms' argument that they "were ready, willing, and able to produce documents, but were unable to do so because Chinese law prevented it" was irrelevant to determining liability under section 106's "willful refusal" standard, and that a "willful refusal" under section 106 does not require conscious

170. Press Release No. 2015-272, U.S. Sec. & Exch. Comm'n, Grant Thornton Ignored Red Flags in Audits (Dec. 2, 2015), www.sec.gov/news/pressrelease/2015-272.html.

171. Press Release No. 2015-184, U.S. Sec. & Exch. Comm'n, SEC Charges BDO and Five Partners in Connection with False and Misleading Audit Opinions (Sept. 9, 2015), www.sec.gov/news/pressrelease/2015-184.html.

172. Press Release No. 2012-249, U.S. Sec. & Exch. Comm'n, SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents (Dec. 3, 2012), www.sec.gov/news/press/2012/2012-249.htm.

173. *See* Initial Decision, *In re* BDO China Dahua CPA Co., Initial Decision Release No. 553 (Jan. 22, 2014), www.sec.gov/alj/aljdec/2014/id553ce.pdf (also censuring the fifth firm, but not barring it from practice).

wrongdoing or a lack of good faith, as the firms argued. The ALJ did note that the firms "did not act with scienter"—they "obviously had no intent to defraud, nor were they reckless"—that is, their conduct was not "an 'extreme departure' from the standards of care."

In February 2015, following the ALJ's ruling, the auditing firms settled with the SEC. As part of the settlement, the SEC censured the firms and each agreed to pay $500,000 and to take specific steps to satisfy SEC requests for similar materials over the next four years.[174]

§ 14:8 The *Janus* Decision

The Supreme Court in *Janus Capital Group, Inc. v. First Derivative Traders* held that an individual or corporation cannot be held primarily liable under Rule 10b-5 for "making" a false or misleading statement unless the person or corporation had "ultimate authority over the statement, including its content and whether and how to communicate it."[175] "One who prepares or publishes a statement on behalf of another," wrote Justice Thomas, "is not its maker. . . . Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it."[176]

Janus only explicitly purported to limit private causes of action and did not appear necessarily to limit actions brought by the SEC. At least one court has suggested that *Janus* is not applicable to SEC enforcement actions.[177] Yet the majority of courts, often without much discussion, apply *Janus* to SEC actions.[178] The SEC itself apparently

---

174. Press Release No. 2015-25, U.S. Sec. & Exch. Comm'n, SEC Imposes Sanctions Against China-Based Members of Big Four Accounting Networks for Refusing to Produce Documents (Feb. 6, 2015), www.sec.gov/news/pressrelease/2015-25.html.

175. Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011).

176. *Id*. at 142–43.

177. SEC v. Pentagon Capital Mgmt. PLC, 844 F. Supp. 2d 377, 421–22 (S.D.N.Y. 2012), *as amended* (Aug. 22, 2012) (stating that the Supreme Court limited its holding in *Janus* to "accord [ ] with the narrow scope" of Rule 10b-5 as applied to private plaintiffs in contrast with the Commission, and that "[t]here is no indication that the Court or Congress intended for actions brought by the SEC to be so limited") (internal quotations omitted).

178. *See, e.g.*, SEC v. C.J.'s Fin., 2012 WL 3600239, at *6 (E.D. Mich. July 30, 2012), *report and recommendation adopted*, 2012 WL 3597644 (E.D. Mich. Aug. 21, 2012).

concedes that its suits under Rule 10b-5(b) are governed by *Janus*.[179] Other courts consider the question open.[180]

The trend seems to be toward a rule that *Janus* applies to SEC actions under Rule 10b-5(b), but not (as some defendants claim) to SEC actions under Rules 10b-5(a) and (c), which do not require a defendant to "make" any untrue statement.[181] Nor does *Janus* appear to apply to SEC actions under section 17(a), the 1933 Act's antifraud provision, which does not provide a private cause of action.[182]

The Commission in late 2014 used an appeal from an administrative proceeding as an opportunity to opine on the "ambiguities" created by *Janus*, stating its position that *Janus* is limited to actions brought under Rule 10b-5(b).[183] The Commission's decision overturned the ALJ's dismissal of charges against the two respondents. On appeal, the First Circuit reversed the Commission's decision without addressing this specific issue, thus apparently leaving the SEC's narrow interpretation of *Janus* in place for the time being.[184]

---

179. *See, e.g.*, SEC v. Brown, 878 F. Supp. 2d 109, 121–22 (D.D.C. 2012) (SEC concedes that after *Janus*, a claim against an officer who only "prepared" documents cannot rest on Rule 10b-5(b)).

180. SEC v. True N. Fin. Corp., 909 F. Supp. 2d 1073, 1119 (D. Minn. 2012) (noting division among district courts as to "whether *Janus* applies to a public securities fraud action").

181. SEC v. Sells, 2012 WL 3242551, at *7 (N.D. Cal. Aug. 10, 2012) (*Janus* "did not address" Rules 10b-5(a) and 10b-5(c)).

182. *See, e.g.*, *id*. (*Janus* does "not apply to claims premised on § 17(a)"); SEC v. Daifotis, 874 F. Supp. 2d 870, 878 (N.D. Cal. 2012) ("*Janus* only applies to Section 10(b) and Rule 10b-5"). Courts generally point to the different language in sections 10(b) and 17(a). SEC v. Sentinel Mgmt. Grp., Inc., 2012 WL 1079961, at *14–15 (N.D. Ill. Mar. 30, 2012) (*Janus* is inapplicable to section 17(a) claims for both textual and policy reasons); SEC v. Big Apple Consulting USA, Inc., 2012 WL 3264512, at *3 (M.D. Fla. Aug. 9, 2012) (*Janus* does not apply to section 17(a) because *Janus* interpreted the "to make" language that only appears in 10b-5).

183. *In re* Flannery & Hopkins, Securities Act Release No. 9689 (Dec. 15, 2014), www.sec.gov/litigation/opinions/2014/33-9689.pdf.

184. Flannery v. SEC, 810 F.3d 1 (1st Cir. 2015).