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WHAT EVERY COMPANY, DIRECTOR AND OFFICER SHOULD KNOW ABOUT CURRENT SEC ENFORCEMENT POLICIES AND TRENDS

Being Aware of SEC Enforcement Priorities Helps Avoid Liability

Issuers and their general counsel, directors and officers should carefully monitor enforcement trends of the Securities Exchange Commission ("SEC" or "the Commission") to ensure proper compliance and avoid entanglement with investigations and potential liability. SEC enforcement continues to follow its traditional approach of sometimes being a "cop on the beat," while at other times being like an archeologist focused on years-old conduct, and at still other times regulating through litigation. These multiple roles cause the Commission sometimes to be a very aggressive cop, pushing at the edges of the law and, at other times, to focus on years-old conduct of little interest to the markets (which are keyed to today and tomorrow) and at other times to create shifting standards as they evolve through litigation. These multiple roles make it critical to understand the trends of SEC enforcement to avoid liability and, if facing an investigation, to assess the proper course to minimize liability.

Overview: An Aggressive, Sometimes Effective Program, But Some Troubling Losses

A review of 2007 enforcement statistics paints a picture of a vibrant, effective program. The number of cases brought by the SEC increased 10 percent over the prior years, marking the first time in years that the number of cases increased (previously, they had been decreasing by approximately 5 percent annually). The SEC prevailed in 92 percent of the actions it brought, obtaining either a settlement or a default. In 2007, it obtained orders requiring the payment of $520 million in disgorgement and penalties.

A closer look, however, reveals troubling signs. The amount of disgorgement and penalties decreased by over 50 percent, prompting congressional calls for an inquiry. The SEC's response, citing record payments in the first quarter of this year based largely on a $600 million settlement in the *McGuire/United Health* options backdating litigation did little to quiet these concerns, since most of the money paid in that matter was in private class and derivative actions and not the SEC action, except that the private settlements were combined with that of the Commission.

Also of concern is the ill-fated, mishandled Pequot Capital inquiry, which resulted from the SEC being the subject of a whistleblower complaint by a former staff member claiming undo influence in the conduct of an insider trading investigation, and resulted in congressional criticism of its investigative processes.

Other troubling signs arose from botched court cases and critical comments from judges. In *SEC v. Packetport.com, Inc.*, 3:05 CV 1747 (PCD) (D. Conn. March 21, 2007), the investigation of what the SEC claimed was a raw market manipulation took so long that the statute of limitations for penalties had expired before the complaint was filed. Later, that complaint was dismissed for want of prosecution. This debacle ended when the defendants consented to a face-saving settlement for the SEC in order to avoid an appeal. In *SEC v. Jones*, No. 07 Civ. 7044, slip op. (S.D.N.Y. Feb. 26, 2007), the Court dismissed SEC claims for civil penalties as time barred and refused to enter its usual statutory injunction because the conduct was so old the remedy would be punitive and thus was also time barred. In *SEC v. Todd*, Civil Action No. 03 CV 2230, slip op. (S.D. Ca. May 30, 2007), the court granted post trial motions largely dismissing the case and criticized the SEC for misrepresenting key facts.

A series of cases against hedge funds involving PIPE offerings intensify concerns about the enforcement program. In each case where the SEC was forced to litigate, it lost claims involving the alleged sale of unregistered securities. What is more troubling, however, is that in two of the three losses the court criticized the securities law legal theory being argued by the SEC, and in one case questioned the agency's candor, echoing a theme raised in *Todd.*

Insider Trading

The SEC has re-emphasized this traditional enforcement area in the wake of congressional calls to step up insider trading enforcement and global reports of rampant insider trading. The Commission answered the call by bringing a series of cases involving trading based on future corporate events, such as mergers and earnings announcements. Many of these cases involved corporate directors, attorneys and, in a new series of actions, "pillow talk" cases involving spouses and family members.

SEC v. Guttenberg, Case No. 1:07-cv-01774-PKC (S.D.N.Y. 2007) is considered by many to be the most significant insider trading case brought in years, in part because the defendants were largely Wall Street professionals trading on information from major investment banks. There, the SEC named 14 defendants and, in what appears to be an increasing trend, DOJ brought criminal charges against thirteen individuals. The cases are based on two trading schemes. One involved trading ahead of UBS market reports. The second alleged trading on transaction information obtained from Morgan Stanley. Each criminal defendant has pled guilty.

The SEC's aggressive enforcement posture in this area means pushing the factual and legal edge of the envelope. Frequently cases are brought based on little more than the trading data in tandem with DOJ with the assistance of foreign regulators. Typical of these cases is the News Corp./Dow Jones insider trading case, *SEC v. Wong*, Civil Action No. 07 Civ. 3628 (SAS) (S.D.N.Y. May 8, 2007). That action, brought within days of the take-over announcement and later settled with the assistance of the Hong Kong Securities and Futures Commission, was based largely on trading data. While the SEC successfully resolved this matter, quickly filing these cases carries risk of wrongful prosecution. The lack of a full investigation, and over-reliance on trading data in such cases, increases the chance of ensnaring the innocent and incorrectly stigmatizing a person as a scofflaw, since many experts agree that evidence of suspicious trading alone, which is frequently the predicate of such actions, is insufficient to prove insider trading and may have innocent explanations.

Other enforcement positions raise significant concerns for executives. Last year, SEC Division of Enforcement Director Linda Thomsen announced that the division was scrutinizing executive trading under Rule 10b5-1 plans. That rule was crafted as a safe harbor for executives to trade without concern about insider trading. Now, however, in the wake of a business school study suggesting that there are abnormal returns under these plans (the same kind of study which touched off the options backdating scandal), the once safe harbor may not be safe.

Other conduct thought immune from prosecution is now apparently under scrutiny. In *SEC v. Barclays Bank*, Civil Action No. 07-CV-04427 (S.D.N.Y. May 30, 2007), the SEC alleged that defendants traded bonds on inside information in six different bankruptcy cases. Some of the transactions involved the use of a "big boy" letter to tell the other parties that the bank may have undisclosed material information about the deal. Many had thought these letters could be used to avoid liability. Because the case settled, there is no opinion on the viability of the insider trading claims involving the letters. It does however, represent the Commission's views on the subject.

The SEC appears to be pushing the edges of insider trading liability in other areas. A key predicate to insider trading liability is a breach of duty. Yet, in *SEC v. Dorozhko*, Civil Action No. 07-cv-9606 (S.D.N.Y. Oct. 29, 2008), the court dismissed the SEC's complaint against a defendant who obtained inside information by hacking a computer system because there was no breach of duty. Not only is that case on appeal, but subsequently, the Commission filed a settled enforcement action based on similar facts where there was no apparent breach of duty. *SEC v. Stummer,* Civil Action No. 1:2008 cv 03671 (S.D.N.Y. April 17, 2008) (defendant hacked into brother-in-law's computer and traded on information from system).

The Foreign Corrupt Practices Act ("FCPA")

The SEC and DOJ are also re-emphasizing enforcement in this traditional area. Last year, there were 38 FCPA cases filed, compared to 15 the prior year. Ten individuals were criminally charged with FCPA violations last year, the same number which was charged over the prior three years. At year end 2007, there were more than 100 open FCPA investigations.

A key trend in this area is industry-wide investigations. Perhaps the most significant examples of these cases stem from the U.N. Oil For Food Program ("OFFP"). A report on the program concluded: (1) that Iraq manipulated the program to dispense contracts based on political preferences and obtain illicit payments; and (2) that 2,253 companies paid over $1.8 billion in illicit income to the Iraqi government. About two dozen companies have disclosed inquiries. The SEC and DOJ have a number of open investigations focused on the oil side of the program, where kick backs are frequently booked as part of the contract, and on the humanitarian side, where typically "after service" fees are added to the deal.

A key focus of the new FCPA enforcement effort is cases against individual. Both the SEC and DOJ have made it clear that, in addition to bringing actions against business organizations, they intend to focus on, and bring actions against, individuals. Last year the SEC and DOJ brought ten actions against individual corporate executives. This year, the first case against brought against a sitting congressman will go to trial. *U.S. v. Jefferson*, Case No. 1:07-cr-00209 (E.D. Va. Filed June 4, 2007).

Like the insider trading area, the new focus on FCPA enforcement is evidenced by aggressive enforcement. Last year, record penalties were imposed in FCPA cases. The payment in the *Baker Hughes* case of $44 million was a record amount paid to resolve a combined SEC/DOJ FCPA case. That case also set another record with the payment of $10 million as a penalty for violating a prior SEC cease-and-desist order — a point which emphasizes the importance of these consent decrees and the need to carefully consider entering into such a settlement. Another record was set in *Vetco International* with the payment of $26 million, the largest payment to resolve a DOJ FCPA case.

Increased emphasis also translates into expansive interpretations of the Act. A key limitation on the anti-bribery provisions, for example, is the requirement that the payment be made to "obtain or retain business" — Congress did not intend to prohibit every payment. Previously, there had been a debate about whether payments related to taxes were within the meaning of that limitation. Two Fifth Circuit decisions have expanded the meaning of that phrase in favor of the government's view that such payments are prohibited. *U.S. v. Kay*, 359 F.3d 738 (5th Cir. 2004); *U.S. v. Kay*, 2007 WL 3088140 (5th Cir. Oct. 24, 2007). *See also In the Matter of Bristow Group, Inc.* Administrative Proceeding File No. 3-12833 (Sept. 26, 2007) (same).

Promotional expenses are also supposed to be exempt from the anti-bribery provisions. Yet, the SEC recently settled a significant case with Lucent Technologies involving such payments. In that case, the SEC concluded that 315 of about 1,000 payments made to Chinese officials in connection with product promotions contained a disproportionate amount of sightseeing, entertainment and leisure. *SEC v. Lucent Technologies, Inc.*, Civil Action No. 07-092301 (D.D.C. Filed Dec. 21, 2007).

Financial Fraud Cases

Financial fraud continues to be a staple of the Enforcement Division. Typical cases from last year included an action against Nortel Networks. In that settled enforcement action, the SEC's complaint alleged improper acceleration of revenue to meet earnings targets and improperly established reserves in 2000, 2001, and 2002. Although the company rendered what the SEC called "substantial cooperation," it paid a $35 million penalty as part of the settlement. *SEC v. Nortel Networks, Corp.*, Civil Action No. 07-CV-8851 (S.D.N.Y. Oct. 15, 2007).

Another example of these cases is the action against Federal Home Loan Mortgage Corporation. There, the company paid a $50 million civil penalty based on claims that it improperly smoothed its earnings curve in 2000-2002. *SEC v. Federal Home Loan Mortgage Corp.*, Case No. 07-cv-1728 (D.D.C. Sept. 27, 2007). The years-old conduct in these cases also illustrates the sometimes slow pace and backward look of enforcement.

The Options Backdating Scandal

The option backdating scandal, which began in the fall of 2005 with a series of academic studies, has spawned dozens of investigations and several enforcement actions by the SEC and DOJ. The key question, however, is the prosecution standards that will be used to resolve the inventory of about 80 open investigations.

The initial cases involved intentional violations of the law in connection with the backdating. *See, e.g.*, *SEC v. Reyes*, No. C 06 84435 CRB (N.D. Cal. July 20, 2006). A case brought in December of last year suggests that the standards may be shifting, however. In *SEC v. Maxim Integrated Products, Inc.*, Civil Action No. C-07-65121 (N.D. Cal Filed Dec. 4, 2007), the SEC alleged that Maxim routinely granted back-dated in-the-money options to its employees. According to the SEC's complaint, Maxim's then-CEO John Gifford directed CFO Carl Jasper to properly account for backdated options. Mr. Jasper did not. Mr. Gifford settled by consenting to a statutory injunction prohibiting future violations of Section 17(a)(3) — a negligence standard — and agreeing to disgorge $652,000, which represented his portion of his bonuses and a civil penalty of $150,000. This represents a significant change in prosecution standards.

The Subprime Crisis

The subprime crisis will be another enforcement priority in coming months. Last spring, the Enforcement Division formed a formed a subprime task force. The task force is apparently focusing on questions relating to securitization, as well as disclosure and valuation issues and sales to investors. The Commission reportedly has 36 open investigations in this area. In addition, the SEC is coordinating with banking regulators and the International Organization of Securities Commissioners ("IOSCO") Subprime Task Force. A key focus of the IOSCO as well as the SEC, will be credit rating agencies and their role in this still-unfolding scandal.

Key Enforcement Policies

Three key enforcement policies concern cooperation, parallel proceedings and corporate penalties. First, cooperation credit — that is, what must be done to cooperate with either the SEC and DOJ to try to avoid or mitigate any prosecution — has been a key topic of concern over the last few years. Many critics claim that the policies of DOJ and SEC have spawned a "culture of waiver," stripping organizations and individuals of key rights. Calls for reform have come from the Congress, which is considering legislation, the American Bar Association, and others.

While DOJ has made some revisions to its policies, the SEC has not. The SEC continues to follow the corporate prosecution and cooperation standards outlined in its 2001 Seaboard Release. Under those policies, a company need not waive privilege to obtain cooperation credit. However, Enforcement Director Thomsen made it clear in a 2007 speech how the policy is administered. In one example cited, the company was not prosecuted; in a second, the company was prosecuted. Both entities cooperated. The first waived privilege. The second did not.

The benefits to cooperation are not uniform, however. Self reporting, cooperating and waiving privilege does not necessarily result in no prosecution. Compare, for example, the result of the SEC's investigation of the *Retirement System of Alabama*, Release No. 574461 (March 6, 2008) (where the SEC concluded that system engaged in insider trading and had inadequate policies, but only filed a Section 21(a) report and did not require disgorgement or any penalty), with *SEC v. Wagner*, Civil Action No 07-22123 (D.D.C. Filed Dec. 7, 2007) (where the former msystems, Ltd. Director self-reported his trading in advance of a merger, but was still required to disgorge his trading profits and pay prejudgment interest). Compare also *SEC v. The BISYS Group, Inc.*, 07 Civ. 4010 (KMK) (S.D.N.Y. May 23, 2007) (where defendant, whose financial results over a three year period were overstated by $180 million, settled for a books and records injunction, disgorgement and prejudgment interest, but no penalty) with *SEC v. Nortel Networks, Corp.*, Civil Action No. 07-CV-8851 (S.D.N.Y. Oct. 15, 2007) (where a company improperly accelerated revenue recognition, but, in a settlement that reflected "significant cooperation," consented to a books and records injunction and still had to pay a civil penalty of $35 million).

A second key policy involves parallel proceedings — an SEC investigation where there is a parallel criminal inquiry. The SEC, as a matter of policy, does not disclose whether it has referred a matter to DOJ, or is even working with criminal prosecutors. Rather, it relies on standard Form 1662, which it furnishes to all witnesses. That multi-page form notes in part that matters may be referred to criminal prosecutors.

The SEC's reliance on Form 1662 was recently approved by the Ninth Circuit Court of Appeals in *U.S. v. Stringer*, No. 06-30100, 2008 WL 901563 (9th Cir. Apr. 4, 2008). There, the court held that as long as SEC and DOJ prosecutors do not make affirmative misrepresentations to witnesses, they are free to work together, conceal the existence of the criminal inquiry to make sure that witnesses and even known targets of the criminal investigation testify fully before SEC investigators and even set up potential witnesses for false statement charges. In view of the increasing criminalization of securities laws cases, counsel will have little choice in view of the SEC's policies in this area to "assume the worst" — that is, that there is criminal inquiry and advise clients accordingly.

A third policy involves corporate penalties. In 2006, the SEC issued a release on this topic, detailing key factors in deciding whether such a penalty should be imposed and if so how much. Last year, SEC Chairman Cox announced a new corporate penalty settlement procedure. Under this policy, the Commission will direct the staff regarding an appropriate corporate penalty prior to negotiations with corporate counsel. Critics argue that the policy undercuts the staff, will further slow the process and impedes meaningful discussions with defense counsel. A review of cases in which corporate penalties have been imposed does not suggest any uniform standards.

Finally, there have been repeated calls for the reform of Enforcement policies. From Congress to a sitting Commissioner, there have been requests for Enforcement to adopt uniform standard procedures like the U.S. Attorney's Office Manual, to revise cooperation policies, to convene a new Wells Commission to review settlement procedures, and to consider other fundamental issues. Unfortunately, these recommendations have gone largely unheeded.

Conclusions

The trends reflected in the SEC's current enforcement program can be expected to continue in the future. Enforcement will continue sometimes to be a "cop on the beat," sometimes to be an archeologist, and sometimes to regulate through litigation. These roles cause enforcers at times to be extremely aggressive, rapidly bringing cases and pushing the edge of the law, such as in the insider trading and FCPA cases; at others to be very slow and backward looking, as in many of the financial fraud cases; and at others to shift standards, such as in some insider trading and option backdating cases.

Moving forward, SEC enforcement can be expected to continue its emphasis on insider trading, the FCPA, financial fraud and to expand into areas related to subprime. A knowledge and understanding of these trends is critical to avoiding entanglement in investigations or enforcement actions and ultimately liability. To avoid or at least minimize liability, issuers and their directors, officers and counsel should carefully review key compliance programs, such as those for insider trading, the FCPA, and fraud detection. Continued employee education in these areas is critical, particularly in view of the comments in the *Lucent* case.

An understanding of these trends is also critical to any person facing an SEC investigation, which presents a series of difficult choices that can have an impact far beyond the immediate investigation. In making those choices, each person should carefully consider, for example, whether cooperation is an appropriate path in view of the inconsistent results it may yield. At the same time, if cooperation is the appropriate choice, a key question involves waiver of privilege. The question of parallel proceedings must also be carefully assessed in making these choices in view of the increasing trend towards criminalization. A parallel criminal inquiry can have a significant impact on the issue of cooperation and the resolution of the matter. In making these choices, it is essential to carefully consider Enforcement Division policies, procedures and trends and their consequences.

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