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SEC Enforcement Trends

2007 NATIONAL DIRECTORS INSTITUTE

SEC ENFORCEMENT TRENDS

Because of its finite manpower, the SEC must carefully choose which cases to bring in order to make the most effective statement of what type of conduct violates the law. Companies, on the other hand, must grapple with a number of questions when confronted with potential problems. Among these are whether to conduct an internal investigation or to hire an outside, independent party and whether to waive privilege by disclosing the details of that investigation to the SEC.

"SEC Enforcement Trends" was a featured breakout session at Foley's sixth annual National Directors Institute program on March 8, 2007 in Chicago. Moderated by Greg Bruch, partner, Foley & Lardner LLP, the panel also featured Merri Jo Gillette, regional director, Securities and Exchange Commission's Midwest Regional Office[*]; David Bloch, principal, Deloitte Financial Advisory Services in the Forensic and Dispute Services Group; and Elizabeth Gray, partner, Foley & Lardner LLP.

Current Statistics

With approximately 3,700 employees nationwide, only 1,100 of whom, professional and non-professional, are in enforcement, the SEC must choose carefully which cases to bring in order to further the goals of the enforcement program, and to maximize the deterrent effect of the program.

While the number of investigations and cases the SEC has brought has decreased somewhat from its high in 2004, the mix of cases has remained constant:

- Market manipulation: 11%
- Insider trading: 20%
- Financial fraud and disclosure: 35%
- Broker dealers: 3%
- Other regulated activities (primarily investment companies and advisors): 10%
- Market fraud: 12%
- Other: 9%

One interesting statistic is the number of cases that are settled at the time of filing. In the current fiscal year (beginning October 1, 2006) 74% of cases were settled at the time of filing; compared to 64% in 2006, 48% in 2005 and 67% in 2004. Criminal indictments have declined since 2004, which was the height of the corporate fraud task force.

Remedies

The stakes have gotten higher for defendants since the Remedies Act of 1990, with which the SEC received authority to impose civil penalties. A company may choose to litigate more in a new area of law, or when potential remedies are expansive and complex. In

[*] Speaking personally, not on behalf of the SEC.

addition to civil penalties, the Commission may order disgorgement and seek an injunction, bar, or suspension.

Before the Sarbanes-Oxley Act (SOX), the largest civil penalty against a company that was not a broker-dealer was $10 million against Xerox, and the next largest was $1 million against Sony Corporation. Because corporate penalties were ultimately paid by shareholders, the SEC was reluctant to impose them and potentially further harm shareholders, who were considered by the Commission to be the victims. The Fair Funds provision of SOX allowed for civil penalties to be paid into a fund for distribution to shareholders. This has resulted in the SEC insisting on significantly larger penalties in settlements: for example, $750 million against WorldCom, $715 million against Adelphia, and $300 million against Time Warner.

When determining whether to settle and pay, for example, a $100 million penalty, a company would want to know the level of certainty of exposure. But recently it has been difficult to get policy statements on remedies from the Commissioners. This has led to uncertainty of whether policies might change, and thus a greater incentive to litigate.

In some areas, such as mutual funds, the remedies could put a fund out of business or end a career. In such a situation, there may be nothing to lose, so a defendant frequently will choose to litigate.

The SEC staff has also increasingly imposed post-judgment remedies, such as monitors, consultants or examiners. A company may get credit for previously taken remedial action, with respect to such post-judgment remedies. If a company has already addressed something on its own, it is less likely that the SEC will impose a more onerous requirement post-judgment. A monitor can be very intrusive and expensive, but also productive. It is a pro-investor, pro-compliance measure that carries no cost to the SEC, but can be expensive to the company.

The SEC prefers to put post-judgment remedies into settlements in administrative proceedings. This is because of the danger that, in a district court action, the defendant could move under Federal Rule of Civil Procedure 60(b) to set aside the order.

Options Backdating

Stock option backdating is an issue that has been in the news recently and the SEC currently has about 140 investigations into stock option backdating. Many more companies have derivative actions filed against them for options backdating issues. It is important to know where in these cases the lines are drawn between opening an investigation, bringing a civil enforcement action, or bringing a criminal case.

When options backdating was first identified as an issue, the SEC staff opened a number of investigations. At that point, the scope of the problem was unclear. Some of these investigations have since been closed with no enforcement action, but many are still open. The Commission has filed five to ten options backdating cases thus far. In determining whether to recommend such an enforcement action, the SEC staff considers the degree of scienter of the individuals involved, the amount of harm, and the personal benefit to those who were directing the activity. The Commission is likely to continue bringing options backdating cases where either conduct was egregious or criminal, or the case involves unique facts that may convey an important message.

Some cases are more attractive to criminal prosecutors than others. First, it is important to note that most company's options backdating problems do not rise to the level of fraud. They are often the result of sloppy administration or record-keeping. While there might be accounting consequences, this is not fraud. On the other hand, the cases in which the U.S. Attorneys are interested are those where "bottom of the V" in-the-money options were granted. In addition, the magnitude of the fraud is important. There are instances in which a smaller company did have fraud in the stock option process, but the amounts were small and the company has since changed managers and taken other steps to prevent it from recurring. These are less likely to result in a criminal prosecution.

Investigations and Cooperation

Options backdating cases have shown that there is tremendous pressure to self-report to the regulators. The McNulty Memorandum, in the criminal context, and the Seaboard Report, in the SEC arena, set out to defendants the benefits of self-reporting. There is pressure to investigate, and of course fix the problem, as well as to cooperate.

There are some factors that the general counsel of a public company should consider in making an assessment of how to investigate a potential problem that may violate securities laws. First, one should briefly discuss with key personnel to make an initial, rapid assessment of the substance of the problem. The next step is often to call outside counsel with expertise in the area of law. The first forty-eight hours after finding the problem are crucial. Some of the benefits of hiring outside counsel to conduct an inquiry are specialized expertise, resources, attorney-client privilege issues, and independence from the company.

Companies must determine whether to conduct an internal or external review. There are benefits to both. The upsides of conducting an internal investigation are cost, control, and containment. An internal investigation keeps costs down, especially because the company can use internal IT and auditors. It can also allow the company to retain greater control of the investigation and to limit the scope. It also allows the company to contain the investigation within its own walls.

On the other hand, there are benefits to retaining outside counsel for the investigation. First, because of outside counsel's independence, the "warts and all" report has more credibility when it is provided to the SEC. Second, independent counsel often will conduct an investigation with a broader scope, looking into issues that an internal review might not. Third, if there is a good tone at the top, the audit committee should want to work with the independent counsel to solve any problems.

Some variables the SEC considers when determining how much credit a company will receive for its cooperation include:

- Nature of the conduct and the level of scienter
- How the conduct arose

- Where in the company it occurred, whether it was isolated or pervasive, if people at high levels were actively involved
- The length of time for which the conduct persisted
- The harm to the public
- The impetus for coming forward
- The investigation conducted by the company
- What remedial steps have already been taken
- Whether the company cooperated throughout the process, or just at the end

While companies still receive credit for self-reporting, this generally does not mean that the self-reporting company will not be sued by the SEC. It may come into play in the determination of how the company will be charged, whether the SEC files a federal court action or a cease-and-desist proceeding, the size or existence of the penalty, and other sanctions.

Beyond self-disclosure, there are many other ways that information can get to the SEC. It may come through the auditors, or through employees posting in chat rooms and blogs. In addition, the SEC has an anonymous hotline and takes complaints through the internet. A company will lose a tremendous amount of credibility if the SEC learns of a violation through an anonymous complaint.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.