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Top Ten SEC Enforcement Developments of 2009

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This article highlights significant developments during 2009 in the enforcement program of the U.S. Securities and Exchange Commission (''SEC''). Developments were selected because they may signal future trends or establish new legal standards.

The Number One enforcement development of 2009 is the continuing fallout from the Bernard Madoff scandal. The revelation that Madoff's fraud had been the subject of several SEC investigations, none of which uncovered Madoff's massive Ponzi scheme, led to questions about the SEC's effectiveness by the media, members of Congress and the SEC's own Inspector General. The SEC responded to these criticisms by making many changes, including changes to the Enforcement Division's leadership, organization and policies and procedures. The remaking of the SEC's Division of Enforcement will undoubtedly be the subject of continuing discussion and debate throughout 2010.

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The Number Two enforcement development of 2009 is the convergence of two developments highlighted in previous years—the SEC's heightened scrutiny of hedge funds and intense focus on insider trading. Between October and December 2009, the SEC charged billionaire hedge fund manager Raj Rajaratnam, Rajaratnam's hedge fund advisory firm, Galleon Management LP, six other hedge funds and trading firms, and 20 other individuals, including executives at public companies, attorneys at prominent law firms, and other individuals with access to inside information, in connection with a massive insider trading scheme that allegedly generated more than $50 million in profits. The SEC's pursuit of insider trading violations was by no means limited to the Galleon matter and, in fact, is the focus of three other developments in this year's Top Ten list.

The remaining Top Ten developments illustrate other significant issues and trends in the SEC enforcement program:

- The Number Three enforcement development of 2009 is the SEC's effort to impose liability on individuals not accused of wrongdoing.
- Number Four is the SEC's assertion of jurisdiction over insider trading in credit default swaps.
- Number Five is the Court's scrutiny of the SEC's proposed settlement of charges against Bank of America in connection with the acquisition of Merrill Lynch.
- Number Six is a pair of cases—with very different outcomes—establishing that a breach of fiduciary duty is unnecessary under the misappropriation theory of insider trading.
- Number Seven is the Fourth Circuit's further dilution of the ''in connection with'' requirement for securities fraud.
- Number Eight is another rejection of the SEC's attempt to hold individuals primarily liable for statements they did not draft and which were not attributed to them.
- Number Nine is the first litigated decision holding that an accountant's negligence may suffice to warrant a suspension of the privilege to practice before the SEC.
- Number Ten is the SEC's continued aggressive pursuit of violators of the Foreign Corrupt Practices Act, including individuals.

1. The Remaking of the SEC's Division of Enforcement Following the Madoff Scandal

The revelation of Madoff's massive Ponzi scheme in December 2008 triggered a chain of events that has revolutionized the SEC's Enforcement Division. This past year has seen the replacement of Director of Enforcement Linda Thomsen with Robert Khuzami, Congressional hearings, an investigation and resulting report by SEC Inspector General David Kotz, and changes to the Enforcement Division's structure, agenda, policies and procedures. In the midst of the SEC's internal upheaval and ongoing external scrutiny and criticism regarding Madoff, allegations that R. Allen Stanford had been conducting an $8 billion investment fraud became public.[1] The SEC's apparent inability to detect and prevent the Madoff and Stanford schemes contributed to an apparent decline in the public's confidence in the agency's ability to police Wall Street and protect investors. According to a poll released in May 2009, the SEC was viewed unfavorably by 55 percent of the respondents – worse even than the Internal Revenue Service.[2]

Within days of the disclosure of the Madoff scheme, on December 16, 2008, then-Chairman Christopher Cox directed Mr. Kotz to conduct a full review of the SEC's inability to uncover Madoff's massive fraud scheme despite numerous tips and reports brought to the attention of SEC Staff.[3] In February, a month after being sworn in as Chairman, Mary Schapiro announced the appointment of Robert Khuzami, a former federal prosecutor, as the new Director of the Division of Enforcement, replacing Linda Thomsen.[4] Thereafter, a flurry of new initiatives, policies, and structural changes were announced and implemented by the SEC. On August 5, 2009, during a speech marking his first 100 days as Director of the Division of Enforcement, Mr. Khuzami outlined five initiatives, which he had already begun to implement, with the goal of revitalizing the Enforcement Division:

- Specialization: Creating the following five specialized units: (1) the Asset Management Unit, (2) the Market Abuse Unit, (3) the Structured and New Products Unit, (4) the Foreign Corrupt Practices Unit and (5) the Municipal Securities and Public Pensions Unit. The staff for each of these units either already will have the requisite expertise or will receive specialized and advanced training.
- Streamlined Management and Internal Processes: Reducing the number of managers, thereby flattening the management structure, to increase the resources dedicated to investigations. The Division also is limiting the use of tolling agreements, which often cause delay, and empowering senior supervisors to approve routine case decisions and to issue formal orders of investigation, which allow Enforcement staff to issue subpoenas.
- Creation of the Office of Market Intelligence: Improving the SEC's handling of tips, complaints, and referrals.
- Fostering Cooperation by Individuals: Mr. Khuzami announced four initiatives to increase incentives to individuals to cooperate in SEC investigations: (1) Creation of a ''Seaboard'' policy for individuals, setting forth standards to evaluate cooperation; (2) expediting the process for submitting immunity requests to the Department of Justice; (3) providing witnesses with early oral assurance as to whether the Division intends to file charges against them; and (4) recommending to the Commission that the SEC enter into deferred prosecution agreements, where appropriate.
- Strategic Use of New Resources: Targeting additional funds allocated to the SEC by Congress to the following areas: (1) adding support personnel to free up investigators for critical front-line work; (2) adding to the ranks of the Trial Unit; (3) introducing technology initiatives; and (4) hiring Chief Operating Officer to manage information technology, oversee project management, and manage the collection and distribution of funds to harmed investors.[5]

On August 31, 2009 the SEC Inspector General submitted his stinging report concerning the SEC's failure to detect Madoff's fraud.[6] The nearly 500-page report

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[1] SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme (SEC Press Release 2009-26), available at http://www.sec.gov/news/press/2009/2009-26.htm. As was the case with Madoff, the disclosure of the Stanford fraud was followed by disturbing allegations that the SEC had missed opportunities to detect the scheme at earlier points in time. *SEC Suspected Stanford Bank as Early as 2005, Documents Show*, Fox Business (July 27, 2009) (available at http://www.foxbusiness.com/story/markets/industries/government/sec-suspected-stanford-bank-early—documents/).

[2] *Beleaguered SEC Seeks Fresh Start in 2010*, Compliance Week (Oct. 13, 2009).

[3] Press Release No. 2008-297 (available at http://www.sec.gov/news/press/2008/2008-297.htm).

[4] *See* SEC Press Release No. 2009-31 (Feb. 19, 2009) (available at http://www.sec.gov/news/press/2009/2009-31.htm).

[5] Robert Khuzami, Director, Division of Enforcement, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009) (available at http://www.sec.gov/news/speech/2009/spch080509rk.htm).

[6] SEC Office of Inspector General, Report No. OIG-509, Investigation of Failure of the SEC To Uncover Bernard Madoff's

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detailed how the SEC missed numerous red flags, including detailed and substantive complaints, which should have led to the exposure of Madoff's scheme. However, the Inspector General found, a ''thorough and competent investigation or examination was never performed.''[7] The report further noted ''systematic breakdowns in the manner in which the SEC conducted its examinations and investigations,'' finding that ''the examinations and investigations . . . were generally conducted by inexperienced personnel, not planned adequately, and were too limited in scope.''[8]

Chairman Schapiro promptly released a statement responding to the Inspector General's report, citing numerous changes that already had been implemented.[9]

Certainly 2010 will be the proving ground for the reinvigorated SEC. If the first few weeks are any indication, the Division of Enforcement is continuing its adoption and implementation of new policies and procedures. On January 13, 2010, the Division of Enforcement announced the adoption of a policy initiative to encourage individuals to cooperate and assist in investigations and also named new specialized unit chiefs and a head of the new Office of Market Intelligence.[10]

2. The SEC's Allegations of a Massive Insider Trading Scheme Orchestrated by High Profile Hedge Fund Managers

On October 16, 2009, the SEC announced a civil action in the U.S. District Court for the Southern District of New York, charging billionaire hedge fund manager Raj Rajaratnam, his hedge fund advisory firm, Galleon Management LP (''Galleon''), and six other individuals with engaging in a massive insider trading scheme that allegedly generated more than $25 million in illicit gains.[11] Less than three weeks later, on November 5, 2009, the SEC filed an amended complaint naming an additional 13 individuals and entities allegedly involved in the insider trading scheme.[12] That same day, the SEC filed a separate complaint against nine defendants, four of whom are also named in the Galleon amended complaint, alleged to be involved in the same insider trading ring, but concerning different public companies.[13] And, on December 10, 2009, the SEC filed yet another complaint against another alleged participant.[14]

In what is the largest insider trading case in decades and the most significant probe of hedge funds in history, the SEC has brought charges against six entities and 21 individuals, including four hedge funds, eight individuals employed by or otherwise associated with those hedge funds, two trading firms, six individuals employed by those trading firms, three executives at public companies, and six other individuals with access to inside information, including three attorneys. These individuals all face criminal charges as well and, as of the date this article went to press, ten have entered guilty pleas and several others are rumored to be in discussions with prosecutors.[15]

The SEC's complaints allege an elaborate ring involving insiders at public companies, lawyers at prominent law firms and other advisors to public companies, and other individuals with access to inside information who passed along such information through a variety of connections (one of whom was referred to as ''Octopussy'' because his tentacles touched so many confidential sources), some even using disposable cell phones.[16] One defendant is even alleged to have attempted to destroy records of telephone phone calls by biting his

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Ponzi Scheme (Aug. 31, 2009) (available at http://www.sec.gov/news/studies/2009/oig-509.pdf).

[7] *Id.* at 21.

[8] *Id.* at 457. The OIG's report also referenced a March 31, 2009 report by the Government Accountability Office (''GAO'') prepared in response to requests by Senators Dodd and Reed of the Senate Banking Committee that the GAO assess the performance of the Division of Enforcement. The GAO report identified numerous areas of concern. According to the GAO report, the SEC under former Chairman Cox instituted certain polices that slowed the pace of enforcement cases and discouraged Enforcement staff from seeking large penalties against companies. The report also quoted an unidentified SEC attorney as stating that it was ''widely felt'' that commissioners prevented the Division from doing its job. In particular, the GAO cited a procedure introduced by Chairman Cox in 2007 that required Enforcement attorneys to seek approval from commissioners before negotiating corporate penalties, which the GAO said led to fewer and smaller corporate fines, reduced incentives for corporations to cooperate with SEC investigations, and generated a backlog of cases. This and other policies introduced during the Cox era ''contributed to an adversarial relationship between enforcement and the commission'' which came to be seen by some Enforcement staff ''as less of an ally in bringing enforcement actions and more of a barrier.'' Government Accountability Office, Report No. 09-358, Securities And Exchange Commission: Greater Attention Needed To Enhance Communication And Utilization Of Resources In The Division Of Enforcement (Mar. 31, 2009). Even before the GAO Report's submission, Chairman Shapiro announced both an end to the ''pre-approval procedure'' for seeking corporate penalties and a revamped procedure to expedite the approval of formal orders of investigation, which authorize the SEC Staff to issue subpoenas. Mary L. Schapiro, Chairman, Address to PLI's ''SEC Speaks in 2009'' (Feb. 4, 2009), available at http://sec.gov/news/speech/2009/spch020609mls.htm. On August 11, 2009, the SEC further expedited the formal order approval process by delegating the authority to approve investigations to the Director of the Division of Enforcement from August 11, 2009 to August 11, 2010. 17 C.F.R. § 200.30-4(a)(13) (2009).

[9] Mary L. Schapiro, Chairman, Statement on the Release of the Executive Summary of the Inspector General's Report Regarding the Bernard Madoff Fraud, (Sept. 2, 2009) (available at http://www.sec.gov/news/speech/2009/spch090209mls-2.htm).

[10] *See* Press Release No. 2010-5 (Jan. 13, 2010) (available at http://www.sec.gov/news/press/2010/2010-5.htm); Press Release No. 2010-6 (Jan. 13, 2010) (available at http://www.sec.gov/news/press/2010/2010-6.htm).

[11] Litigation Rel. No. 21255 (Oct. 16, 2009) (available at http://www.sec.gov/litigation/litreleases/2009/lr21255.htm).

[12] *SEC v. Galleon Mgt., LP, et al.*, Case No. 09 Civ. 8811(JSR), Amended Complaint (available at http://www.sec.gov/litigation/complaints/2009/comp21284.pdf).

[13] *SEC v. Arthur J. Cutillo et al.*, Case No. 09 Civ. 9208, Complaint (available at http://www.sec.gov/litigation/complaints/2009/comp21283.pdf); *see also* Litigation Rel. No. 21283 (Nov. 5, 2009) (available at http://www.sec.gov/litigation/litreleases/2009/lr21283.htm).

[14] *SEC v. Brien P. Santarlas*, Case No. 09 Civ. 10100, Complaint (available at http://www.sec.gov/litigation/complaints/2009/comp21332.pdf).

[15] Zachery Kouwe, *Kurland Pleads Guilty in Galleon Insider Case*, N.Y. Times, Jan. 27, 2010 (available at http://dealbook.blogs.nytimes.com/2010/01/27/kurland-pleads-guilty-in-galleon-insider-case).

[16] Amended Complaint in *SEC v. Galleon Mgt., LP, et al.*, Case No. 09 Civ. 8811(JSR); Complaint in *SEC v. Arthur J. Cutillo et al.*, Case No. 09 Civ. 9208; Complaint in *SEC v. Brien P. Santarlas*, Case No. 09 Civ. 10100.

phone's SIM card with his teeth. Robert S. Khuzami, the SEC's Director of Enforcement, when announcing the expanded charges on November 5, 2009, pointed out that ''if you find yourself chewing the memory card in your cell phone to destroy the record of your misconduct, something has gone terribly wrong with your character.''[17]

In the Galleon amended complaint, the SEC alleged that widespread insider trading took place at four hedge funds – Galleon, New Castle Funds LLC, Spherix Capital LLC, and S2 Capital Management, LP – with access to a variety of sources of insider information including a managing director at Intel Corporation, a director at McKinsey & Co., a senior executive at IBM, an analyst at Moody's, a senior executive at Polycom, Inc., an employee at Market Street Partners, an investor relations consulting firm, an executive at Akamai Technologies, Inc., and an executive at Atheros Communications, Inc.[18] These sources – some, but not all of whom are named as defendants – provided inside information relating to at least 12 public companies and, according to the SEC, the insider trading resulted in more than $33 million in illicit gains.[19]

The separately filed complaint against Arthur J. Cutillo and eight other individuals and entities, four of whom are also named in the Galleon amended complaint, expands the insider trading ring even further.[20] This complaint accuses Cutillo, a lawyer at Ropes & Gray LLP, of misappropriating information regarding four corporate acquisitions involving Ropes & Gray clients in exchange for kickbacks.[21] The complaint also charges another attorney whom Cutillo allegedly used as a conduit for passing the information to defendant Zvi Goffer – the trader known as ''the Octopussy'' – who traded on the information and passed the information to six additional defendants who also traded on the information.[22] According to the SEC, this insider trading resulted in over $20 million in illicit profits.[23] The last complaint, filed on December 10, 2009, charged a second attorney at Ropes & Gray LLP, Brien P. Santarlas, of working with Cutillo and tipping insider information to Goffer.[24]

All of the defendants are charged with insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. In addition, certain of the defendants are charged with violating Section 17(a) of the Securities Act of 1933.

While muted as compared to the vociferous criticism that the SEC faced in connection with the failed Madoff investigations, the fact that the SEC had previously investigated Rajaratnam in connection with insider trading and taken no action has not escaped media comment.[25]

3. The SEC's Effort to Impose Liability on Individuals Not Accused of Wrongdoing

An important development in 2009 was the SEC's use of both the ''claw back'' provision in Section 304 of the Sarbanes-Oxley Act of 2002 and Section 20(a) of the Securities Exchange Act of 1934 to attempt to impose liability on individuals not accused of any actual wrongdoing.

In *SEC v. Jenkins*, the SEC seeks a court order pursuant to Section 304 against Maynard Jenkins, the former chief executive officer of CSK Auto Corp. (''CSK'').[26] The SEC filed a settled action against CSK earlier in 2009 alleging that CSK had improperly accounted for vendor allowances and overstated income over a three-year period.[27] Jenkins, however, is not accused of any wrongdoing in connection with the accounting or financial reporting.[28]

Section 304 – which, until this case, had been used only against individuals alleged to have been personally involved in wrongdoing – 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 law,'' the CEO and chief financial officer must 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 original financial statement.[29] According to the SEC, Jenkins made more than $4 million in bonuses and stock sales that are required to be reimbursed to CSK pursuant to Section 304.[30] Jenkins' motion to dismiss the SEC's complaint remained pending as this article went to press.

The SEC also obtained a ''no fault'' remedy in an action holding ''control persons'' responsible for violations of the Foreign Corrupt Practices Act. As discussed in more detail below, on July 31, 2009, the SEC filed a settled action in the District of Utah against Nature's Sunshine Products (''NSP''), its Chief Operating Officer Douglas Faggioli, and its Chief Financial Officer Craig D. Huff.[31] The SEC alleges that NSP's Brazilian subsidiary made illegal cash payments to customs officials which NSP failed to disclose in its filings with the SEC.[32] The SEC does not allege that Faggioli or Huff took part in, or even knew of, the illegal payments, but because they had ''supervisory responsibilities'' for

[17] Robert Khuzami, Director of Division of Enforcement, Remarks at November 5, 2009 Press Conference (available at http://www.sec.gov/news/speech/2009/spch110509rk.htm).

[18] *SEC v. Galleon Mgt., LP, et al.*, Case No. 09 Civ. 8811(JSR), Amended Complaint, at ¶¶ 1-2, 6-26.

[19] *Id.* at ¶¶ 1-2.

[20] Complaint in *SEC v. Arthur J. Cutillo et al.*, Case No. 09 Civ. 9208.

[21] *Id.* at ¶ 1.

[22] *Id.* at ¶¶ 1-2.

[23] *Id.* at ¶ 1.

[24] Complaint in *SEC v. Brien P. Santarlas*, Case No. 09 Civ. 10100.

[25] *E.g.*, Peter J. Henning, *Did Galleon Fall Through the Cracks Before? N.Y. Times*, Dec. 27, 2009 (available at http://dealbook.blogs.nytimes.com/2009/12/07/did-galleon-fall-through-the-cracks-before).

[26] Litigation Rel. No. 21149A (July 23, 2009) (available at http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm).

[27] *Id.*

[28] *Id.*

[29] 15 U.S.C. § 7243.

[30] Litigation Rel. No. 21149A (July 23, 2009) (available at http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm).

[31] Complaint filed in *SEC v. Nature's Sunshine Prods., Inc.*, No. 09 Civ. 0672 (D. Utah 2009) (available at http://www.sec.gov/litigation/complaints/2009/comp21162.pdf).

[32] *Id.*

making and maintaining NSP's books to accurately reflect its dealings in Brazil, they were charged as control persons under Section 20(a) of the Exchange Act.[33]

4. The SEC's Assertion of Jurisdiction Over Transactions in Credit Default Swaps

In yet another insider trading case brought by the SEC this past year, the SEC asserted jurisdiction over transactions in credit default swaps (''CDSs''). On May 5, 2009, the SEC charged Jon-Paul Rorech and Renato Negrin with violating Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, alleging that Rorech, a bond and CDS salesman employed by Deutsche Bank Securities Inc. (''DBSI'') and Negrin, a portfolio manager with Millennium Partners, L.P. (''Millennium'') engaged in unlawful insider trading in CDSs.[34] The SEC alleged that Rorech, by virtue of his employment at DBSI, learned of confidential information regarding the restructuring of an upcoming bond issuance by VNU N.V., a Dutch media conglomerate and that such information was material to the market price of CDSs that referenced VNU bonds. The SEC further alleged that Rorech provided this information to Negrin who, on behalf of Millennium, placed two orders for VNU CDSs prior to the public announcement regarding the bond issuance. Negrin sold the VNU CDSs after the public announcement at a profit of approximately $1.2 million.

CDSs are not themselves securities. In 2000, when Congress passed the Commodity Futures Modernization Act, also known as the Gramm-Leach-Bliley Act, the SEC was prohibited from regulating the CDS market, except with respect to antifraud enforcement in the case of ''security-based swap agreements.'' Under Section 206B of the Act, a ''security-based swap agreement'' is a contract of which a ''material term'' is based on the ''price, yield, value or volatility of any security, or any group or index of securities, or any interest therein.''[35] The SEC has acknowledged that its case against Rorech and Negrin was its first enforcement action alleging insider trading in CDSs.

Both Rorech and Negrin moved to dismiss the SEC's complaint arguing, among other things, that the SEC lacked subject matter jurisdiction over the VNU CDSs because they are not ''security based swap agreements.''[36] Rorech and Negrin argued that, that the court must only look at the face of the CDS contracts and that, on the face of the VNU CDSs, no material term is based on the price, yield, value, or volatility of the underling VNU bonds.[37]

In an opinion dated December 10, 2009, U.S. District Judge John Koeltl denied defendants' motion to dismiss, stating that ''it cannot be that traders can escape the ambit of § 10(b) and Rule 10b-5 by basing CDS's material term on a security, but simply omitting reference to the security from the text of the CDS contract.''[38] The court acknowledged that, in this case, ''the face of the contracts does not reveal whether a material term of the CDSs was based on a security'' but stated that a material term of the CDSs could nonetheless be based on the underlying bonds.[39] Noting that the CDSs could be bought and sold on the secondary market, the court concluded that ''[t]here is at least an issue of fact whether that price [at which the CDSs are bought or sold] would be based on the value of the underlying bond, for example, if the bond was about to go into default.''[40] The court also acknowledged the SEC's arguments that certain other provisions – including those in an annex agreement between DBSI and Millennium – called for value calculations that relied in part on the value of the underlying bonds.[41] While Rorech and Negrin disputed that the annex was a material term, the court held that ''[t]he scope of the material terms of the CDS contracts and whether they were actually based on securities are questions of facts that cannot be resolved at this stage of the proceeding.''[42]

The court also looked to Congressional intent, stating that, in passing the Commodity Futures Modernization Act, Congress ''made it clear that what was prohibited in trading securities was also prohibited in trading securities-based swap agreements.''[43] Here, the court reasoned that, had the defendants' alleged conduct involved the underlying VNU bonds, rather than the CDSs, the alleged conduct clearly would have constituted insider trading in violation of Section 10(b).[44] This fact, the court concluded, ''appears, at the pleading stage, to bring the CDSs into the heartland of the instruments Congress intended to govern under § 10(b) and Rule 10b-5.[45]

In reaching its conclusion, Judge Koeltl noted that ''[i]n determining whether other novel financial instruments were securities, courts have taken a flexible approach and looked to the 'economic reality' of the instruments and the public's expectations of their nature.''[46]

5. The Rejection of the SEC's Initial Proposed Settlement of Action Against Bank of America

On September 14, 2009, in a blistering opinion, U.S. District Judge Jed S. Rakoff rejected the proposed consent order submitted by the SEC and Bank of America which would have settled the SEC's charges that Bank of America hid from its shareholders the fact that as much as $5.8 billion would be given to executives of Merrill Lynch & Co. (''Merrill'') prior to the closing of the merger between Bank of America and Merrill.[47]

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[33] *Id.*
[34] *See* Complaint in *SEC v. Jon-Paul Rorech & Renato Negrin*, No. 09 Civ. 4329 (available at http://www.sec.gov/litigation/complaints/2009/comp21023.pdf).
[35] Pub. L. No. 106-102, § 206B, 113 Stat. 1138 (Nov. 12, 1999).
[36] *SEC v. Rorech*, No. 09 Civ. 4329, 2009 WL 4729921, at *1 (S.D.N.Y. Dec. 10, 2009).
[37] *Rorech*, 2009 WL 4729921, at *5.
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.* at *6.
[44] *Id.*
[45] *Id.*
[46] *Id.* (citing *Stechler v. Sidley Austin Brown & Wood, L.L.P.*, 382 F. Supp. 2d 580, 596-97 & n. 121 (S.D.N.Y. 2005).
[47] *SEC v. Bank of America Corp.*, 653 F. Supp. 2d 507 (S.D.N.Y. 2009).

Judge Rakoff concluded that the SEC's proposed consent order, providing for a fine of $33 million and an injunction against future false statements in proxy solicitations, was – even applying the "most deferential standard of review" – "neither fair, nor reasonable, nor adequate."[48] The court's primary concern was that the fine would further penalize the victims of Bank of America's alleged misstatements. The court dismissed out of hand the SEC's argument that a corporate penalty would better allow shareholders to assess the quality and performance of management, stating that "[t]his hypothesis . . . makes no sense when applied to the facts here: for the notion that the Bank of America shareholders, having been lied to blatantly in connection with the multi-billion purchase of a huge, nearly-bankrupt company, need to lose another $33 million of their money in order to 'better assess the quality and performance of management' is absurd."[49]

The court also took the SEC to task for failing to pursue a case against any of the individuals responsible for the alleged wrongdoing. Indeed, the court concluded that the consent judgment was not reasonable because it "would effectively close the case with the S.E.C. not adequately accounting for why, in contravention of its own policies . . . it did not pursue charges against either Bank management or the lawyers who allegedly were responsible for the false and misleading proxy statements."[50] In response to the SEC's protestations that its ability to go after executives of Bank of America was impaired because lawyers for Bank of America and Merrill drafted the documents at issue and made the relevant decisions concerning disclosure of the bonuses, the court asked "why are the penalties not sought from the lawyers?"[51] While the SEC argued that its efforts to investigate individuals were stymied by Bank of America's refusal to waive attorney-client privilege, the court accused the SEC of failing to pursue the issue of whether Bank of America's claims that its lawyers made all of the relevant decisions constituted a waiver, or "whether it fit within the crime/fraud exception to the privilege."[52]

Following the issuance of Judge Rakoff's opinion, on December 11, 2009, the SEC's Enforcement Director, Robert Khuzami testified before the House Committee on Oversight and Government Reform that:

> The Commission has been and will continue to be aggressive in bringing actions against individual wrongdoers that violate the securities laws. Moreover, the Commission will continue to vigorously pursue penalties from culpable individuals, including culpable corporate executives. Indeed, the Commission has a strong record of charging and seeking substantial penalties from individual executives in recent cases, and we will continue to do so in the future.[53]

The Director further explained the SEC's rationale for not charging any Bank of America executives or lawyers was based on the investigative record, including the SEC's inability to compel Bank of America to waive attorney-client privilege.[54] He stressed, however, that because the case had proceeded to contested litigation, "we have used the additional discovery available in the litigation to further pursue the facts and determine whether it is appropriate to seek additional charges in this case."[55] These "additional avenues for discovery" included reaching "an agreement with Bank of America on the terms of a court order governing disclosure of information Bank of America previously had withheld on the basis of legal privileges. That order resulted in a broad waiver of the attorney-client privilege on matters relating to the Bank of America case."[56]

While the court's criticisms of the SEC for not pursing the allegedly responsible individuals and instead proposing to punish the shareholders has received considerable press, the opinion is also noteworthy for its discussion of the inadequacy of the proposed injunction. While the proposed injunction, prohibiting Bank of America from issuing false or misleading statements in the future, is typical of the provisions routinely included in SEC settlements, the court described the injunction as "too nebulous to comply with Rule 65(d) of the Federal Rules of Civil Procedure, which requires, among other things, that an injunction 'describe in reasonable detail . . . the act or acts restrained.' "[57] The court did not stop there, however, and stated that the injunction is "pointless" given that Bank of America denies having made a false or misleading statement in the first place.[58] According to the court, such an injunction may be supportable in cases where the respondent neither admits nor denies the allegations, but not in this case, where the Bank has made its position clear (at the court's request) that the proxy statement at issue was in accordance with the law.[59] The court reasoned that "notwithstanding the injunctive relief here sought by the S.E.C., the Bank would feel free to issue exactly the same kind of proxy statement in the future" and therefore, "the broad but vague injunctive relief here sought would be a pointless exercise, since the sanction of contempt may only be imposed for violation of a particularized provision known and reasonably understood by the contemnor, all of which would be lacking here."[60] The court's position calls into question the adequacy of any injunction against future violations consented to *after* litigation has begun and a responsive pleading has been filed.

Also notable are the court's harsh words that seem directed toward the settlement process generally or, even more broadly, the relationship between the SEC and the industry it regulates. For example, the court concluded the substantive portion of its opinion with the following remarks:

> The proposed Consent Judgment in this case suggests a rather cynical relationship between the parties: the S.E.C. gets to claim that it is exposing wrongdoing on the part of the Bank of America in a high-profile merger; the Bank's management gets to claim that they have been coerced into

[48] *Id*. at 509.

[49] *Id*. The court also noted that the amount of the $33 million fine "is a trivial penalty for a false statement that materially infected a multi-billion-dollar merger." *Id*. at 512.

[50] *Id*. at 511.

[51] *Id*. at 509.

[52] *Id*. at 511.

[53] Robert Khuzami, Director of Division of Enforcement, Testimony Concerning Events Surrounding Bank of America's Acquisition of Merrill Lynch (Dec. 12, 2009) (available at http://www.sec.gov/news/testimony/2009/ts121109rk.htm).

[54] *Id*.

[55] *Id*.

[56] *Id*.

[57] 653 F. Supp. 2d at 511.

[58] *Id*.

[59] *Id*.

[60] *Id*.

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> an onerous settlement by overzealous regulators. And all this is done at the expense, not only of the shareholders, but also of the truth.[61]

The SEC and Bank of America have had better luck on their second attempt to settle this proceeding.[62] On February 4, 2010, the SEC announced that it had reached a settlement agreement whereby Bank of America will pay $150 million, to be distributed to Bank of America shareholders harmed by the Bank's alleged disclosure violations.[63] In addition, the proposed settlement requires that Bank of America must for a period of three years: (1) retain an independent auditor to perform an audit of the Bank's internal disclosure controls; (2) have its Chief Executive and Chief Financial Officers certify that they have reviewed all annual and merger proxy statements; (3) retain disclosure counsel who will report to, and advise, the Audit Committee; (4) adopt a ''super-independence'' standard for all members of the Compensation Committee prohibiting them from accepting other compensation from the Bank; (5) maintain a consultant to the Compensation Committee that would also meet super-independence criteria; (6) provide shareholders with an annual non-binding ''say on pay'' as to executive compensation; and (7) implement and maintain incentive compensation principles and procedures and ''prominently publish'' them on the Bank's website.[64]

On February 22, 2010, the court approved the proposed settlement, but not without expressing significant misgivings.[65] In keeping with the court's earlier focus on potential individual liability, the court devoted considerable attention to a civil action brought by the New York Attorney General's Office against Bank of America, its former CEO Kenneth D. Lewis, and its former CFO Joseph L. Price.[66] The court ultimately held that the SEC's conclusion that the Bank and its officers had acted negligently, rather than intentionally, was ''a reasonable conclusion supported by substantial evidence, that a reasonable regulator could draw.''[67] The court, however, continued to express strong reservations about the amount of the fine, describing the $150 million as ''paltry.''[68] The court was also not fully mollified by the method of distributing that money to the aggrieved shareholders, complaining that the effect is ''very modest, amounting perhaps to more than a few pennies per share'' and again pointing out that the Bank's executives are not contributing to the payment.[69] The court ultimately summed up the settlement as ''[w]hile better than nothing, this is half-baked justice at best.'' The court pointed out that, if the court were reviewing the settlement *de novo*, it would reject the settlement as ''inadequate and misguided'' but, in light of the deference that the court is legally required to give the SEC and considerations of judicial restraint, the court would approve the settlement, albeit ''while shaking its head.''[70]

6. Two Cases – With Very Different Outcomes – Establishing That a Breach of Fiduciary Duty Is Unnecessary Under the Misappropriation Theory of Insider Trading

In 2009, two courts ruled that the SEC need not prove a breach of fiduciary duty under the misappropriation theory of insider trading.

The decision by the U.S. District Court for the Northern District of Texas dismissing the SEC's action against Mark Cuban was a loss for the SEC, at least with respect to Mr. Cuban.[71] The SEC's complaint alleged that Cuban sold his entire position, 600,000 shares, or a 6.3 percent stake in Mamma.com, after learning of an impending private investment in public equity (''PIPE'') offering, avoiding losses in excess of $750,000.[72] Cuban had learned of the impending transaction from the CEO of Mamma.com who invited Cuban, then Mamma.com's largest known shareholder, to participate.[73] The SEC alleged that the CEO prefaced his call to Cuban by telling Cuban that the information was confidential and securing Cuban's agreement to keep the information confidential prior to telling him of the PIPE offering.[74] According to the SEC, Cuban reacted angrily to the news and, at the end of the call, stated ''[w]ell, now I'm screwed. I can't sell.''[75]

Cuban argued that the SEC failed to establish liability under the misappropriation theory of insider trading because the SEC had merely alleged that Cuban had agreed to keep the information confidential but not that such agreement arose out of a fiduciary or fiduciary-like relationship.[76] The court rejected Cuban's argument, holding that while the individual trading must be under a legal duty to refrain from trading, such duty need not arise out of a fiduciary or fiduciary-like relationship.[77] Rather, the court held that an agreement imposing duties of non-disclosure and non-use can support liability under the misappropriation theory.[78]

Notwithstanding the court's rejection of this aspect of Cuban's argument, the court concluded that the SEC had failed to adequately allege that Cuban had entered into an agreement sufficient to create a duty of non-disclosure and non-use. The court acknowledged that the SEC had adequately alleged that Cuban entered into

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[61] *Id*. at 512.

[62] The proposed settlement also encompasses a second enforcement action filed against Bank of America accusing the Bank of failing to disclose the extraordinary losses that Merrill sustained in October and November 2008. Litigation Rel. No. 21377 (Jan. 12, 2010) (available at http://www.sec.gov/litigation/litreleases/2010/lr21377.htm).

[63] Litigation Rel. No. 21407 (Feb. 4, 2010) (available at http://www.sec.gov/litigation/litreleases/2010/lr21407.htm).

[64] *Id*.

[65] *SEC v. Bank of America Corp*., 09 Civ. 6829 (JSR) (Opinion, dated Feb. 22, 2010).

[66] Notably, the New York Attorney General's Office filed this civil action against on the same day that the SEC announced it had reached a second settlement agreement with Bank of America. *See* Press Release (available at http://www.ag.ny.gov/media_center/2010/feb/feb04a_10.html).

[67] Opinion, at 8.

[68] *Id*. at 11.

[69] *Id*. at 13.

[70] *Id*. at 15.

[71] *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009).

[72] *Id*. at 717.

[73] *Id*.

[74] *Id*.

[75] *Id*.

[76] *Id*. at 718.

[77] *Id*. at 725-26.

[78] *Id*. at 726.

a confidentiality agreement by virtue of his discussion with Mamma.com's CEO, but found that the SEC had not alleged that Cuban agreed to refrain from trading or otherwise using the information for his own benefit.[79] The court concluded that Cuban's alleged statement that he was ''screwed'' and could not sell his shares ''cannot reasonably be understood as an agreement not to sell'' and the fact that Mamma.com believed that Cuban would not sell was insufficient to create a duty to refrain from selling.[80]

The court granted the SEC leave to amend, but the SEC chose instead to request that the court enter final judgment, enabling the SEC to appeal.[81] The court granted the SEC's request and, on August 13, 2009, modified its opinion to dismiss the SEC's complaint with prejudice.[82] The appeal remains pending before the U.S. Court of Appeals for the Fifth Circuit.[83]

SEC v. Dorozhko held that a breach of a fiduciary duty was not a prerequisite for the misappropriation theory to apply, and netted a much more favorable result for the SEC.[84] In *Dorozhko*, the U.S. Court of Appeals for the Second Circuit upheld the SEC's theory of liability against an individual who allegedly traded on information he obtained by computer hacking.[85] The SEC alleged that Dorozhko was aware that IMS Health, Inc. (''IMS'') was intending to release its third-quarter earnings after the market close on October 17 2007. He then hacked into a secure server and successfully obtained the IMS earnings reports at 2:15 pm on October 17, and began trading on that information at 2:52 pm resulting in an overnight profit of $286,456.59.[86]

The SEC filed an action against Dorozhko within 12 days of the transaction and successfully obtained a temporary restraining order freezing the proceeds of the trading.[87] The district court, however, denied the SEC's motion for a preliminary injunction, holding that computer hacking is not ''deceptive'' within the meaning of Section 10(b) and therefore, the SEC could not establish a likelihood of success on the merits, since a breach of fiduciary duty is required to establish a deceptive device under Section 10(b).[88]

The Second Circuit reversed. As in *Cuban*, the court held that breach of a fiduciary duty is not a required element of an insider trading claim under Section 10(b).[89] Indeed, the court stressed that ''[i]n its ordinary meaning, 'deception' covers a wide spectrum of conduct involving cheating or trading in falsehoods.''[90] The court further opined that ''[i]n our view, misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word.''[91] The court did not, however, conclude that Dorozhko's actions constituted a deceptive act, but remanded that question to the district court.[92]

7. The Fourth Circuit Further Dilutes the ''In Connection With'' Requirement

In *United States Securities and Exchange Commission v. Pirate Investor LLC*,[93] the SEC accused Pirate Investor LLC (''Pirate''), a publisher of investment newsletters and a subscription-based e-mail service called the ''Blast,'' and Frank Porter Stansberry (''Stansberry''), Pirate's editor-in-chief, of violating Section 10(b) and Rule 10b-5 by offering and selling an e-mail stock tip that they knew not to be true.

According to the SEC, in April 2002, Stansberry became aware of a company called USEC, Inc., a provider of uranium-enrichment services.[94] Under a disarmament pact between Russia and the U.S., Russia sells uranium formerly used in nuclear warheads to the U.S. for use as fuel in nuclear power plants.[95] This pact requires that USEC and its Russian counterpart periodically renegotiate the price of uranium.[96] Any new pricing agreement is subject to approval by both the U.S. and Russian governments.[97] A new pricing agreement had been negotiated in February 2002, but had not been approved as of early May 2002, and USEC had requested that the U.S. government place the pricing agreement on the agenda for an summit between Presidents Bush and Putin scheduled for later that month.[98]

Stansberry interviewed USEC's Director of Investor Relations on May 2, 2002.[99] Shortly thereafter, he prepared a promotional email telling investors to ''DOUBLE YOUR MONEY ON MAY 22ND WITH THIS 'SUPER INSIDER' TIP.''[100] This ''Super Insider Tip E-mail'' urged recipients to purchase a report for $1,000, which purportedly contained information from ''a senior company executive'' that would allow investors to know exactly when ''a major international agreement between the United States and Russia'' would be concluded, resulting in substantial profits for a particular U.S. company.[101] Stansberry's email identified May 22 as the day the deal would close and ''inveigled investors with assurances that '[t]his is the kind of insider information that could make you a lot of money.' ''[102]

The report, purchased by 1,217 investors, identified USEC as the company referenced in the ''Super Insider

[79] *Id.* at 728.
[80] *Id.*
[81] *Id.* at 731-32.
[82] *Id.* at 732.
[83] The SEC and Cuban, however, are continuing to do battle in the district court, with Cuban filing a petition for attorneys' fees arguing that the SEC lacked a good faith basis for bringing its action and alleging a wide array of misconduct by the SEC in the course of its investigation. Cautioning that it was not ''sanctioning a 'fishing expedition,' '' the district court issued an opinion allowing Cuban to conduct limited discovery in connection with his attorneys' fees petition. *SEC v. Cuban*, No. 08 Civ. 2050-D, 2009 WL 4544178 (N.D. Tex. Dec. 4, 2009).
[84] *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009).
[85] *Id.*
[86] *Id.* at 44.
[87] *Id.*
[88] *Id.*
[89] *Id.* at 46-50.
[90] *Id.* at 50 (quoting Webster's Int'l Dict. 679 (2d ed. 1934).
[91] *Id.* at 51.
[92] *Id.* The court acknowledged that some computer hacking may not constitute a deceptive action: ''It is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft.'' *Id.*
[93] 580 F.3d 233 (4th Cir. 2009).
[94] *Id.* at 237.
[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] *Id.* at 238.
[101] *Id.*
[102] *Id.*

Tip E-mail,'' provided some financial analysis and background information regarding USEC, and reiterated the email claim that ''[a] USEC senior executive has assured me that the new Russian agreement will be approved prior to the upcoming Bush-Putin summit. In fact, he said 'watch the stock on May 22nd.' ''[103]

In fact, the Director had not told Stansberry that approval of the new pricing agreement would be announced on May 22, 2002 and indeed, approval was not announced on May 22.[104] Rather, approval was not announced until June 19, 2002.[105]

On April 18, 2003, the SEC charged Stansberry, Pirate, and its parent company, Agora, Inc. with securities fraud, and following a bench trial, Stansberry and Pirate were found to have violated Section 10(b).[106] Stansberry and Pirate appealed, arguing that the SEC had not proven that the false statement was made ''in connection with the purchase or sale of securities'' because they had not traded in USEC stock or breached any fiduciary duties.[107]

The Fourth Circuit affirmed, noting that the ''[t]he Supreme Court has consistently embraced an expansive reading of § 10(b)'s 'in connection with' requirement.''[108] The court then outlined four factors to be considered in determining whether the ''in connection with'' requirement has been satisfied: ''(1) whether a securities sales was necessary to the completion of the fraudulent scheme; (2) whether the parties' relationship was such that it would necessarily involve trading in securities; (3) whether the defendant intended to induce a securities transaction; and (4) whether material misrepresentations were 'disseminated to the public in a medium upon which a reasonable investor would rely. . . .''[109] The Fourth Circuit stressed that these factors are not mandatory requirements and are not intended to exclude other relevant factors. Rather, ''[t]he application of the factors should be rooted in the understanding that the 'in connection with' requirement is a flexible one and the questions concerning its scope are best examined on a case-by-case basis.''[110]

As for the first factor, whether a securities sale was necessary, the defendants argued that the alleged fraud was completed when the recipient purchased the report for $1,000 and, therefore, no actual securities sale was necessary to complete the alleged fraud.[111] The court described this argument as ''a rather short-sighted view of the fraudulent scheme'' and pointed out that the defendants marketed the reports in waves and pointed out in later versions of the email that the price of the stock had jumped (due to purchases by earlier recipients of the report).[112] In other words, ''[t]he fraud was not complete when investors paid $1,000 to learn the identify of the company in question; Appellants also needed those investors to purchase the stock thereby increasing the stock price so as to boost the credibility of the solicitation e-mail to obtain more $1,000 payments.''[113]

The court concluded that the second factor – whether the parties' relationship was such that it would necessarily involve trading in securities –weighed in favor of Pirate and Stansberry as there was no trading relationship between the parties, and the decision to purchase securities was made solely by those who received the email and purchased the report.[114]

The court held, on the other hand, that the third factor – whether the defendant intended to induce a securities transaction – weighed against Pirate and Stansberry, particularly given the language of the report which urged investors to ''call your broker now and tell him to buy shares of USEC.''[115]

The court devoted considerable time to its analysis of the fourth factor – whether material misrepresentations were disseminated to the public in a medium upon which a reasonable investor would rely, a standard derived from *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968).[116] Having already concluded that the misrepresentations were material, the court focused on whether reasonable investors would base their investment decisions on ''mass e-mails from a purveyor of internet investment advice.''[117] The court acknowledged that the email in question is not a press release, annual report, or other type of communication typically found to be encompassed by the *Texas Gulf* standard.[118] Indeed, the court stated that ''[a]t first glance, we question whether any reasonable investor would rely on the Super Insider Tip E-mail'' and ''we feel confident that a reasonable investor would not base investment decisions on mass email communications such as these. . . .''[119]

The court nonetheless refused to find that this factor weighed in favor of Pirate and Stansberry, essentially stripping the ''reasonable'' component from the *Texas Gulf* standard. The court reasoned that the Texas Gulf standard ''is about notice'' and ''by requiring that misstatement be communicated in a medium upon which a reasonable investor would rely, the *Texas Gulf* standard protects unknowing speakers from liability and ensures that there is a sufficient nexus between the misrepresentations and the securities sales that they induce . . . .''[120] Here, on the other hand, Pirate and Stansberry specifically targeted investors who trusted internet investment advice and ''should not have been shocked to learn that their fraudulent statements induced securities transaction[s].''[121] Accordingly, the court concluded that a strict application of the *Texas Gulf* standard to exclude these types of communications ''would run contrary to § 10(b)'s core purpose-'to protect inves-

[103] *Id.* at 239.
[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] *Id.* at 244.
[108] *Id.* (quoting *SEC v. Wolfson*, 539 F.3d 1249, 1262 (10th Cir. 2008)).
[109] *Id.* (quoting *Semerenko v. Cendant Corp.*, 223 F.3d 165, 176 (3rd Cir. 2000) (internal citations omitted).
[110] *Id.* at 245.
[111] *Id.* at 245.
[112] *Id.*

[113] *Id.* at 245-46. The court also noted that Stansberry and Pirate also relied on the rise in stock price to not only boost their credibility in connection with this particular scheme, but also result in a general increase in their reputation as ''trusted purveyors of internet investment advice.'' *Id.* at 247.
[114] *Id.*
[115] *Id.* at 248.
[116] *Id.* at 247-51.
[117] *Id.* at 248.
[118] *Id.* at 250.
[119] *Id.*
[120] *Id.* at 250-51.
[121] *Id.* at 251.

tors, to prevent inequitable and unfair practices and to insure fairness in securities transactions generally.' ''[122]

The court ultimately concluded that Pirate and Stansberry's knowledge that they were directing their misstatements to investors who relied on internet investment advice (albeit unreasonably) supports a finding that the misstatement occurred 'in connection with' securities transactions.[123] The court concluded that the absence of a trading relationship did not preclude the Section 10(b) claim.[124]

8. A District Court's Rejection of the SEC's Attempt to Hold Individuals Primarily Liable for Statements They Did Not Draft and Which Were Not Attributed to Them

In *SEC v. Lucent Technologies*, 610 F. Supp. 2d 342 (D.N.J. 2009), the SEC alleged that the four individual defendants created misleading financial statements by authorizing or approving verbal side agreements, which caused the company to materially overstate its pre-tax income.[125] Specifically, the SEC alleged that two of the defendants made verbal side agreements and hid these facts from the company's accounting department, while another defendant signed a management representation letter acknowledging her responsibility for fair representation in the financial statements in accordance with GAAP, while falsely stating that she was unaware of any verbal side agreements.[126] A fourth defendant was alleged to have known about the verbal side agreements and failed to disclose their existence. The SEC acknowledged that the defendants did not draft or sign any of the company's financial reports filed with the SEC, and that these reports did not contain any statements attributed to them.

In rejecting the SEC's primary liability claims, the court adopted the ''bright line'' standard as applied by the Second and Eleventh Circuits.[127] The ''bright line'' standard requires that, in order to be held primarily liable, a person must actually make the material misstatement or omission and that misrepresentation must be attributed to the person at the time of public dissemination.[128] The court found that the ''bright line'' test was more consistent with the statutory language of Section 10(b) and the U.S. Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 114 S. Ct. 1439 (1994) in that it sufficiently distinguished primary liability from the test for secondary or aiding and abetting liability.[129]

The SEC sought leave to file an interlocutory appeal of the court's summary judgment ruling arguing that immediate review was necessary to avoid prejudice to SEC actions before other courts in which defendants have been citing the summary judgment ruling.[130] This request was denied, but the SEC's position demonstrates the SEC's commitment to continue to attempt to expand the scope of primary liability for financial fraud claims.[131]

9. The First Litigated Decision Holding That Negligence May Warrant a Suspension of an Accountant's Privilege to Practice Before the SEC

In *Dearlove v. SEC*,[132] the D.C. Circuit issued the first litigated decision upholding a sanction against an accountant for negligent conduct in connection with an audit. In stark contrast to its decision 12 years ago in *Checkosky v. SEC*,[133] the court accorded significant deference to the SEC's determination of what constitutes negligence, and how that determination is made under Commission Rule of Practice 102(e).

Rule 102(e) allows the SEC to suspend or disbar accountants from practicing before the SEC if they are found to have engaged in unethical or improper professional conduct.[134] In *Checkosky*, the court dismissed a Rule 102(e) action against an accountant ''[b]ecause it was unclear whether simple negligence could support a violation of Rule 102(e) and, considering the SEC's 'failure to articulate a discernable standard,' we instructed the Commission to dismiss the proceedings under review.''[135] The SEC, however, amended Rule 102(e) and set forth the following three types of ''improper professional conduct'' for accountants: (1) ''Intentional or knowing conduct, including reckless conduct, that results in violation of applicable professional standards;'' (2) ''A single instance of highly unreasonable conduct that results in a violation of applicable professional standards;'' and (3) ''Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.''

The administrative law judge held that Dearlove, a Deloitte & Touche auditor who served as the engagement partner in charge of the 2000 audit of Adelphia Communications Corporation (''Adelphia''), engaged in a single instance of highly unreasonable conduct as well as repeated instances of unreasonable conduct.[136] Upon review of the initial decision, the SEC concluded that Dearlove had only engaged in repeated instances of unreasonable conduct.[137]

Dearlove appealed, arguing that the SEC failed to establish that he had violated the common law negligence standard of care as evidenced by expert testimony.[138] Pointing to the text of Rule 102(e)(1)(iv)(B)(2), Dear-

[122] *Id.* (quoting 3 Fletcher Cyc. Corp. § 900.65 (perm. ed. 2002).
[123] *Id.*
[124] *Id.* at 252. The court also rejected arguments the its treatment of the ''in connection with'' requirement raised First Amendment issues. *Id.* at 252-54.
[125] *SEC v. Lucent Tech.*, 610 F. Supp. 2d 342, 345 (D.N.J. 2009).
[126] *Id.* at 345-48.
[127] *Id.* at 353.
[128] *Id.*; *See also S.E.C. v. Lucent Tech., Inc. (''Lucent I '')*, 363 F. Supp. 2d 708, 719-24 (D.N.J. 2005).
[129] *Id.*
[130] *SEC v. Lucent Tech.*, No. 23315, 2009 WL 4508553 *4-5 (D.N.J. Nov. 16, 2009).
[131] *Id.* at *10.
[132] 573 F.3d 801 (D.C. Cir. 2009).
[133] 139 F.3d 221 (D.C. Cir. 1998).
[134] 17 C.F.R. § 201.102(e)(1)(ii).
[135] *Dearlove*, 573 F.3d at 805 (quoting *Checkosky*, 139 F.3d at 227).
[136] 573 F.3d at 803.
[137] *Id.*
[138] *Id.* at 804.

love argued that the SEC had to prove that not only did he violate applicable professional standards (i.e., GAAS or GAAP), but that his conduct was ''unreasonable.''[139] The court rejected Dearlove's argument, finding that:

> All violations of the Rule, whether by intentional, knowing, highly unreasonable, or merely unreasonable conduct, are also violations of the GAAS; the term ''unreasonable'' as used in the Rule only serves to distinguish among degrees of deviation. Therefore, the SEC need not establish a standard of care separate from the GAAS in order to give meaning to Rule 102(e)(1)(iv)(B)(2).[140]

This language strongly suggests that the SEC need only point to any GAAS or GAAP violation – even a very minor violation or a violation that is the result of a reasonable, but incorrect, interpretation of GAAS or GAAP – in order to establish unreasonable conduct under Rule 102(e).

The court attempted to avoid this result, stating that Rule 102(e) ''requires the SEC to engage in an objective inquiry whether Dearlove's conduct was unreasonable in the specific factual circumstances at issue.''[141] According to the court, in the course of making this ''objective inquiry,'' the SEC may weigh evidence and ''determine, *in its own expert view*, whether the conduct at issue was unreasonable.''[142] In this case, the court accorded substantial deference to the SEC's ''expert'' determination that Dearlove's approval of Adelphia's practice of netting accounts receivable and payables from related entities was unreasonable – a determination made *before* the SEC examined the applicable professional standards.[143] In other words, the Court concluded that the SEC may determine whether conduct is unreasonable, not based on the applicable professional standards or any common law standard of care, but based on the SEC's own ''expert'' and ''objective'' opinion.[144]

The Court's deference to the SEC did not stop at its review of the SEC's substantive evaluation of respondent's conduct. Dearlove also argued that he was denied due process by the administrative law judge's refusal to grant a 60-day extension, resulting in Dearlove having only four months to review the investigative record compiled by the SEC over several years, and to prepare for a hearing.[145] The court rejected this argument emphasizing ''the broad discretion the agency has in ordering the conduct of its proceedings. . . .''[146]

10. The SEC's Continued Aggressive Pursuit of Violators of the Foreign Corrupt Practices Act, Including Individuals

The SEC and U.S. Department of Justice (''DOJ'') continued to pursue aggressively violators of the Foreign Corrupt Practices Act (''FCPA'') throughout 2009. In August 2009, Robert Khuzami, Director of the Division of Enforcement, announced plans to create a specialized FCPA unit that ''will focus on new and proactive approaches to identifying violations of the Foreign Corrupt Practice Act. . . .''[147] Mr. Khuzami also noted that while the SEC has been ''active in this area, more needs to be done, including being more proactive in investigations, working more closely with our foreign counterparts, and taking a more global approach to these violations.''[148]

One way in which the SEC has been active in this area is through the filing of actions against individual corporate officers. For example, in December 2009, the SEC filed a complaint against Pride International, Inc.'s FCPA compliance officer. The SEC alleged that Bobby Benton, a vice president responsible for ensuring that the company ''conducted its Western Hemisphere operations in compliance with the FCPA,'' authorized payments to third parties believing that they would be given to Venezuelan and Mexican officials in exchange for favorable treatment and signed false certifications in connection with the company's annual reports.[149] Benton was charged with violating the FCPA's anti-bribery laws, falsifying books and records, making false representations to accountants, aiding and abetting violations of the anti-bribery statute, and the falsification of books and records.

The SEC has also pursued enforcement against other corporate officers with supervisory responsibilities, but with no direct involvement or knowledge of the alleged misconduct. As noted above, on July 31, 2009, the SEC filed a settled complaint in the District of Utah against Nature's Sunshine Products (''NSP''), its Chief Operating Officer, Douglas Faggioli, and its Chief Financial Officer, Craig D. Huff.[150] NSP manufactures nutritional and personal care products and markets its products worldwide, with Brazil being its largest foreign market.[151] When Brazil reclassified certain vitamins and other NSP products, requiring them to be registered as medicines, NSP's Brazilian subsidiary was unable to register all of the reclassified products as medicines.[152] Thus, the SEC alleged, the Brazilian subsidiary ''made undocumented cash payments to Brazilian customs brokers, some of which were later paid to Brazilian customs officials to allow unregistered products to be imported then sold in Brazil.''[153] The SEC further alleged that NSP failed to disclose those payments in its filings with the SEC.[154]

The SEC claimed that Faggioli and Huff had ''supervisory responsibilities'' for making and maintaining NSP's books to accurately reflect its dealings in Brazil. The SEC did not allege that they took part in, *or even*

[139] *Id.* at 805.
[140] *Id.*
[141] *Id.*
[142] *Id.* at 805-06 (emphasis added).
[143] *Id.* at 806-07.
[144] Indeed, given that the question of reasonableness is to be made before consideration of the applicable standards, it appears that the SEC could conclude that an audit that complies with GAAS and GAAP in every way could still be found to be unreasonable (albeit not a violation of Rule 102(e)).
[145] *Id.* at 807.
[146] *Id.*

[147] Robert Khuzami, Director of Division of Enforcement, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009) (available at http://www.sec.gov/news/speech/2009/spch080509rk.htm).
[148] *Id.*
[149] http://www.sec.gov/litigation/complaints/2009/comp21335.pdf.
[150] *SEC v. Nature's Sunshine Prods., Inc.*, No. 09 Civ. 0672 (D. Utah 2009). Complaint available at http://www.sec.gov/litigation/complaints/2009/comp21162.pdf.
[151] *Id.*
[152] *Id.*
[153] *Id.*
[154] *Id.*

knew of, NSP's illegal payments, but were charged as ''control persons'' pursuant to Section 20(a) of the Exchange Act.[155] NSP, Faggioli and Huff all consented to the entry of final judgment against them, with NSP paying a civil penalty of $600,000 and the two officers paying a civil penalty of $25,000 each.[156]

The SEC did not allege that Faggioli and Huff had any knowledge of the illegal activities. While the SEC has previously used control person liability to hold company officers accountable, the NSP case represented the first attempt to impose control person liability in the FCPA context. Corporate officials with supervisory responsibility will need to be vigilant in enforcing compliance with the FCPA, or face personal exposure.

Another FCPA-related development last year was the increase in overseas enforcement of anti-corruption laws. The United Kingdom's Serious Fraud Office (''SFO'') brought its first action for overseas corruption against a company, Mabey & Johnson Ltd.[157] The company pled guilty to influencing ''decision-makers in public contracts in Jamaica and Ghana'' and for breaching UN sanctions in connection with the Iraqi ''Oil-for-food'' program and agreed to pay over £ 6 million in fines and reparations. The UK is also considering a new Bribery Bill, which the SFO will enforce if it passes.[158]

Enforcement of anti-bribery statutes by foreign jurisdictions presents a new set of issues for companies considering voluntarily disclosing violations of the FCPA. The SFO requires simultaneous voluntary disclosure of corruption with foreign jurisdictions. Indeed, the SFO has stated that if ''the case is also within our jurisdiction we would expect to be notified at the same time as the DOJ.''[159] Simultaneous disclosure to both the DOJ and the SFO (or other foreign enforcement agencies) may subject a party to liability in multiple jurisdictions without the assurance that those governments will cooperate in formulating a comprehensive settlement.

[155] *Id.*

[156] Litigation Rel. No. 21162 (July 31, 2009) (available at http://www.sec.gov/litigation/litreleases/2009/lr21162.htm).

[157] http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2009/mabey—johnson-ltd-sentencing-.aspx.

[158] http://www.justice.gov.uk/publications/bribery-bill.htm.

[159] Approach of the Serious Fraud Office in Dealing with Overseas Corruption (available at http://www.sfo.gov.uk/media/28313/approach%20of%20the%20sfo%20to%20dealing%20with%20overseas%20corruption.pdf).

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