Top Ten SEC Enforcement Developments of 2011

*By Marc Dorfman and Ellen Wheeler**

This article highlights significant developments during 2011 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.

In November 2011, the SEC announced that it had filed a "record" 735 enforcement actions in the fiscal year ending September 30.[1] In a reversal of trends in recent years, there was not a significant increase in the number of insider trading cases initiated by the SEC (57 in 2011 vs. 54 in 2010) and there was a significant decrease in the number of "Ponzi" scheme cases. The most significant increase was a 30 percent increase in the number of actions involving investment advisors and broker-dealers (146 in 2011 vs. 112 in 2010), including several of the enforcement developments highlighted below. All indications are that the SEC plans to continue to increase the level of enforcement activity in 2012.[2]

The Number One enforcement development of 2011 is the increasing scrutiny by courts of settlements negotiated between the SEC and defendants. Pursuant to long-standing practice, the SEC routinely permits defendants to agree to the entry of consent judgments "without admitting or denying" the underlying factual allegations. As we prepare this article for publication, the U.S. Court of Appeals for the Second Circuit is considering an appeal by the SEC from a decision issued by U.S. District Court Judge Jed S. Rakoff rejecting a settlement negotiated by the SEC with Citigroup Capital Markets as "neither reasonable, nor fair, nor adequate, nor in the public interest" because it "asks the Court to impose substantial injunctive relief, enforced by the Court's own contempt power, on the basis of allegations unsupported by any proven or acknowledged facts whatsoever . . ..."[3] The SEC has asked the Second Circuit to reject Judge Rakoff's approach, but if its appeal is unsuccessful, the SEC will have little choice but to revisit its practices in negotiating settlements. Indeed, on January 6, 2012, the SEC announced that it would no longer ac-

---

*Marc Dorfman and Ellen Wheeler, partners at Foley & Lardner LLP, are members of the firm's Securities Enforcement & Litigation Practice Group. Foley & Lardner LLP represents parties who are the subject of SEC enforcement inquiries and actions, including in cases discussed in this article.

cept "without admitting or denying" settlements from parties who had agreed to plead guilty in parallel criminal proceedings, a fairly minor change in the SEC's settlement practices.[4]

The Number Two enforcement development of 2011 is the U.S. Supreme Court's narrowing of what it means to "make" a statement for purposes of Rule 10b-5. In *Janus Capital Group v. First Derivative Traders*, the Court held that the maker of a statement is the person or entity with "ultimate authority" over the statement, "including its content and whether and how to communicate it."[5] The Court explained its ruling as being "best exemplified" by the distinction between the person drafting a speech and the speaker, as only the speaker has "entire control" over what is said. The *Janus* decision, while itself the outcome of private civil litigation, has already been applied in several litigated SEC enforcement actions.

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

- The Number Three enforcement development of 2011 is the SEC's first ever use of a deferred prosecution agreement in an FCPA case, in a year that also saw more individuals named and more unsettled FCPA cases filed.
- Number Four is the SEC's filing of unsettled complaints against the former officers of Fannie Mae and Freddie Mac.
- Number Five is the SEC's stepped up criticism and increased willingness to bring actions against attorneys appearing before the agency.
- Number Six is the SEC's aberrational performance inquiry resulting in multiple actions against investment advisory firms and individuals.
- Number Seven is the SEC's filing of several enforcement proceedings against quant traders.
- Number Eight is the SEC's "enhanced oversight" of FINRA and SROs.
- Number Nine is the SEC's continued pursuit of insider trading cases.
- Number Ten is the SEC's increased scrutiny of the conduct of chief compliance officers.

1. Increased Scrutiny by the Courts of SEC Settlements

On March 21, 2011, the Honorable Jed S. Rakoff of the U.S. District Court for the Southern District of New York approved consent judgments against three defendants in *SEC v. Vitesse Semiconductor Corporation*.[6] Judge Rakoff, however, complained that the SEC was "confident that the courts in this judicial district were no more than rubber stamps" and had filed the consent judgments "without so much as a word of explanation as to why the Court should approve these Consent Judgments or how the Consent Judgments met the legal standards the Court is required to apply before granting such approval."[7] Judge Rakoff, however, after conducting a hearing and receiving written submissions from the parties, found "the financial and injunctive terms of the settlements to be fair, reasonable, adequate, and in the public interest."[8] Despite this finding, Judge Rakoff expressed concern regarding the SEC's practice of requesting court approval of settlements in which the defendants do not admit or deny the allegations of the complaint. Judge Rakoff explained:

> The result is a stew of confusion and hypocrisy unworthy of such a proud agency as the S.E.C. The defendant is free to proclaim that he has never remotely admitted the terrible wrongs alleged by the S.E.C.; but, by gosh, he had better be careful not to deny them either (though, as one would expect, his supporters feel no such compunction). Only one thing is left certain: the public will never know whether the S.E.C.'s charges are true, at least not in a way that they can take as established by these proceedings.[9]

Notwithstanding this concern, Judge Rakoff approved the consent judgments, noting that the two individual defendants had already admitted their guilt in parallel criminal proceedings and that the third defendant, the company, had agreed to such a significant penalty that "[n]o reasonable observer of these events could doubt that the company has effectively admitted the allegations of the complaint in the way that, for a company, is particularly appropriate: by letting its money do the talking."[10] Judge Rakoff cautioned that this case presented "unusual circumstances" and that the court was "reserving for the future substantial questions of whether the Court can approve other settlements that involve the practice of 'neither admitting nor denying' . . ..."[11]

The "future" turned out to be only eight months away. In a scathing opinion issued on November 28, 2011, Judge Rakoff rejected a proposed settlement between the SEC and Citigroup Global Markets Inc. ("Citigroup").[12]

On October 19, 2011, the SEC filed a complaint against Citigroup alleging that Citigroup, recognizing that the market for mortgage-backed securities was weakening, created a billion-dollar fund where it dumped "dubious assets" and which it marketed to investors as "attractive investments rigorously selected by an independent investment advisor."[13] According to the SEC, Citigroup realized net profits of approximately $160 million, while its investors lost more than $700 million. At the same time the SEC filed the complaint, the SEC also submitted a consent judgment which contained (1) a permanent injunction enjoining Citigroup from engaging in future violations of Sections 17(a)(2) and (3) of the Securities Act, (2) a requirement that

Citigroup disgorge its $160 million in profits plus $30 million in interest, (3) a $95 million civil penalty, and (4) a number of undertakings on the part of Citigroup regarding its internal processes. Citigroup consented to the entry of the order without admitting or denying the allegations of the SEC's complaint.

While acknowledging that the SEC is due "substantial deference," Judge Rakoff took issue with virtually every aspect of the proposed settlement and the settlement process itself, including the following:

- The SEC's decision to pursue non-scienter-based claims against Citigroup when it was simultaneously pursuing a scienter-based claim against a Citibank employee;[14]
- The SEC's decision to charge a "very modest penalty" of $95 million, which Judge Rakoff characterized as "pocket change" to any entity as large as Citigroup, and the fact this penalty is so much less than the $535 million penalty in last year's consent judgment between the SEC and Goldman Sachs;[15]
- The SEC's decision to seek injunctive relief that a "recidivist" company such as Citigroup knows the SEC has not in the past enforced;[16] and
- The impact, or lack thereof, of the proposed settlement on aggrieved investors given that the investors cannot rely on the consent judgment and that the SEC has not committed to return any of the penalty or disgorgement amounts to the investors.[17]

Indeed, Judge Rakoff questioned "what the S.E.C. is getting from this settlement other than a quick headline."[18] The most potentially far-reaching of Judge Rakoff's critiques, however — and the one that drove his decision to reject the proposed settlement — is the one foreshadowed by his earlier decision in *SEC v. Vitesse*. Judge Rakoff complained that the SEC's "long-standing policy — hallowed by history, but not by reason — of allowing defendants to enter into Consent Judgments without admitting or denying the underlying allegations, deprives the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any real basis in fact."[19] Judge Rakoff concluded that the proposed consent judgment is "neither reasonable, nor fair, nor adequate, nor in the public interest" because it "asks the Court to impose substantial injunctive relief, enforced by the Court's own contempt power, on the basis of allegations unsupported by any proven or acknowledged facts whatsoever . . .."[20]

The SEC promptly appealed Judge Rakoff's decision, and also issued a public statement criticizing the opinion. In a December 15 press release, the Director of the Division of Enforcement, Robert Khuzami, stated that the SEC believes the district court "committed legal error by announcing a new and unprecedented standard that inadvertently harms investors by depriving them of substantial, certain and immediate benefits."[21] Mr. Khuzami warned that such a standard "could in practical terms press the SEC to trial in many more instances, likely resulting in fewer cases overall and less money being returned to investors."

On December 28, 2011, without discussing the merits, the Second Circuit granted the SEC's emergency motion to stay further proceedings in its case against Citigroup pending its appeal. Judge Rakoff had denied the SEC's request a day earlier, characterizing the SEC's appeal as having "no basis."[22] The emergency motion is scheduled to be submitted to the Second Circuit's motions panel on January 17, 2012, but there has been no indication when the motions panel will rule or whether the Second Circuit will consider the merits of the SEC's appeal either as an interlocutory appeal or as a writ of mandamus.

It is an open question to what extent Judge Rakoff's reasoning will be approved by the Second Circuit or adopted by other courts. At least one court, however, has already relied on Judge Rakoff's Citigroup opinion in raising concerns regarding a proposed settlement. In SEC v. Koss Corp., Judge Rudolph T. Randa of the Eastern District of Wisconsin sent a letter, dated December 20, 2011, to the SEC requesting, among other things, that the SEC "provide a written factual predicate for why it believes the Court should find that the proposed final judgments are fair, reasonable, adequate, and in the public interest."[23]

It is also an open question whether the standard set by Judge Rakoff will in fact "press the SEC to trial in many more instances." It seems likely that the SEC will increasingly bring settled actions as administrative proceedings, taking advantage of Dodd-Frank's expansion of the sanctions available in administrative proceedings to include civil penalties. Indeed, the SEC appears to be already bringing more administrative actions (including settled actions) following the enactment of Dodd-Frank. In the six months ending September 30, 2011, the Division brought 116 new matters before administrative law judges as opposed to 82 in the prior six months.[24] Of the 112 dispositions by administrative law judges in the six months ending September 30, 2011, 92 are classified as "other dispositions (*e.g.*, settlements, defaults)." The prior six months only saw 64 "other dispositions." Judge Rakoff's decision suggests that this trend will likely continue.

On January 6, 2012, in a development which the SEC maintained was "unrelated" to the pending appeal from Judge Rakoff's decision, the SEC announced a minor change in its policies and practices in negotiating settlements: future defendants who have already admitted their guilt in parallel criminal proceedings will no longer be permitted to enter into "without admitting or denying" settlements with the SEC.[25] While the SEC has thus resolved some of the issues Judge Rakoff raised in *Vitesse*, the controversy over the broader use of "without admitting or denying" settlements continues.

2. The Supreme Court's Narrowing of What It Means to "Make" a Statement for Purposes of Rule 10b-5.

In *Janus Capital Group, Inc. v. First Derivative Traders*, the U.S. Supreme Court limited the scope of what it means to "make" a statement for purposes of Rule 10b-5, holding that the maker of a statement is the person or entity with "ultimate authority" over the statement:

> For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed. This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit—or blame—for what is ultimately said.[26]

As such, the Supreme Court concluded that Janus Capital Management LLC, a mutual fund investment advisor and administrator, was not the maker of statements made in the prospectuses of the managed fund, Janus Investment Fund.[27]

In the months following *Janus*, a number of courts have dismissed Rule 10b-5(b) claims brought by civil plaintiffs, finding that the plaintiffs had failed to meet the standard set by *Janus*.[28] In SEC actions, however, the majority of courts have thus far rejected *Janus*-based arguments. For example, in *SEC v. Carter*, the district court rejected the defendant CEO's argument that he was not the maker of several press releases, finding that "[b]ecause the amended complaint states that defendant, in his capacity as CEO, approved the releases before they were made available to the public, plaintiff has sufficiently alleged that defendant had ultimate authority for the statements and 'made' them for the purposes of *Janus*."[29] In *SEC v. Mercury Interactive, LLC*, the district court denied the defendant's motion for reconsideration, finding that allegations that the defendant signed the proxy statements were sufficient to survive a motion to dismiss (although the court agreed that allegations regarding the defendant's involvement in preparing annual and quarterly reports were insufficient to state a Rule 10b-5(b) claim).[30] The court noted that the SEC had alleged facts sufficient to state a "viable scheme liability claim under Rule 10b-5(a) and (c)."[31] In *SEC v. Das*, the district court rejected the argument of two former chief financial officers that their former employer was the sole maker of any misstatements in various public filings.[32] The court found that "[a]s the CFOs who signed and certified the statements, [the defendants] were the persons with ultimate authority and control over the content of the statements and whether and how they were communications."[33] In *SEC v. Boock*, the court refused to reconsider its partial denial of summary judgment, noting that its prior ruling found that the defendant was a direct participant in a fraudulent scheme under Rule 10b-5(a) and (c), not Rule 10b-5(b).[34] In *SEC v. Landberg*, the court denied the defendant's motion to dismiss on *Janus* grounds, finding that (1) the SEC had plausibly alleged a Rule 10b-5(a) and (c) claim and (2) the SEC had alleged circumstances such that a reasonable fact finder could conclude that the defendant was the maker of the alleged fraudulent statements.[35]

In *SEC v. Kelly*, however, the court granted the defendants' motions for judgment on the pleadings on *Janus* grounds.[36] In that case, the SEC conceded that its Rule 10b-5(b) claims were foreclosed by *Janus*, but argued that *Janus* did not affects its ability to assert a "scheme liability" claim under Rule 10b-5(a) and (c).[37] The district court agreed that the Supreme Court did not address "scheme liability," but noted that "where the primary purpose and effect of a purported scheme is to make a public misrepresentation or omission, courts have routinely rejected the SEC's attempt to bypass the elements necessary to impose 'misstatement' liability under subsection (b) by labeling the alleged misconduct a 'scheme' rather than a 'misstatement.' "[38] The court found that the SEC's "scheme liability" claim was in fact premised on a misrepresentation and therefore barred by *Janus*.[39] The court further held that the SEC's claim under Section 17(a) of the Securities Act was also barred because, while the language of Section 17(a) and Rule 10b-5(b) is not identical, "both provisions have the same functional meaning" and "it would be inconsistent for *Janus* to require that a defendant have made the misleading statement to be liable under subsection (b) of Rule 10b-5, but not under subsection (2) of Section 17(a)."[40]

Additionally, SEC Chief Administrative Law Judge Brenda Murray, in an initial decision issued October 28, 2011, adopted the reasoning in *Kelly* and applied *Janus* to an SEC enforcement proceeding alleging violations of Section 17(a) and Rule 10b-5.[41] Judge Murray dismissed the claims finding that neither respondent was responsible for or had ultimate authority over the alleged misstatements.

3. The SEC's First Ever Use of a Deferred Prosecution Agreement in an FCPA Case, in a Year That Also Saw More Individuals Named and More Unsettled FCPA Cases Filed

The SEC filed 16 enforcement actions asserting violations of the Foreign Corrupt Practices Act (FCPA) in 2011. Although this number is significantly less than the 22 actions filed in 2010, last year's total included seven actions arising out of the same alleged conduct. In fact, this past year saw significantly more individuals charged and a related increase in the willingness of the SEC to file unsettled actions. This past year also saw fewer actions with headline-grabbing penalties.

In 2010, the SEC charged six individuals with FCPA violations. That number doubled in 2011, although a large part of the increase is attributable to the action the SEC filed against seven former Siemens executives (Siemens itself was charged in 2008).[42] Notably, six of those seven individuals charged have not agreed to settle the charges filed by the SEC.

The SEC also filed an unsettled action against three former top executives with Magyar Telekom Plc. ("Magyar"), the largest telecom provider in Hungary.[43] The SEC filed a settled action against Magyar itself and its parent company, Deutsche Telekom AG. The SEC accused the three former executives of bribing government and political party officials in Macedonia and Montenegro to prevent competition and win business.

Magyar agreed to pay $31.2 million in disgorgement and prejudgment interest to the SEC. In connection with a parallel Department of Justice investigation, Magyar also agreed to pay a criminal penalty of $59.6 million and its parent company agreed to pay criminal penalty of $4.36 million. This settlement involved the second largest non-criminal penalty in 2011. The largest non-criminal penalty was assessed against Johnson and Johnson, who was charged with paying bribes and kickbacks to doctors in Europe and Iraq to obtain contracts.[44] Johnson and Johnson agreed to pay approximately $48.6 million in disgorgement and prejudgment interest. Johnson and Johnson also agreed to pay a $21.4 criminal penalty pursuant to an agreement reached with the Department of Justice. The largest criminal penalty and largest FCPA settlement of 2011 by far was JGC Corporation's agreement to pay a $218.8 million criminal penalty; the most recent settlement arising out of the Department of Justice's investigation of a "decade-long scheme to bribe Nigerian government officials" in order to obtain contracts.[45] This settlement included the only penalty in excess of $100 million in 2011. In contrast, 2010 saw three settled SEC/DOJ actions with combined penalties in excess of $100 million, two of which exceeded $300 million.[46]

Also noteworthy in 2011 was the SEC's first-ever use of a deferred prosecution agreement, which it announced on May 17, 2011 in connection with the resolution of an FCPA investigation involving Tenaris, S.A.[47] According to the SEC, while Tenaris's employees had clearly violated the FCPA by bribing government officials in Uzbekistan to obtain government contracts, when Tenaris discovered the illegal conduct, it took "noteworthy steps" to address the violations, including immediate self-reporting and cooperation with the SEC. As part of the deferred prosecution agreement with the SEC, Tenaris agreed to pay $5.4 million in disgorgement of illegal profits and interest. Tenaris also agreed to pay a $3.5 million fine in connection with a non-prosecution agreement entered into with the DOJ.

4. Enforcement Actions Against Former Executives of Fannie Mae and Freddie Mac

On December 16, 2011, the SEC announced that it had charged six former top executives of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) with securities fraud, alleging that they knew and approved of misleading statements which significantly understated Fannie Mae's and Freddie Mac's holdings of higher-risk mortgage loans, including subprime loans.[48]

The SEC filed two complaints in the U.S. District Court for the Southern District of New York, asserting numerous violations of federal securities law by three former Fannie Mae executives and three former Freddie Mac executives.

Both lawsuits allege that the former executives caused the federal mortgage firms to materially misstate their holdings of subprime mortgage loans in filings with the SEC, public statements, investor calls, and media interviews.

The SEC's complaint against the former Fannie Mae executives alleges that, when Fannie Mae began reporting its exposure to subprime loans in 2007, it significantly understated its exposure. According to the SEC, Fannie Mae broadly described subprime loans as those "made to borrowers with weaker credit histories," but reported less than one-tenth of its loans that met that description. The SEC charges that such statements were made with the knowledge, support, and approval of the former executives.

In the complaint against the former Freddie Mac executives, the SEC alleged that the charged executives and Freddie Mac led investors to believe that the firm had far less exposure to subprime loans than in fact existed. According to the complaint, two executives claimed that Freddie Mac had little or no exposure to subprime loans in its Single Family Guarantee business when, in fact, Freddie Mac's

Single Family business was exposed to approximately $141 billion of loans internally referred to as "subprime" or "subprime like" (or ten percent of the portfolio) as of December 31, 2008 and that exposure grew to approximately $244 billion (or 14 percent of the portfolio) as of June 30, 2008.

The SEC filed these actions despite a federal court ruling earlier this year that Freddie Mac's disclosures regarding its subprime exposure appeared to be adequate. On March 30, 2011, a district court in the Southern District of New York granted, without prejudice, Freddie Mac's motion to dismiss a putative securities fraud class action alleging, among other things, that Freddie Mac misrepresented its exposure to "nonprime mortgage loans."[49] The court focused on Freddie Mac's disclosures in its November 2007 Financial Report, particularly Freddie Mac's statement that it had "increased [its] securitization volume of non-traditional mortgage products, such as interest-only loans as well as loans originated with lower documentation in the last two years in response to the prevalence of these products within the origination market," and held that the plaintiffs had failed to explain why such statements were insufficient.[50] The court also noted that, while Freddie Mac used a non-standard definition of "subprime" loan, Freddie Mac disclosed the criteria it was using.[51]

In addition to filing the two complaint against former executives, the SEC entered into non-prosecution agreements with Fannie Mae and Freddie Mac whereby each company agreed to cooperate with the SEC's litigation against the six former executives and any other litigation or proceeding related to its investigation. Each agreement expressly notes that, in determining to enter into the agreement, the SEC "recognizes the unique circumstances presented by the Respondent's current status, including the financial support provided to the Respondent by the U.S. Treasury, the role of another government agency [Federal Housing Finance Agency] as conservator, and the costs that may be imposed on U.S. taxpayers."

5. The SEC's Stepped Up Criticism and Increased Willingness to Bring Actions Against Attorneys Appearing Before the SEC

In 2011, the Director of the Division of Enforcement, Robert Khuzami, gave a number of speeches and interviews in which he criticized the conduct of defense attorneys. For example, in a speech to the Criminal Law Group of the UJA-Federation of New York, Mr. Khuzami highlighted the following practices as ones the Division sees "too frequently:"

> Multiple representation of witnesses with what appear to be adverse interests;

Multiple witnesses represented by the same counsel who all adopt the same implausible explanation of events;

Witnesses who answer "I don't recall" dozens and dozens of times in testimony, sometimes hundreds of times, including in response to questions about basic and uncontroverted facts documented in their own writings;

Counsel signaling to clients during testimony; and

Questionable tactics in document productions and internal investigations.[52]

Mr. Khuzami warned that, in situations where the Division expresses concerns about multiple representations and those concerns are not addressed, the Division will not be inclined to extend courtesies such as providing extensions in order to retain independent counsel to respond to Wells notices. He also indicated that the Division will be more willing to bring in senior supervisors to address obstructive practices in testimony, more likely to refer cases to the Department of Justice for witnesses who engage in obstruction and perjury, including false claims of lack of recollection, more likely to make referrals to state bar associations, and more likely to seek to suspend or bar attorneys from appearing before the Commission.

Mr. Khuzami repeated many of these criticisms at a securities law conference in October, noting that the SEC has seen "situations where counsel represents 20, 30 or 40 witnesses and the company in a case. . . . It's conceivable that there are no conflicts, but when you see those kinds of numbers you start to get concerned."[53] At another seminar in November 2011, Mr. Khuzami complained again about multiple representations, "suspiciously harmonious" testimony, failures of recollection, signaling of witnesses during deposition, concerns regarding document productions, and "defensive" internal investigations.[54]

The SEC was sufficiently concerned about one firm's representation of multiple parties that it moved to disqualify the firm. In *SEC v. King Chuen Tang*, an insider trading action pending in federal court, the SEC sought to disqualify counsel for a defendant who had previously represented two defendants during the course of the SEC's investigation, but withdrew its appearance for one of the defendants after that defendant indicated his intent to plead guilty in a parallel criminal proceeding.[55] The firm continued to represent the non-pleading defendant, ultimately on a *pro bono* basis once its client could no longer afford to pay for representation. Despite the defendant's plea that he could not afford to retain new counsel, the SEC filed a motion to disqualify arguing that the firm had a conflict. The SEC argued that the firm could only continue to defend its remaining client by undermining the credibility of its former client. The court concluded, however, that the SEC lacked standing to move to disqualify the defendant's counsel and that, even if the SEC had standing, it had waived any objection to the firm's continued representation due to its "substantial delay" in asserting its objection. The court also held that the SEC's motion failed on its merit because the firm's former client had given informed written consent to the joint representation and waived any conflict arising out of the firm's continued representation of the other defendant.

On December 16, 2011, the U.S. Court of Appeals for the DC Circuit confirmed the SEC's ability to commence enforcement proceedings against attorneys — not for violations of securities laws, but for violations of state disciplinary rules.[56] The SEC charged Steven Altman with violating three Disciplinary Rules of the New York Bar Association Lawyer's Code of Professional Responsibility, asserting that Mr. Altman attempted to negotiate a severance package on behalf of his client whereby his client would agree not to cooperate with the SEC in connection with its investigation of the client's former employer. Mr. Altman's client had been subpoenaed by the SEC and Mr. Altman allegedly indicated that his client would not cooperate or "remember" in an SEC interview.

An administrative law judge found that Mr. Altman had violated New York's disciplinary rules governing the conduct of lawyers and suspended him from appearing before the SEC for nine months. On appeal to the Commission, the ALJ's findings were affirmed, but the Commission imposed a permanent bar rather than a suspension.

Mr. Altman appealed to the D.C. Circuit complaining, among other things, that the SEC lacked the authority to sanction him based on violations of New York Bar disciplinary rules. The court disagreed noting that Section 4C of the Securities Exchange Act of 1934 expressly provides that the SEC may sanction a person found to have "engaged in unethical or improper professional conduct." The court was also not persuaded by Altman's arguments that the SEC had previously indicated that it generally would not institute Rule 102(e) proceedings absent a securities law violation, noting that "[n]othing in these statements suggested that the Commission would not act in the appropriate circumstances."

In January 2011, the SEC charged another attorney, this time for allegedly engaging in improper professional conduct during an SEC examination.[57] According to the SEC, David Tamman altered private placement memoranda used in the offer and sale of securities issued by his client by adding disclosure language that was not included in the memoranda provided to investors.

6. SEC's Aberrational Performance Inquiry Results in Actions Against Multiple Investment Advisory Firms and Individuals

On December 1, 2011, the SEC announced the Aberrational Performance Inquiry — its initiative to combat hedge fund fraud by identifying abnormal investment performance — had resulted in four enforcement actions against three investment advisory firms and six individuals for various violations of the securities laws, including improper use of fund assets, fraudulent valuation of assets, and misrepresentation of fund returns.[58]

First, the SEC charged two individuals with overvaluing the reported returns and net asset value of the Millennium Global Emerging Credit Fund by as much as $163 million as part of scheme involving providing fictional prices to two brokers to be passed on to the fund's valuation agent and auditor. Second, the SEC charged a hedge fund firm and its managing director with fraud with fraud in connection with two funds they managed. The SEC accused the firm and its director of overstating the performance of a fund, inflating the firm's assets, exaggerating the firm's longevity and performance history, and misrepresenting the size and credentials of the firm's management. Third, the SEC charged an investment advisory firm and its owner with fraud for using the assets of the fund they managed to become wholly invested in a financially troubled company of which advisor himself was chairman. The SEC charged that the defendants concealed both the investments and the relationship from the fund's investors for four years and continued to lie about the extent of the relationship even after revealing the investments. Finally, the SEC charged an unregistered investment advisor and its two general partners and owners with inducing investors to invest in a hedge fund they controlled through misrepresentations and omissions regarding the negative regulatory history of one of the owners, the compensation of the owners, one of the owners' interest in and control of some of the companies to which he directed fund investments, and the liquidity of the investments.

The SEC attributed these actions to the Aberrational Performance Inquiry which, according to Robert Khuzami, Director of the Division of Enforcement, uses "risk analytics and unconventional methods to help achieve the holy grail of securities law enforcement — earlier detection and prevention." In describing these particular cases, the co-chiefs of the Division's Asset Management Unit stated that "[t]he extraordinary returns reported by these advisors and portfolio managers were, in most cases, too good to be true. In other cases, outlier returns were a telltale sign that something else was amiss."

7. Enforcement Proceedings Against Quant Traders

The SEC brought at least four actions against trading firms and individuals using or purportedly using quantitative investment models. Two of these actions concern alleged fraudulent schemes involving quantitative hedge funds.

First, on August 31, 2011, the SEC announced that it had obtained preliminary injunctions against a money manager and his hedge fund advisory firm.[59] According to the SEC, the defendants solicited "highly sophisticated individuals" to invest in a hedge fund that they managed that "supposedly used a proprietary algorithm to carry out an arbitrage strategy involving trading in liquid exchange-traded funds (ETFs)." The SEC charged that, among other things, the defendants distorted the fund's performance, misrepresented that other wealthy investors had invested in the fund, and misrepresented that the fund was audited by a top-tier auditor. Bruce Karpaty, Co-Chief of the Asset Management Unit in the SEC's Division of Enforcement, warned that "[e]ven sophisticated institutional investors should be wary of unscrupulous hedge fund managers who cloak their misrepresentations in lofty pitches about a complex investment strategy."

Second, on October 26, 2011, the SEC announced that it had obtained an asset freeze against another money manager and investment advisory firm.[60] Here, too, the defendants were charged with misleading investors in soliciting investments in a supposed quantitative hedge fund. According to the SEC, the money manager lied about his education credentials and his prior work experience, falsely claimed that a top tier auditing firm served as the fund's auditor and falsely stated that the hedge fund had more than $1.2 billion in assets.

The other two quant trading cases arise out of the same set of facts. On February 3, 2011, the SEC filed a settled action against three AXA Rosenberg entities.[61] The SEC charged that these entities engaged in securities fraud for concealing a significant error in the computer code of the quantitative investment model used to manage client assets. According to the SEC, the error resulted in $217 million in investor losses. The error — which disabled one of the key components for managing risk — was introduced into the model in April 2007. When it was discovered by senior management, neither the error itself nor its impact on performance was disclosed to clients. Rather, the model's underperformance was attributed to market volatility.

The three entities agreed to a cease-and-desist order, a censure, a $25 million penalty, to engage in certain undertakings and to pay approximately $217 million to redress harm resulting from the coding error.

In announcing the settled action, Director of Enforcement, Robert Khuzami, expressed concern that quantitative investment managers, in an effort to protect trade secrets, "often isolate their complex computer models from the firm's compliance and risk management functions and leave oversight to a few sophisticated programmers." He warned that "[t]he secretive structure and lack of oversight of quantitative investment models . . . cannot be used to conceal errors and betray investors."

On September 22, 2011, the SEC charged the co-founder of AXA Rosenberg with securities fraud in connection with his alleged role in concealing the error. According to the SEC, Barr M. Rosenberg learned of the error in June 2009, but directed others to keep it quiet and not fix it immediately. Mr. Rosenberg agreed to a $2.5 million penalty and a lifetime securities industry bar.

8. The SEC's "Enhanced Oversight" of FINRA and SROs

On March 10, 2011, the SEC released a report prepared by the Boston Consulting Group, Inc. ("BCC") entitled "U.S. Securities and Exchange Commission: Organizational Study and Reform."[62] This report was mandated by Section 967 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and focused on four main areas: (1) organization structure; (2) personnel and resources; (3) technology and resources; and (4) relationships with self-regulatory organizations. With respect to the fourth category, BCG recommended that the SEC implement several initiatives in order to "enhance its role as both an overseer of, and co-regulator with, SROs." One such recommended initiative is for the SEC to strengthen oversight of SROs. In order to do so, BCG asserted that "[t]he SEC should enhance the disclosures SROs make about their regulatory activities, develop metrics and standards that SROs can be measured against, and enhance oversight of the Financial Industry Regulatory Authority (FINRA)." The Enforcement Division appears to be doing its part to implement this initiative, filing settled actions against both FINRA and two exchanges in October 2011.

On October 13, 2011, the SEC filed a settled action against EDGA Exchange, Inc., EDGX Exchange Inc. and their affiliated routing broker Direct Edge ECN LLC, charging the respondents with violations of securities laws arising out of weak internal controls that resulted in million of dollars in trading losses and a systems outage.[63] The SEC's order details two incidents, one involving the overfilling of orders and the other involving the failure to remove quotations from public market data for 24 minutes after the inadvertent disabling of database connections. The three respondents agreed to a censure and the entry of a cease-and-desist order. In addition, the respondents submitted a comprehensive remediation plan requiring the exchanges to take a number of steps to improve their internal controls.

On October 27, 2011, the SEC filed a settled action against FINRA asserting that, in August 2008, the Director of FINRA's Kansas City District Office caused certain records to be altered just hours before those records were to be produced to the SEC. The SEC's order requires that FINRA hire an independent consultant and undertake other remedial measure to improve its policies and procedures and training in connection with producing documents during SEC inspections.[64]

9. The SEC's Continued Pursuit of Insider Trading Cases

The SEC filed 57 insider trading actions in the fiscal year ending September 30, 2011, an approximately eight percent increase over the prior fiscal year. The actions included cases against company executives,[65] board members,[66] tippees,[67] analysts,[68] attorneys,[69] and other professionals with access to inside information.[70]

While many of the cases brought by the SEC involve traditional "one off" insider trading, others contain allegations of schemes involving multiple individuals, multiple companies, and millions of dollars of illicit profits. For example, the SEC continued expanding its Galleon-related probe, bringing even more charges against more individuals (and obtained a record penalty of $92.8 million against Galleon's founder and manager).[71] The SEC also brought multiple actions arising out of an investigation of an alleged expert network insider trading scheme. On February 3, 2011, the SEC announced that it had filed suit against six expert network consultants and employees, charging the defendants with insider trading for tipping hedge funds and other investors and generating millions of dollars in illicit gains.[72] According to the SEC, four of the defendants were technology company employees who were "moonlighting" as consultants to Primary Global Research LLC ("PGR") without their employers' knowledge and providing confidential information about their employers to PGR for which they received hundreds of thousands of dollars in purported consulting fees. The other two defendants, PGR employees, were charged with facilitating the transfer of inside information. Less than a week later, on February 8, 2011, the SEC added a hedge fund and four hedge fund portfolio managers and analysts to the list of defendants.[73] The SEC charged the managers and analysts with receiving the illegal tips from the expert network consultants and causing their funds to trade on the tips.

10. SEC's Increased Scrutiny of the Conduct of Chief Compliance Officers

The SEC brought more than 30 actions against chief compliance officers in 2011. While many of these cases are not terribly surprising — *e.g.*, actions against CCOs who held multiple positions with small broker-dealers or investment advisors[74] or CCOs alleged to have directly participated in fraudulent schemes[75] — the SEC appears to be increasingly willing to bring enforcement proceedings against CCOs for more "run of the mill" compliance failures. For example, on April 7, 2011, the SEC filed a settled action against Mark A. Ellis, the former Chief Compliance Officer of GunnAllen Financial, Inc. (GunnAllen).[76] The SEC charged Mr. Ellis with violating Rule 30(a) of Regulation S-P (the "Safeguard Rule"), which requires registered broker-dealers to adopt written policies and procedures reasonably designed to ensure the confidentiality and the physical security of customer information.

According to the SEC, from at least July 2005, GunnAllen lacked adequate policies and procedures reasonably designed to safeguard customer information. The SEC described GunnAllen's policies and procedures as "general and vague" and "less than a page long." In addition, they simply recited the Safeguard Rule and provided a few examples of safeguards that "may be adopted" but did not specify any safeguards actually adopted. The procedures also failed to instruct registered representatives how to protect customer information or set forth procedures in the event of a security breach.

The SEC asserted that the inadequacy of GunnAllen's procedures became evident when, over a one-and-a-half-year period, three laptops belonging to GunnAllen registered representatives were stolen and the password of a fourth representative was "misappropriated" resulting in the unlawful access of its e-mail system by a terminated employee. The SEC claimed that Ellis failed to revise or supplement GunnAllen's policies and procedures for safeguarding customer information in response to the security breaches.

The SEC's order charged Ellis with willfully aiding and abetting and causing GunnAllen's violations of the Safeguard Rule. Ellis consented to the entry of the order censuring him, requiring him to cease and desist from committing or causing any violations or future violations of the provisions charged, and ordering him to pay a $15,000 civil penalty.

NOTES:

[1]SEC Enforcement Division Produced Record Result in Safeguarding Investors and Markets, Release No. 2011-234 (Nov. 9, 2011).

[2]Robert S. Khuzami, Director, Division of Enforcement, SEC, Remarks Before the Consumer Federation of America's Financial Services Conference (Dec. 1, 2011).

[3]*S.E.C. v. Citigroup Global Markets Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 96597, 2011 WL 5903733, *6 (S.D.N.Y. 2011), motion for stay pending appeal denied, 2011 WL 6762964 (S.D.N.Y. 2011), supplemented, (Dec. 29, 2011).

[4]Edward Wyatt, S.E.C. Changes Policy on Firms' Admission of Guilt, NY Times

(Jan. 6, 2012).

[5]131 S. Ct. 2296, 2301 (2011).

[6]*S.E.C. v. Vitesse Semiconductor Corp.*, 771 F. Supp. 2d 304, Fed. Sec. L. Rep. (CCH) ¶ 96250 (S.D.N.Y. 2011).

[7]*Id*. at 306.

[8]*Id*. at 308.

[9]*Id*. at 309.

[10]*Id*. at 310.

[11]*Id*.

[12]*S.E.C. v. Citigroup Global Markets Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 96597, 2011 WL 5903733 (S.D.N.Y. 2011), motion for stay pending appeal denied, 2011 WL 6762964 (S.D.N.Y. 2011), supplemented, (Dec. 29, 2011).

[13]*Id* at *1.

[14]*Id* at *1, 5.

[15]*Id* at *5.

[16]*Id*.

[17]*Id*.

[18]*Id*.

[19]*Id* at *4.

[20]*Id* at *6.

[21]SEC Enforcement Director's Statement on Citigroup Case, Release No. 2011-265 (Dec. 15, 2011).

[22]*S.E.C. v. Citigroup Global Markets Inc.*, 2011 WL 6762964, *3 (S.D.N.Y. 2011), supplemented, (Dec. 29, 2011).

[23]Case No. 11-C-991 (E.D. Wis.), Dkt. No. 5.

[24]Report on Administrative Proceedings for the Period April 1, 2011 Through September 30, 2011, Release No. 34-65691 (Nov. 4, 2011).

[25]Edward Wyatt, S.E.C. Changes Policy on Firms' Admission of Guilt, NY Times (Jan. 6, 2012).

[26]131 S. Ct. 2296, 2301 (2011).

[27]*Id*. at 2304–05.

[28]*See, e.g.*, *In re Coinstar Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶ 96564, 2011 WL 4712206, *10 (W.D. Wash. 2011) (dismissing claims against individual defendants where individuals were not alleged to have made any of the allegedly fraudulent statements); *City of Roseville Employees' Retirement System v. EnergySolutions, Inc.*, 2011 WL 4527328 (S.D.N.Y. 2011) (holding that individual defendants who neither signed registration statements nor were directors at the time of their issuance could not be deemed "makers" of the registration statements despite statement in the registration statements that individuals would become directors upon completion of IPO); *Hawaii Ironworkers Annuity Trust Fund v. Cole*, 2011 WL 3862206, *5 (N.D. Ohio 2011), as amended, (Sept. 7, 2011) (reversing prior denial of motion to dismiss and finding that plaintiffs had not stated a claim for primary liability under *Janus* because defendants did not have ultimately authority of the

content of the allegedly fraudulent statement).

[29]*S.E.C. v. Carter*, Fed. Sec. L. Rep. (CCH) ¶ 96603, 2011 WL 5980966, *2 (N.D. Ill. 2011).

[30]No. 5:07-cv-2822-WHA, 2011 WL 5871020, *2 (N.D. Cal. Nov. 22, 2011).

[31]*Id*.

[32]No. 8:10CV102, 2011 WL 4375787, *6 (D. Neb. Sept. 20, 2011).

[33]*Id*.

[34]No. 09 Civ. 8261(DLC), 2011 WL 5417106, *2 (S.D.N.Y. Nov. 9, 2011).

[35]No. 11 Civ. 0404(PKC), 2011 WL 5116512, *4 (S.D.N.Y. Oct. 26, 2011).

[36]No. 08 Civ. 4612(CM), 2011 WL 4431161, *4 (S.D.N.Y. Sept. 22, 2011).

[37]*Id*. at *2.

[38]*Id*. at *3 (citations omitted).

[39]*Id*. at *4.

[40]*Id*. at *6.

[41]Initial Decision, In the Matter of John P. Flannery, File No. 3-14081 (Oct. 28, 2011).

[42]SEC Charges Seven Former Siemens Executives with Bribing Leaders in Argentina, Release No. 2011-263 (Dec. 13, 2011).

[43]SEC Charges Magyar Telekom and Former Executives with Bribing Officials in Macedonia and Montenegro, Release No. 2011-279 (Dec. 29, 2011).

[44]SEC Charges Johnson & Johnson With Foreign Bribery, Release No. 2011-87 (Apr. 7, 2011).

[45]Press Release, U.S. Dep't of Justice, JGC Corporation Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay a $218.8 Million Criminal Penalty (Apr. 6, 2011) (available at http://www.justice.gov/opa/pr/2011/April/11-crm-431.html).

[46]SEC Charges Alcatel-Lucent with FCPA Violations, Release No. 2010-258 (Dec. 27, 2010) (combined settlement of more than $137 million); SEC Charges Italian Company and Dutch Subsidiary in Scheme Bribing Nigerian Officials With Carloads of Cash, Release No. 2010-119 (July 7, 2010) (combined settlement of $365 million); SEC Charges Technip with FCPA Violations, Release No. 2010-110 (June 28, 2010) (combined settlement of $338 million).

[47]Tenaris to Pay $5.4 Million in SEC's First-Ever Deferred Prosecution Agreement, Release No. 2011-112 (May 17, 2011)

[48]SEC Charges Former Fannie Mae and Freddie Mac Executives With Securities Fraud, Release No. 2011-267 (Dec. 16, 2011).

[49]*Kuriakose v. Federal Home Loan Mortg. Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 96270, 2011 WL 1158028, *4 (S.D.N.Y. 2011).

[50]*Id*. at *10.

[51]*Id*. at *11.

[52]Robert S. Khuzami, Director, Division of Enforcement, SEC, Remarks to the Criminal Law Group of the UJA-Federation of New York (June 1, 2011).

[53]Joshua Gallou, *SEC's Khuzami Faults Defense Lawyers for Conflicts of Interest*, Businessweek (Oct. 28, 2011), http://www.businessweek.com/news/2011-11-08/sec-s-k

huzami-faults-defense-lawyers-for-conflicts-of-interest.html.

[54]Securities Regulations Institute Live Blog: An Interview With Key Enforcement Officials (Nov. 11, 2011), http://seclawcenter.pli.edu/2011/11/11/securities-regulation-institute-live-blog-an-interview-with-key-enforcement-officials.

[55]*S.E.C. v. King Chuen Tang*, 2011 WL 5914028 (N.D. Cal. 2011).

[56]*Altman v. S.E.C.*, 2011 WL 6266482 (D.C. Cir. 2011).

[57]SEC Institutes Proceedings Against California Attorney for Falsifying Documents for Production to SEC Staff, Release No. 2011-29 (Jan. 28, 2011).

[58]SEC Charges Multiple Hedge Fund Managers With Fraud in Inquiry Targeting Suspicious Investment Returns, Release No. 2011-252 (Dec. 1, 2011).

[59]SEC Halts Fraud by Manager of Startup Quantitative Hedge Fund, Release No. 2011-174 (Aug. 31, 2011).

[60]SEC Halts Fraud by Purported Quant Hedge Fund Manager, Release No. 2011-225 (Oct. 26, 2011).

[61]SEC Charges AXA Rosenberg Entities for Concealing Errors in Quantitative Investment Model, Release No. 2011-37 (Feb. 3, 2011).

[62]The Boston Consulting Group, U.S. Securities & Exchange Comm'n: Organizational Study and Reform (Mar. 10, 2011), available at http://www.sec.gov/news/studies/2011/967study.pdf.

[63]SEC Sanctions Direct Edge Electronic Exchanges and Orders Remedial Measures to Strengthen Systems and Controls, Release No. 2011-208 (Oct. 13, 2011).

[64]SEC Orders FINRA to Improve Internal Compliance Policies and Procedures, Release No. 2011-227 (Oct. 27, 2011).

[65]SEC Charges Kentucky Steel Company Executives With Insider Trading, Release No. 2011-69 (Mar. 17, 2011) (four executives and four of their friends and family members charged with trading on inside information regarding company's acquisition).

[66]SEC Charges Former Mariner Energy Board Member and Son With Insider Trading, Release No. 2011-162 (Aug. 5, 2011) (board member and his son charged with trading on information about upcoming acquisition learned of during the course of board meetings; both individuals charged with tipping and/or trading on behlf of others); Board Member of Goldman Sachs and Procter & Gamble Charged in Insider Trading Scheme, Release No. 2011-53 (Mar. 1, 2011) (Rajat Gupta charged with illegally tipping Galleon Management founder and hedge fund manager, Raj Rajaratnam, with information regarding quarterly earnings and about an impending $5 billion investment by Berkshire Hathaway in Goldman).

[67]SEC Charges Former Professional Baseball Player Doug DeCinces and Three Others With Insider Trading, Release No. 2011-161 (Aug. 4, 2011) (Doug DeCinces and three other charged with trading on information about an acquisition DeCinces obtained from a source at the company to be acquired); SEC Charges Former Investment Fund Employee With Insider Trading in Marvel Stock Prior to Disney Deal, Release No. 2011-166 (Aug. 11, 2011) (individual charged with trading on information learned from his girlfriend who worked at Disney).

[68]Former Banco Santander Analyst Agrees to Settle Insider Trading Charges, Release No. 2011-98 (Apr. 25, 2011) (former analyst charged with trading on information regarding upcoming tender offer learned in the court of his firm's providing advice to the bidder).

[69]SEC Charges Corporate Attorney and Wall Street Trader in $32 Million Insider Trading Ring, Release No. 2011-85 (Apr. 6, 2011) (attorney and trader charged with insider trading in advance of at least 11 merger and acquisition announcements involving clients of the firm where the attorney worked).

[70]SEC Charges Former NASDAQ Managing Director With Insider Trading, Release No. 2011-117 (May 26, 2011) (former managing director of NASDAQ charged with trading on information provided to him in his role at NASDAQ); SEC Charges FDA Chemist With Insider Trading Ahead of Drug Approval Announcements, Release No. 2011-76 (Mar. 29, 2011) (FDA chemist charged with trading on confidential information about upcoming announcements of FDA drug approval).

[71]SEC Obtains Record $92.8 Million Penalty Against Raj Rajaratnam, Release No. 2011-233 (Nov. 8, 2011).

[72]SEC Brings Expert Network Insider Trading Charges, Release No. 2011-38 (Feb. 3, 2011).

[73]SEC Charges Hedge Fund Managers and Traders in $30 Million Expert Network Insider Trading Scheme, Release No. 2011-40 (Feb. 8, 2011).

[74]*See, e.g.*, In the Matter of Divine Capital Markets, Release No. 63980 (Feb. 25, 2011) (OIP against individual who held position of CCO, CEO and General Securities Principal); In the Matter to JSK Associates, Inc. Release No. 3175 (Mar. 14, 2011) (OIP against CCO of investment advisor and of broker dealer, president of investment advisor, and vice president of broker dealer); In the Matter of LPB Capital, Release No. 65409 (Sept. 27, 2011) (OIP against founder, majority owner, CEO and CCO of investment advisor).

[75]*See, e.g.,* Complaint, SEC v. Jupiter Capital Advisors LLC, No. 11 cv 00291 (complaint alleging that CCO failed false Form ADV with the SEC and refused to cooperate with investigation); In the Matter of Alfred Clay Ludlum, III, Release No. 3294 (Sept. 29, 2011) (OIP against CCO of investment advisor accused of making fraudulent misrepresentations to investors and using investor funds for his personal use).

[76]In the Matter of Marc A. Ellis, Release No. 64220 (Apr. 7, 2011); *see also* In the Matter of Wunderlich Securities, Inc., Release No. 64558 (May 27, 2011) (OIP charging chief compliance officer with causing the firm's failure to satisfy disclosure and client consent requirements and with aiding and abetting the firm's failure to maintain certain required written policies and procedures and a written code of ethics).