

Client Alert

March 10, 2015

SEC Annual Conference Highlights 2014 Accomplishments and Promises to Turn Up the Heat in 2015

By Daniel Nathan, Randy Fons, Brian Hoffman, and Tiffany Rowe

With Chair Mary Jo White in her second year at the helm, the Securities and Exchange Commission showcased its efforts, improvements, and enforcement successes at this year's SEC Speaks Conference. The Commission highlighted that it brought a record number of cases—755 enforcement actions—in fiscal year 2014, and obtained \$4.1 billion in monetary relief. The Commission continues to emphasize its increased use of data analytics in both its regulatory efforts and enforcement investigations. As usual, the Commission, and the Division of Enforcement in particular, used the Conference to present their case that the SEC is firing on all cylinders.

INSIDER TRADING UP FRONT

According to Division of Enforcement leadership, insider trading continues to be a priority; the SEC has named 580 defendants in insider trading cases over the last 5 years and strong cases are still in the pipeline. The Staff's evolving ability to analyze trading, both within a single account and across the accounts of multiple entities and individuals, enables the staff to identify traders and their information sources who may be potentially violating the insider trading laws. This, in turn, has helped the Staff discover, investigate, and initiate many cases, and has helped fill the Enforcement Division's inventory for the upcoming year.

It was no surprise that Enforcement staff commented on the Second Circuit's decision in *U.S. v. Newman*.¹ The decision—vacating two criminal convictions for insider trading—could have a significant impact on insider trading enforcement as it appears to potentially raise the standard for finding liability by tippers and tippees in insider trading cases. As a result, the Commission has joined the U.S. Attorney in seeking a modification of the ruling. However, the Staff indicated that despite its disagreement with the *Newman* ruling, the majority of its current cases will not be affected by the decision.

FOCUS ON FINANCIAL REPORTING FRAUD “BEARING FRUIT”

Chair White and the Staff praised the Division's renewed focus on financial reporting and auditing cases. The Financial Reporting and Audit (FRAud) Task Force is “bearing fruit,” according to Chair White, who predicted a continued uptick as the Task Force continues to focus on identifying cases through its use of new resources. Some key areas under scrutiny include revenue recognition, expense recognition, auditor independence, faulty valuations, related-party disclosures, and deficient audits.

David Woodcock, Regional Director of the Ft. Worth Regional Office and Chair of the FRAud Task Force, and Margaret McGuire, Senior Counsel to the Director and Vice-Chair of the FRAud Task Force, noted the marked decrease in restatements in recent years and suggested that companies, boards, and auditors are more in tune to

¹ *United States v. Newman et al.*, Nos. 13-1837-cr(L), 13-1917-cr(con), at *6 (2d Cir. Dec. 10, 2014).

Client Alert

the possibility of financial fraud. Mr. Woodcock highlighted some of the important financial fraud cases brought last year, including: *SEC v. CVS Caremark Corp.*, where misleading disclosures resulted in a \$20 million penalty, and *SEC v. Diamond Foods Inc.*, a case of underreporting expenses to inflate income that led to a \$5 million penalty against the company.

The Task Force heads also discussed several cases brought last year alleging faulty internal controls that stood without the usual accompanying fraud allegations. One example is an action against JDA Software, which agreed to settle allegations of improper revenue recognition for service agreements and inaccurate reporting of revenues. The violations stemmed from inadequate internal controls surrounding revenue recognition, including the lack of adequate revenue recognition policies and procedures and failure to identify all service-related contracts necessary for fair value testing.

In addition to the above cases, the staff reminded the audience that the conduct of financial reporting gatekeepers such as auditors remains under the microscope of Operation Broken Gate. And last year's broker-dealer audit sweep—handled in conjunction with the Public Company Accounting Oversight Board—netted settlements in eight cases alleging auditor independence violations.

McGuire highlighted issuer monitoring and Internal Control over Financial Reporting (ICFR) as two of the FRAud Task Force's initiatives. The Task Force has instituted its own review process, and is using internal and external data and tools to review and monitor issuers so they can spot potential areas of investigative interest early in the process. The Task Force has identified over 200 issuers of interest spanning various industries and accounting practices. According to McGuire, after reviewing each individual matter, the Task Force can decide either to close the matter because there is no reason to investigate further, to refer the matter to Enforcement because there is a clear need for further investigation, or to "incubate" the matter further within the Task Force.

FCPA ENFORCEMENT EXPLAINS COOPERATION

Kara N. Brockmeyer, Chief of the FCPA Unit, reported that in fiscal year 2014 the Unit brought seven cases. In this fiscal year, beginning in October, the Unit has already filed as many cases as it filed in all of fiscal 2014. Ms. Brockmeyer indicated that the FCPA Unit remains focused on the perennial hot spots: China, Russia, and Africa. However, the Middle East and Southeast Asia have seen an uptick in bribery schemes. Going forward, the Unit is going to focus on small- and medium-sized companies that enter international markets for the first time.

Key to the Unit's ability to perform more efficient and effective investigations is its efforts to give meaningful credit for cooperation. Real-time reporting of investigative findings, bringing foreign employees to the United States or other jurisdictions where they can be interviewed, and advising the SEC of terminations prior to letting employees go, illustrate the high level of assistance that is expected in order to merit such credit. The recent case against *Goodyear* outlines many of the steps that a company can take to receive meaningful cooperation credit. The Unit has seen an uptick in self-reporting, according to Ms. Brockmeyer, as well as increasing levels of international cooperation and an increasing number of cases where the Unit works in tandem with foreign regulators and foreign prosecutors.

Client Alert

THE BD TASK FORCE INCUBATES CASE IDEAS

The Broker-Dealer Task Force was described by Director of the New York Regional Office Andrew Calamari as an “incubator of ideas.” Its work includes initiatives relating to anti-money laundering regulations and recidivist brokerage firms that shelter rogue brokers and engage in abusive activities. In addition, the Broker-Dealer Task Force works closely with the broker-dealer program within the Office of Compliance, Inspections and Examinations, as well as the Division of Trading and Markets and FINRA. Here are some of the staff’s announced priorities:

- Churning, the practice of brokers recommending excessive trading for commissions, reappears on the Commission’s task list more than 30 years after its peak.
- A Bank Secrecy Act Review Group that functions within the Office of Market Intelligence is looking at anti-money laundering compliance by analyzing securities-related SARs to identify patterns and trends in the information. This type of analysis could help determine whether there are compliance-related violations and could assist in other ongoing investigations. Enforcement’s so-called “17a-8 Working Group,” with members nationwide, will take on AML-related investigations.
- Investments in alternative products and IRA rollovers and retirement vehicles, given the greater imprecision in valuation and the opportunity to take advantage of investors, are of renewed interest.

COMPLEX INSTRUMENTS UNIT STREAMLINES ITS APPROACH

Michael J. Osnato stated that the Complex Financial Instruments Unit under his direction works to keep the Enforcement Division on the cutting edge of complex financial instruments. The Unit looks for ways to streamline its investigations through the aggressive use of cooperation and resolution tools such as reverse proffers, in which the staff lays out the case for counsel and the firm at a relatively early stage with a view to cutting past much of the investigative work and heading straight to settlement discussions. In 2015, the Unit will maintain a significant focus on complex products and their impact on a bank or financial institution’s financial disclosures.

LITIGATION REACHES NEW HEIGHTS

Chief Litigation Counsel Matt Solomon recounted the Enforcement Division’s litigation highlights, noting that the 30 trials in 2014 were the most trials for the Commission in a decade, and five times the number of trials in 2013. Two-thirds were federal court trials, with the balance adjudicated by administrative law judges. Overall, Solomon said, the Commission boasts an 80% win rate. The victories include some high profile cases, such as the verdict against Sam and Charles Wyly, Texas businessmen that the Commission accused of using offshore accounts to hide stock purchases and sales that netted more the \$500 million in profits over a decade. Solomon said that Sam Wyly and the estate of his late brother are subject to the “staggering” penalties despite the army of defense lawyers involved in the case. Solomon stated that the Commission will not shy away from litigating difficult cases that could significantly impact securities jurisprudence. He summarized that the Commission “will be fair, but will throw hard punches. If we’re not losing, we’re not being aggressive enough.”

Client Alert

THE COMMISSION EXPLAINS FRAUD

Assistant Chief Counsel Sam Waldon discussed what he called the “most significant” Commission decision of the year, *In the Matter of Flannery and Hopkins*. Addressing interpretations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities and Exchange Act of 1934, [this decision](#) puts issuers and members of the investing public on notice of the Commission’s views regarding how these antifraud statutes and their subparts work together. Waldon stated that the Commission’s interpretation of the anti-fraud statutes is both broader and narrower than those adopted by the Courts.

Waldon extracted the four key aspects of the case and the effect of the Commission’s decision on longstanding judicial interpretation.

1. The subparts of Section 17(a) and Section 10(b) are mutually supporting, not mutually exclusive.
2. Primary liability under Section 17(a)(1) and(3) and under Rule 10b-5(a) and (c) extends to anyone involved in making a material misstatement as well as those who draft or devise the misstatement.
3. Only conduct that is manipulative or deceptive can violate Section 10(b). But Section 17(a) is not limited to conduct that is manipulative or deceptive. A defendant who engages in a legitimate transaction knowing that the transaction will be used to misstate financial information can be liable for violating Section 17(a).
4. Materiality is defined by two principles: the information is objectively material regardless of the sophistication of the investor; and materiality does not require a showing that the information would have caused the investor to change his decision. Rather, information is material as long as it would be important to the investor’s analysis.

The Commission’s straightforward pronouncement—which in some ways conflicts with federal appellate jurisprudence—demonstrates that the Commission will maintain its interpretation of what constitutes fraudulent conduct despite court decisions that could either extend or limit the reach of the securities laws.

CONCLUSION

A strong Enforcement Division continues to reign at the SEC, with an ever-increasing array of investigative bells and whistles at its disposal in the form of enhanced technology, dedicated task forces, and tools to increase cooperation and self-reporting. The Division will need these tools as the always-expanding list of priorities fills the Staff’s pipeline.

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Client Alert

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