SEC Developments

Top 10 SEC Enforcement Matters

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Almost one year ago, on January 24, 2013, a new Chair of the Securities and Exchange Commission (“SEC”), Mary Jo White, was appointed by President Obama and confirmed on April 8, 2013. White became the first former criminal prosecutor, as the former United States Attorney for the Southern District of New York, to serve in that role. Given her background, Chair White has continued the path begun under her predecessor, Mary Schapiro, to re-shape and re-energize the SEC’s Enforcement Division, through the adoption of law enforcement techniques and policy goals previously only utilized by criminal law enforcement, such as deferred prosecution and non-prosecution agreements, and cooperation agreements. Concepts such as public accountability by requiring admissions of wrongdoing by defendants have been expanded greatly.

For the fiscal year (“FY”) ending September 30, 2013, the SEC’s enforcement program resulted in a record $3.4 billion in monetary sanctions ordered against wrongdoers, which was ten percent higher than in FY 2012.¹ There were a total of 686 enforcement actions in FY 2013, down from 734 and 735, respectively, in the prior fiscal years. Broker-Dealer, Delinquent Filings, Investment Adviser/Investment Company and Securities Offering actions comprised the top four areas of proceedings.

What follows is our list of the Top 10 Enforcement Highlights for 2013, beginning with the action against a large, well-known hedge fund manager, Philip Falcone, for self-dealing and fraud, in which he was required to admit to wrongdoing. As you go through our Top 10, you will see that many of these actions are against well-known persons and/or entities, which continues the longstanding pattern of the agency of bringing certain kinds of cases to capture the attention of the public and industry participants for deterrence purposes. As we move into 2014, we expect a greater emphasis on other kinds of violations of the federal securities laws, perhaps in the areas of accounting fraud, supervision, valuations by private equity firms and hedge funds, market manipulation, and conflicts of interest.

1. The Settlement by Hedge Fund Harbinger Capital Partners and Philip Falcone

The SEC began to break away from its longstanding practice of allowing defendants to settle cases without admitting or denying guilt in 2012, by requiring
admission in settlements with parties that have pled guilty in a parallel criminal action. This change was amplified significantly in 2013, under leadership of Chair White. In June 2013, White stated that the SEC would also, under certain circumstances, require admissions in cases that do not involve parallel criminal prosecution.

In August 2013, the SEC announced its first settlement under its new policy, in which both New York-based hedge fund adviser Philip A. Falcone and his advisory firm Harbinger Capital Partners admitted certain wrongdoing. In June 2012, the SEC commenced two civil lawsuits against Falcone and Harbinger alleging fraud. The most serious charge was that Falcone borrowed $113 million from a Harbinger fund to pay his personal taxes during a time period when his investors were prohibited from withdrawing their own money from the fund. In August 2013, the SEC announced a settlement with Falcone and Harbinger. Under the terms of the settlement, both defendants admitted to acting “recklessly” and to a long list of facts, including that Falcone improperly borrowed millions of dollars to pay personal tax obligations, and that he and Harbinger improperly granted favorable redemption and liquidity terms to certain large investors without disclosing these arrangements to the fund’s board of directors and other fund investors.

The SEC’s new policy of requiring admissions as part of negotiated settlements in certain cases met with some criticism. Critics claim that the policy exceeds the SEC’s prerogative to regulate securities markets and promote the raising of capital, as it seeks to deter bad behavior and punish offenders through public “accountability” – corrective actions which more properly lie with the Department of Justice (“DOJ”). Some in the defense bar further argue that due to collateral consequences of admitting guilt, the new policy may reduce the total number of SEC enforcement actions and result in disproportionately harsh treatment of individual defendants and smaller firms which lack the resources to litigate their case to trial. Admissions of wrongdoing could also expose defendants to heightened vulnerability in investor class actions, criminal proceedings, and state regulatory actions. Whether this new policy is a wise and effective one, consistent with the obligations of a civil, not criminal, regulator, time will tell.

2. Supreme Court Declines to Extend Five-Year Statute of Limitations for SEC Actions in Gabelli v. SEC

In February 2013, the Supreme Court declined to apply a discovery rule to extend the five-year statute of limitations applicable to SEC enforcement actions seeking civil penalties for violations of the Investment Advisers Act of 1940, making it more difficult for the SEC to bring such actions. At issue in Gabelli was a civil action against the former portfolio manager of the Gabelli Global Growth mutual fund, and the chief operating officer of the fund’s registered investment adviser, Gabelli Funds, LLC. The SEC alleged that the defendants allowed a fund investor to engage in “market timing” – a strategy that takes advantage of time delays in the valuation systems used by mutual funds. The defendants moved to dismiss the complaint as untimely and barred by the five-year statute of limitations set forth in 28 U.S.C. § 2462. That section provides that an action for a civil fine “shall not be entertained unless commenced within five years from the date when the claim first accrued.” The Supreme Court found that Section 2462’s statute of limitations begins to run when the violation takes place, and not when the violation was, or should have been, discovered.

Of note, the decision in Gabelli, while certainly definitive, is a narrow one: it only applies to civil penalties. For one, the Supreme Court did not address whether Section 2462’s statute of limitations applies to equitable remedies, such as injunctions and disgorgement. Therefore, most SEC enforcement actions – which seek injunctive relief – will be unaffected by this ruling. Further, Gabelli is limited to the application of Section 2462’s discovery rule, as the Court did not address other tolling mechanisms. The Court expressly stated that the application of the fraudulent concealment doctrine to Section 2462 was not before it. Accordingly, the door remains open for the SEC to bring claims older than five years by arguing that the defendant fraudulently concealed his or her actions. Still, many policy considerations underlying the Court’s decision in Gabelli may equally apply to a fraudulent concealment argument, for example, that the burden lies with the government to work diligently to uncover fraudulent behavior and that it is generally important to place a definitive limit on penalty ac-
tions. Such questions regarding Gabelli’s reach will ultimately be answered in the coming years.

3. The SEC’s (and Justice Department’s) Continued Insider Trading Investigation of S.A.C. Capital

The investigations by the SEC and Department of Justice into allegations of insider trading at S.A.C. Capital Advisors, L.P. (“SAC”) kept SAC and its affiliates in the spotlight throughout 2013. Major developments in 2013 included the following:

- In March 2013, CR Intrinsic Investors, LLC (“CR Intrinsic”), a hedge fund advisory firm and affiliate of SAC, agreed to pay approximately $600 million in disgorgement, prejudgment interest and monetary penalty, to settle SEC charges that it participated in an insider trading scheme involving the tipping of and trading on negative clinical trial results for a drug under development. The settlement was the SEC’s largest ever in an insider trading case.

- Simultaneously, Sigma Capital Management, LLC (“Sigma”), another hedge fund advisory firm and affiliate of SAC, agreed to pay almost $14 million in disgorgement, prejudgment interest and monetary penalty, to settle SEC charges that it engaged in insider trading based on non-public information obtained through one of its analysts about the quarterly earnings of Dell, Inc. and Nvidia Corporation.

- Also in March 2013, the SEC charged Michael Steinberg (“Steinberg”), a portfolio manager at Sigma, with insider trading. The SEC’s action coincided with the filing of criminal charges against Steinberg.

- In July 2013, the SEC initiated an administrative action against SAC’s founder and owner, Steven A. Cohen, charging him with failing to supervise Steinberg and another portfolio manager, Mathew Martoma (“Martoma”), and failing to prevent them from insider trading while under his supervision. When it announced these charges, the SEC’s Enforcement Division said it would seek in this action to bar Cohen from overseeing investor funds.

- Less than a week later, the Justice Department unsealed an indictment against SAC and three affiliated companies, charging them with securities fraud and wire fraud. At the same time, the Justice Department announced the filing of a related civil forfeiture action against the same companies.

- In November 2013, SAC and various affiliates agreed to plead guilty to criminal insider trading charges, as part of a global resolution that would also resolve the civil forfeiture action. The global resolution would require SAC and affiliates to pay a criminal fine of $900 million, plus a forfeiture payment of $900 million. After applying a credit for the approximately $616 million that SAC and affiliates agreed to pay in settling the SEC’s CR Intrinsic and Sigma actions, the global resolution would require an additional payment of almost $1.2 million.

- On December 18, 2013, a jury in the U.S. District Court for the Southern District of New York convicted Steinberg of insider trading charges after a five-week trial. Of eight former SAC employees criminally charged with engaging in insider trading for the benefit of SAC, six had pled guilty. Steinberg, the first to contest the charges at trial, became the seventh to be convicted. The criminal trial of the last of these eight, Martoma, is scheduled to begin in January 2014.

4. Mark Cuban’s Jury Acquittal of Insider Trading Charges

The SEC’s high-profile case against Mark Cuban was resolved in October 2013, with Cuban emerging victorious: a Texas jury acquitted Cuban after less than four hours of deliberations. The SEC filed its complaint in November 2008, alleging insider trading in connection with Cuban’s conversation with the CEO of online search engine company Mamma.com which took place in 2004. After acquiring a large stake in Mamma.com, Cuban discussed the company’s strategy for raising additional capital with the company’s CEO and investment bank. Cuban then sold his stock, also expressing disapproval of the company’s strategy. By selling his shares in advance of the announcement, Cuban saved more than $750,000 in potential losses.
Based on these facts, the SEC filed suit against Cuban under the “misappropriation” theory, under which a person violates Section 10(b) of the Securities Exchange Act of 1934 if he misappropriates confidential information for securities trading purposes, in breach of a duty of trust and confidence owed to the source of the information. The type of relationship which could ultimately lead to an insider trading claim was the focal point of the Cuban litigation. The district court, initially ruling on the case, relieved the SEC of the burden to prove a fiduciary relationship, holding that liability under the misappropriation theory could be based on a duty created by agreement. In situations where a party agrees to keep information confidential and not trade on it for personal gain, that agreement can serve as a basis for an insider trading claim. Though this earlier decision was vacated by the Fifth Circuit, the district court still considered that opinion on remand. In denying Cuban’s motion for summary judgment before trial, the court analyzed whether the SEC presented sufficient facts to show that a confidentiality agreement—and an agreement not to trade—existed. This standard also manifested in the jury instructions.

Even though the jury returned a verdict for Cuban, money managers and other traders should exercise caution in the way they treat non-public information. The court’s analysis of the SEC’s claim shows that a casual conversation with a corporate insider who conveys confidential information could give rise to insider trading charges, if the trader agrees not to disseminate the information or use it for trading.

The Cuban case is a rare insider trading loss for the SEC. Still, in a public statement following Cuban’s acquittal, the SEC seemed undeterred, stating that “[w]hile the verdict in this particular case is not the one we sought, it will not deter us from bringing and trying cases where we believe defendants have violated the federal securities laws.” Illegal insider traders beware.

5. The SEC Award of $14 Million to a Single Whistleblower

The SEC’s whistleblower program reached a landmark on October 1, 2013, when the program announced its largest award to date, an award of more than $14 million. According to the SEC, the whistleblower provided information that allowed the SEC within six months to bring an enforcement action that recovered substantial investor funds. Later that month, on October 30, 2013, the SEC announced its most recent whistleblower award to date, an award of more than $150,000 to a whistleblower whose tip helped the SEC stop a scheme that was defrauding investors. Both of these whistleblowers chose not to be publicly identified.

The SEC established its Office of the Whistleblower in August 2011, one year after the Dodd-Frank Act directed the SEC to make monetary awards to individuals who provide “original information” that leads to successful SEC enforcement actions resulting in monetary sanctions over $1 million. Whistleblowers may be eligible for an award equal to 10 to 30% of monies collected by the SEC or in a related action. By law, the SEC must protect the confidentiality of whistleblowers’ identities, subject to certain limitations.

According to the program’s annual report, from the program’s inception through September 2013, the program received 6,573 tips and complaints from whistleblowers. To date, the SEC has made awards to six whistleblowers. Many more can be expected in 2014.

6. Extensive Cooperation by Ralph Lauren Corporation Earns It a Non-Prosecution Agreement

Ralph Lauren Corporation (“Ralph Lauren”) entered into the SEC’s first non-prosecution agreement (“NPA”) in April 2013, in connection with alleged Foreign Corrupt Practices Act (“FCPA”) violations by its Argentinean subsidiary from 2005 to 2009. Ralph Lauren did not admit or deny liability for alleged FCPA violations and will not be charged by the SEC. However, the NPA places certain affirmative obligations on Ralph Lauren, including extensive future cooperation with the SEC.

Specifically, the SEC alleged that Ralph Lauren’s Argentinean subsidiary avoided customs requirements by paying approximately $568,000 to a customs broker who then funneled the money to Argentinean customs officials. The payments were allegedly disguised as “loading and delivery expenses” and “stamp tax/label tax.” The SEC further claimed that the Argentinean subsidiary provided additional gifts to Ar-
gentinean government officials to assist with importation of products, in the amount of $25,000.

The improper payments were uncovered through an internal investigation. Within two weeks of discovery, Ralph Lauren self-reported its preliminary findings to the SEC and the DOJ. The SEC cited the company’s “prompt reporting of the violations on its own initiative” and “its extensive, thorough, and real-time cooperation with the SEC’s investigation” as the basis for the NPA. Kara Brockmeyer, the SEC’s FCPA Unit Chief, stated that the NPA demonstrates the “benefit of implementing an effective compliance program,” as Ralph Lauren discovered the problem after putting in place an enhanced compliance program and beginning to train its employees. Ralph Lauren’s remedial measures were further commended by George S. Canellos, the Acting Director of the SEC’s Division of Enforcement, who said that this NPA “makes clear that [the SEC] will confer substantial and tangible benefits on companies that respond appropriately to violations and cooperate with the SEC.” As such, Ralph Lauren has become a vivid example of how companies can receive substantial cooperation credit (including avoidance of enforcement) through implementing appropriate remedial measures in addressing violations and preventing recurrence.

7. The SEC’s “Broken Windows” Strategy, Exemplified by Actions Against 23 Firms for Short Sale Violations

In a speech she gave on October 9, 2013, SEC Chair Mary Jo White highlighted her goal that the SEC’s enforcement program be perceived to be “everywhere, pursuing all types of violations of our federal securities laws, big and small.” She likened this approach to the “broken windows” philosophy pursued in the area of law enforcement in the 1990s by New York City Mayor Rudy Giuliani and Police Commissioner Bill Bratton. As Chair White explained it, “The theory is that when a window is broken and someone fixes it, it is a sign that disorder will not be tolerated. But, when a broken window is not fixed, it ‘is a signal that no one cares . . .’.”

The SEC demonstrated this aggressive approach three weeks earlier, when it announced actions against 23 firms for violations of Rule 105 of Regulation M, under the Securities Exchange Act of 1934. Rule 105 generally prohibits purchasing securities in follow-on and secondary offerings when the purchaser has effected short sales in the securities within a specified amount of time, generally five days, prior to the pricing of an offering. One of the charged firms, G-2 Trading LLC, contested the alleged violations, while the other 22 firms agreed to settlements.

Notwithstanding that the SEC did not allege wrongful intent on the part of the charged firms, that some of the firms engaged in merely one allegedly unlawful short sale, and that some of the firms’ allegedly illicit profits from the charged conduct was minimal, the monetary sanctions in the settlements were substantial, totaling over $14.4 million. Andrew Ceresney, Co-Director of the SEC’s Division of Enforcement, when announcing these actions, highlighted the “broken windows”-type strategy behind them: “The benchmark of an effective enforcement program is zero tolerance for any securities law violations, including violations that do not require manipulative intent.”

Another interesting aspect of the settlements is that the SEC suggested that many of the firms received a benefit for having promptly undertaken remedial acts and for cooperating with the SEC staff. Any such benefit, however, was hard to discern, given that, in one instance, a firm noted for its cooperation and prompt remediation was found to have gained just $4,091 from its violation, but was nonetheless required to pay a civil money penalty of $65,000.

8. SEC Enforcement Actions against Exchanges

a. NASDAQ

In May 2013, two subsidiaries of NASDAQ OMX Group agreed to pay a $10 million fine to settle SEC allegations of violations related to secondary market trading after the initial public offering (“IPO”) of Facebook, Inc. The settlement figure is the largest SEC fine to date against a securities exchange. In its settlement, NASDAQ did not admit or deny the SEC’s allegations.

The SEC alleged that NASDAQ failed to address problems with its system for matching buy and sell orders, causing disruptions to the IPO. NASDAQ senior leadership members believed that the problem was repaired and allowed secondary market trading of Facebook shares to commence. Howev-
er, the problem in fact persisted, causing 30,000 Facebook shares to become stuck in NASDAQ’s system, instead of being executed or cancelled, for more than two hours. George S. Canellos, the Acting Director of the SEC’s Division of Enforcement, stated that, “[t]his action against NASDAQ tells the tale of how poorly designed systems and hasty decision-making not only disrupted one of the largest IPOs in history, but produced serious and pervasive violations of fundamental rules governing our markets.”

b. Chicago Board Options Exchange

In June 2013, the SEC meted a $6 million fine against the Chicago Board Options Exchange, Incorporated (“CBOE”) for allegedly failing to enforce rules designed to prevent illegal short-term trading.29 The fine was the first penalty against a securities exchange for oversight issues (rather than misconduct in an exchange’s business operations). It also marks the third time that the SEC has fined an exchange. 30 In its settlement, CBOE did not admit or deny the SEC’s allegations.

The SEC alleged that in April 2012, C2 Options Exchange, Incorporated (“C2”), a CBOE member brokerage firm, violated Regulation SHO. Regulation SHO requires that firms deliver securities to a clearing agency within three days after a trade date. If the securities are not delivered on time, the firm must borrow or purchase the securities to close out the position no later than four days after the trade date. The SEC claimed that the CBOE failed to enforce Regulation SHO because its staff lacked a “fundamental understanding” of the rule and its investigators never received formal training on the regulation. The SEC further claimed that the CBOE failed to provide the SEC with information and even helped C2 contest SEC’s claims against C2.

9. Actions Against Three Investment Advisers For Violating the SEC’s Custody Rule

On October 28, 2013, the SEC highlighted its enforcement of the “custody rule” – which applies to investment advisers that have legal ownership or access to client assets or an arrangement permitting them to withdraw client assets – by simultaneously announcing administrative actions and settlements with three investment advisers.31

In 2010, the SEC amended the custody rule – SEC Rule 206(4)-2, under Section 206(4) of the Investment Advisers Act of 1940 – by requiring all advisers with custody to undergo an annual “surprise exam,” conducted by an independent public accountant, to verify the existence of client assets. All three of the sanctioned firms violated this aspect of the custody rule, as well as numerous other provisions of the securities laws and rules.

Among other violations committed by the three firms, as found by the SEC: Knelman Asset Management Group, LLC used a distribution methodology that was contrary to agreement and made improper discretionary cash distributions32; GW & Wade, LLC failed to identify certain of its custody arrangements and failed to fully disclose its assets under custody in public filings with the SEC33; and Further Lane Asset Management, Inc. engaged in undisclosed related party transactions and undisclosed principal transactions with advisory clients without consent, and made inaccurate statements in its Form ADV Parts I and II. 34

This diverse assortment of violations may be seen by the SEC staff as evidence that violations of the custody rule may be likely to coincide with other serious violations and the prospect for significant investor harm. The SEC is signaling it will continue to be vigilant in enforcing the custody rule. In announcing these three actions, Andrew Ceresney, Co-Director of the SEC’s Division of Enforcement, warned, “These firms failed to comply with their custody rule obligations, and other firms who hold client assets should take notice that we will vigorously enforce such requirements.”

10. Actions Charging Deficient Disclosures of Risks in Offerings of Residential Mortgage-Backed Securities

In a speech in September 2013, SEC Chair Mary Jo White touted the performance of the SEC’s Enforcement Division in the wake of the financial crisis, stating that, since 2008, the Division had brought crisis-related actions against more than 160 entities and individuals, while also bringing thousands of non-crisis-related cases at the same time.35 One crisis-related area the SEC continued to pursue in 2013 was alleged inadequate disclosures in offerings of residential mortgage-backed securities (RMBS).
In August 2013, the SEC filed a complaint in the U.S. District Court for the Western District of North Carolina, charging Bank of America (BOA) and two subsidiaries with defrauding investors by failing to disclose key risks and misrepresenting facts about the underlying mortgages in an $855 million RMBS offering in 2008. The SEC charged that BOA failed to tell investors that over 70% of the mortgages backing a particular offering originated through the bank’s “wholesale” channel of mortgage brokers unaffiliated with BOA entities, even though BOA knew that such wholesale channel loans presented significantly greater risks of delinquencies and defaults. This case is still pending.

In November 2013, the SEC announced a settlement with RBS Securities Inc. ("RBS"), a subsidiary of the Royal Bank of Scotland plc, over charges that it misled investors in a 2007 subprime RMBS offering. The SEC charged that RBS told investors the loans backing the offering were “generally in accordance with” the lenders’ underwriting guidelines, even though almost 30% of the loans did not meet those guidelines. RBS, without admitting or denying the SEC’s allegations, agreed to a final judgment ordering it to pay over $150 million in disgorgement, prejudgment interest and monetary penalty.

More information regarding certain matters discussed above can be found in Executive Alerts previously issued by Baker Hostetler.

Endnotes

2 Robert Khuzami, Director of the SEC’s Division of Enforcement, Public Statement by SEC Staff: Recent Policy Change (Jan 7, 2012), http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171489600.
5 Press Release, SEC, Philip Falcone and Harbinger Capital Agree to Settlement (Aug. 19, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222. Falcone and Harbinger must also pay a penalty of more than $18 million to the SEC. Falcone is additionally barred from the securities industry for at least five years.
16 SEC v. Cuban, 654 F. Supp. 2d 713 (N.D. Tex. 2009), vacated and remanded, 620 F.3d 551 (5th Cir. 2010).
21 The Dodd-Frank Act added Section 21F ("Securities Whistleblower Incentives and Protection") to the Securities Exchange Act of 1934

January 17, 2014
35 Mary Jo White, Chair, SEC, Deploying the Full Enforcement Arsenal (Sept. 26, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539841202.