

Implications of Recent Developments in SEC Enforcement: A Six Month Review of Chairman Mary Jo White's Tenure

In the six months since Mary Jo White was sworn in as the Securities and Exchange Commission's 31st Chairman, the SEC has announced important new policies and initiatives as the agency has begun to utilize new enforcement authority under the Dodd-Frank Act and to redeploy resources. In recent weeks, White and Andrew Ceresney, Co-Director of the Division of Enforcement, have made important public announcements regarding enforcement priorities. Taken together, these policies, initiatives, and announcements signal a shift toward more aggressive enforcement. This advisory discusses these developments.

Approach to Enforcement

From the time of her nomination, White stressed that the SEC would take an aggressive approach to enforcement under her leadership. At her March 12, 2013 confirmation hearing, White pledged that one of her highest priorities as Chairman would be "to further strengthen the enforcement function of the SEC" in a way that is "bold and unrelenting." White also stated that the SEC would pursue "all wrongdoers – individual and institutional, of whatever position or size" in order to deter wrongdoing and protect the integrity of financial markets.¹

White has continued this message in recent speeches before the Council of Institutional Investors on September 26 and the Securities Enforcement Forum on October 9.² During these speeches, White emphasized that "a robust enforcement program is critical to fulfilling the SEC's mission," and that she wants "our markets ... to know there is a strong cop on the beat." Examples from White's recent remarks include the following:

- The SEC should look at its enforcement mission by following the "broken windows" theory of policing that was championed by former New York City Mayor Rudy Giuliani, under which "no infraction was too small to be uncovered and punished." "The same theory can be applied to our securities markets – minor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines. And so, I believe it is important to pursue even the smallest infractions."

¹ See generally *Mary Jo White Confirmed to Chair SEC; "Bold" Enforcement Envisioned*, Arnold & Porter LLP Advisory (April 2013), available at <http://www.arnoldporter.com/resources/documents/ADV413MaryJoWhiteConfirmedToChairSecBoldEnforcementEnvisioned.pdf>.

² Mary Jo White, *Deploying the Full Enforcement Arsenal* (Sept. 26, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539841202>; Mary Jo White, *Remarks at the Securities Enforcement Forum* (Oct. 9, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539872100>.

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- “[W]hen we detect wrongdoing, we should consider all the legal avenues to pursue it. If we do not have the evidence to bring a case charging intentional wrongdoing, then bring the negligence case that does not require intent.”
- “Expect to see more ... mandatory undertakings in future cases so that we are not just punishing past wrongs, but also acting to prevent future wrongs.”
- Notwithstanding the “broken windows” approach, the SEC is “continuing to prioritize the bigger cases – pursuing and punishing major offenses by significant and high-profile market participants, sending a strong message of deterrence to the industry and boosting the confidence of investors.”

Increased Emphasis on Individual and Gatekeeper Accountability

In their recent statements, White and Ceresney have emphasized the need to pursue (i) responsible individuals and (ii) gatekeepers (such as auditors and directors).

Individuals. In her September 26 remarks, White emphasized the need for individual accountability, meaning that the SEC would “pursue responsible individuals wherever possible,” with the goal that individuals should understand that they “risk it all if they do not play by the rules.” White acknowledged that “this is something our enforcement division has always done.” White also noted, however, that she had asked the Enforcement Division to make a “subtle shift” by “looking first at the individual conduct and working out to the entity, rather than starting with the entity as a whole and working in” and “has made it clear that the staff should look hard to see whether a case against individuals can be brought.”

White further emphasized the need to punish individuals for wrongdoing in an effort to prevent similar conduct from recurring, noting that “[o]ne of the most potent tools the SEC has is a court order imposing a bar on an individual – a bar from, for example, working in the securities industry or serving on the board of a public company.” And, as discussed below, the SEC’s modified policy on requiring admissions of wrongdoing in settlements further reflects the SEC’s shift in emphasis with respect to individuals.

While it remains to be seen how the Enforcement Staff will implement this priority and whether it will have any practical effect on enforcement efforts, the strategy appears to be reflected in recent SEC enforcement actions, including the settlement with Harbinger Capital Partners founder Philip Falcone (discussed below), as well as in recent high-profile trials against Goldman Sachs trader Fabrice Tourre and Dallas Mavericks owner Mark Cuban.

Gatekeepers: Auditors and Accountants. Both White and Ceresney recently stated that the Enforcement Division has placed a renewed “focus” on accounting fraud. In an extended address on September 19 to an American Law Institute (ALI) Accountants’ Liability conference, Ceresney acknowledged that, “in the wake of the financial crisis ... we devoted fewer resources to accounting fraud.”³ Ceresney stated, however, that he found it “hard to believe that we have so radically reduced the instances of accounting fraud simply due to reforms such as governance changes and certifications and other Sarbanes-Oxley innovations.” Noting that “the incentives are still there to manipulate financial statements,” Ceresney said that the SEC “will not know whether there has been an overall reduction in accounting fraud until we devote the resources to find out, which is what we are doing.”

In addition to noting that he expected the Enforcement Division would focus on such traditional accounting issues as revenue recognition and reserves, Ceresney said that there would be a focus on auditors. As Ceresney stated, “if there is a significant restatement or if we learn about improper accounting ... you can expect that we will scrutinize not only the CEO, CFO and Controller, but also the engagement partner, engagement quality reviewer, and the auditing firm as a whole.” Ceresney also said that the Staff was “focused on investigating [auditor] independence violations” and would “probe the quality of the audit and determine whether the auditors missed or ignored red flags, whether they have proper documentation, and whether they followed the professional standards.”

³ Andrew Ceresney, Financial Reporting and Accounting Fraud (Sept. 19, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539845772>.

In conjunction with these efforts, White noted on October 9 that the Staff was focusing on auditors and recently had launched an initiative called “Operation Broken Gate,” which she described as an effort “to identify auditors who neglect their duties and the required auditing standards.” On September 30, in the first enforcement effort related to this initiative, the SEC announced charges against three auditors for purportedly failing to comply with auditing standards.⁴

The “Operation Broken Gate” initiative follows the SEC’s July 2 announcement that it was establishing a Financial Reporting and Audit Task Force, focused on the preparation of financial statements, issuer reporting and disclosure, and audit failures, with the goal of detecting and preventing fraud and increasing the prosecution of violations involving false or misleading financial statements and disclosures.⁵ During comments at the recent ALI conference, Task Force Director David Woodcock (who also is the Director of the Fort Worth Regional Office) noted that the Task Force had six attorneys and six accountants detailed full time to the effort. Woodcock said that, in addition to traditional methods of identifying potential fraud (which include referrals from the Public Company Accounting Oversight Board, the Office of Chief Accountant, and the Division of Corporation Finance), the Task Force intended to focus on certain industry-specific “street sweeps” and utilize its Accounting Quality Model (AQM) with an aim of identifying instances of earnings management.⁶ Whistleblowers also are a significant source in this area, according to Ceresney, who noted in his September 19 remarks that 18.2 percent of whistleblower tips received in 2012 related to “corporate financial and disclosures.”

Gatekeepers: Directors. During her October 9 remarks, White noted that the Staff would be looking at directors, stating that “being a director or in any similar role where

you owe a fiduciary duty is not for the uninitiated or the faint of heart.” In this regard, she noted that the Staff recently brought a series of actions against directors who served on investment company boards. Ceresney similarly noted in his September 19 remarks that it is “important to focus on Audit Committees, which serve as a sort of gatekeeper for audit quality,” and “we intend to continue holding committees and their members accountable when they shirk their responsibilities.”

Tougher Conditions of Settlement

In her recent speeches, White indicated that the SEC will be taking a new approach with regard to certain aspects of its settlements, stating on September 26 that “we need to be certain our settlements have teeth, and send a strong message of deterrence.” White reported that she has “encouraged our enforcement teams to think hard about whether the remedies they are seeking would sufficiently redress the wrongdoing and cause would-be future offenders to think twice.”

Admissions of Wrongdoing. During White’s tenure, the SEC has continued its efforts to modify its longstanding policy of allowing certain defendants to settle charges without admitting or denying allegations of wrongdoing.⁷

On June 18, White announced that the SEC would modify its policy regarding admissions of wrongdoing – and, during her September 26 remarks, she elaborated on the modified policy. While acknowledging that “no-admit-no-deny settlements are a very important tool in our enforcement arsenal that we will continue to use when we believe it is in [the] public interest to do so,” White explained that “[c]andidates potentially requiring admissions include” cases where:

⁴ SEC Press Release, *SEC Charges Three Auditors in Continuing Crackdown on Violations or Failures By Gatekeepers*, available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539850572>.

⁵ See generally *SEC Announces New Enforcement Initiatives*, Arnold & Porter LLP Advisory (July 2013), available at <http://www.arnoldporter.com/resources/documents/ADV713SecAnnouncesNewEnforcementInitiatives.pdf>.

⁶ The AQM is a proprietary system the SEC is developing to compare registrants’ filings in an attempt to identify anomalous filings and potential accounting improprieties.

⁷ These efforts followed a series of developments, including (i) Southern District of New York Judge Jed Rakoff’s rejection of a proposed US\$285 million settlement in the *Citigroup* case on the grounds that the settlement failed to include an admission of liability (which is currently on appeal to the Second Circuit, see *SEC v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011)), (ii) criticism of the SEC’s admissions of wrongdoing policy by other federal judges, and (iii) the Enforcement Division’s announcement in January 2012 that it would require admissions in cases where the defendant had pled guilty in a parallel criminal proceeding. See generally *SEC Announces New Enforcement Initiatives*, Arnold & Porter LLP Advisory (July 2013), available at <http://www.arnoldporter.com/resources/documents/ADV713SecAnnouncesNewEnforcementInitiatives.pdf>.

- “a large number of investors have been harmed or the conduct was otherwise egregious”;
- “the conduct posed a significant risk to the market or investors”;
- “admissions would aid investors deciding whether to deal with a particular party in the future”;
- “reciting unambiguous facts would send an important message to the market about a particular case.”

During his September 19 remarks, Ceresney similarly stated that, although “the majority of cases will continue to be resolved on a no admit no deny basis,” in other cases the SEC will “demand admissions, and if the defendant is not prepared to admit the conduct, litigate the case at trial.”

The SEC’s modified policy has been deployed in two recent high-profile settlements:

- First, on August 19, the SEC announced a settlement with Harbinger Capital Partners and its founder, Philip Falcone. In the settlement, Harbinger and Falcone made admissions with respect to certain conduct in connection with funds that they advised (including, for example, the failure to disclose to fund investors for a period of time that Falcone had borrowed US\$113.2 million from one fund to pay personal tax liabilities, and granting favorable redemption terms to certain investors in another fund).⁸ Notably, this settlement followed a prior agreement in principle that Harbinger and Falcone had reached with the Staff that had not required admissions of wrongdoing, which the Commission voted not to approve.⁹ Ceresney later cited the Harbinger/Falcone settlement as the first instance of the SEC’s modified policy in action.

⁸ SEC Press Release, *Philip Falcone and Harbinger Capital Agree to Settlement*, available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222>.

⁹ In May, Harbinger Group Inc. disclosed the agreement in principle. See Form 10-Q, Harbinger Group Inc. (May 9, 2013). In July, Harbinger Group Inc. disclosed that the SEC voted not to approve the agreement in principle. See Form 8-K, Harbinger Group Inc. (July 18, 2013).

- Second, on September 19, the SEC announced that JPMorgan Chase & Co. agreed to settle charges arising out of the “London Whale” matter, which involved trading losses of nearly US\$6 billion in a large portfolio of credit derivatives held by the firm’s chief investment office.¹⁰ In addition to agreeing to pay a US\$200 million civil penalty, JPMorgan made admissions regarding the inadequacies of its internal controls and failure by senior management to adequately inform the audit committee about certain information prior to an SEC filing being made.

Appearing at a Practising Law Institute conference on October 1, Ceresney warned that “these two will not be the last ... we have more admission cases coming down the pike” and that “naming and shaming ... inflicts pain on wrongdoers, who have to learn that settling with the SEC is not just a cost of doing business.”¹¹

Penalties. During her September 26 remarks, White stated that “we must make aggressive use of our existing penalty authority” and noted that penalties “make companies sit up and take notice of what our expectations are and how vigorously we will pursue wrongdoing.” She stated that the SEC’s 2006 release, *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, set forth a “useful, non-exclusive list of factors that may guide a Commissioner’s consideration of corporate penalties.”¹² White also expressed support for proposed legislation that would allow the Staff to obtain “either

¹⁰ SEC Press Release, *JPMorgan Chase Agrees to Pay \$200 Million and Admits Wrongdoing to Settle SEC Charges*, available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965>. The SEC Order is available at <http://www.sec.gov/litigation/admin/2013/34-70458.pdf>.

¹¹ See Stewart Bishop, SEC Will Demand More Admissions of Guilt, Official Says, Law360 (Oct. 1, 2013); Alison Frankel, SEC Enforcement Co-director: We’re Bringing ‘Swagger’ Back, Reuters (Oct. 1, 2013).

¹² See SEC Press Release, *Statement of the Securities and Exchange Commission Concerning Financial Penalties* (Jan. 4, 2006), available at <http://www.sec.gov/news/press/2006-4.htm>. This release noted that the imposition of monetary sanctions would be affected by (i) the egregiousness of the misconduct, (ii) how widespread it was, and (iii) whether the company cooperated and had a strong compliance program.

three times the ill-gotten gains or the amount of investor losses – whichever is greater.”

Undertakings. White also noted during her September 26 remarks that the Staff should routinely “consider whether to require the company to adopt measures that make the wrong less likely to occur again.” Noting that the SEC, when it settles a case involving violations of the Foreign Corrupt Practices Act, frequently “requires [the company] to put in place better training and reporting programs,” White said that similar measures “can also be useful in other kinds of cases.”

Leveraging New Enforcement Tools and Technologies

In her October 9 remarks, White emphasized that, in order to “be everywhere” and “cover the whole market,” the Enforcement Division needs to utilize its tools and technologies in a manner that will create “a presence that exceeds our physical footprint” and cause the agency “to be felt and feared in more areas than market participants would normally expect that our resources would allow.”

Whistleblower Office. White noted that the Enforcement Division was “using with growing frequency and success” information from its Office of the Whistleblower. Originally established in 2011 in conjunction with the Dodd-Frank Act, the Office reported receiving 3,001 tips during fiscal year 2012. In her October 9 remarks, White noted that the program was a “tremendously effective force-multiplier, generating high quality tips and, in some cases, virtual blueprints laying out an entire enterprise, directing us to the heart of an alleged fraud.”

These remarks follow several recent and prominent awards under the program. On August 30, the SEC announced that three whistleblowers were awarded the first installment of an anticipated total payment of US\$125,000 for information they provided to the SEC and DOJ related to a hedge fund.¹³ On October 1, the SEC

announced an award of more than US\$14 million to one whistleblower, the largest award since the SEC’s Office of the Whistleblower was established.¹⁴

National Examination Program. In her October 9 remarks, White noted that the SEC has ongoing examinations at registered entities, such as broker-dealers and investment advisers, which “gives us a real-time look into developing industry practices that may sometimes constitute violations that warrant further investigation and enforcement action.” In her September 26 remarks, White emphasized the need for “closely coordinating our enforcement teams and our examination teams.”

Data Analytics. White has stated that the Enforcement Division is increasingly utilizing technology “to make it easier for us to spot fraud early on.” During her October 9 remarks, she noted the use of the “Advanced Bluesheet Analysis Program” to “identif[y] suspicious trading before market-moving events,” stating that its use had led to the filing of an “unprecedented” number of insider trading actions (more than 200) over the last four years. Similarly, as discussed above, Woodcock cited the development of the AQM to detect potential accounting improprieties.

Conclusion

Although the clear impact of the SEC’s enforcement priorities only will be seen as the initiatives are developed and executed, they reveal a convincing tone being set by the new leadership. Companies and entities of all types, along with professionals and other individuals, should take notice of the shift in approach, including the overall renewed emphasis on financial reporting and the focus on individual accountability, gatekeepers, and lesser violations. Particular attention should be paid to the effectiveness of existing compliance and training programs to prevent and detect violations of the securities laws and whether upgrades should be made. In addition, entities that are facing the possibility of an SEC

¹³ SEC Press Release, *SEC Rewards Three Whistleblowers Who Helped Stop Sham Hedge Fund*, available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539796657>.

¹⁴ SEC Press Release, *SEC Awards More Than \$14 Million to Whistleblower*, available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258>.

investigation should consider whether and how they will cooperate, including whether to self-report violations and how to address allegations of wrongdoing by individual directors, officers, or employees. Individuals similarly will need to weigh how to best respond. These decisions are likely to be increasingly important in determining how a matter ultimately will be resolved in this new and somewhat uncharted era of aggressive SEC enforcement.

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