# Tone at the Top (of the SEC): Tough

October 7, 2013

As the fiscal year comes to a close—even while the Securities and Exchange Commission, amidst the government shutdown, continues to fund its operations through a carryover balance from FY 2013—it is a good time to review recent signs of SEC skepticism regarding financial statement reporting practices and the SEC's current focus on public company officers, directors, and auditors as targets of potential enforcement actions. Since Mary Jo White was confirmed as the new Chairman in April, and George Canellos and Andrew Ceresney were named Co-Directors of the Division of Enforcement later that month, a number of enforcement actions and SEC statements suggest a heightened vigilance, particularly with respect to potential corporate accounting failures.

## Recent Developments Highlight SEC's Tough Tone

Consider the following chronology:

- **Change to "No Admit, No Deny" Policy:** On June 18, at a *Wall Street Journal* CFO Network conference, Chairman White announced a seminal change in the SEC's use of "no admit, no deny" provisions in settlement agreements, which had traditionally allowed defendants in SEC enforcement actions to resolve charges without admitting to any legal violations or admitting to any of the underlying alleged conduct. As reported in the *Wall Street Journal*, under the new policy, the SEC would decide on a "case-by-case" basis whether to allow a particular defendant to settle in the traditional manner, or whether to require an admission of liability. Although most cases would continue to include "no admit, no deny" statements, the SEC would deviate from this approach where there is "intentional conduct or widespread harm to investors." An internal SEC memo from Ceresney and Canellos elaborated on the new policy, adding, according to a *New York Times* report, that admissions might also be sought when the defendants placed "the market at risk of potentially serious harm" and "when the defendant engaged in unlawful obstruction of the commission's investigative processes."
- **Initiatives to Combat Financial Reporting and Microcap Fraud:** On July 22, the SEC announced three new initiatives designed to bolster the Enforcement Division's technological and analytical capabilities. The SEC established a "Financial Reporting and Audit Task Force" to strengthen its focus on fraudulent or improper financial reporting. It also established a "Microcap Fraud Task Force" to target abusive trading and fraudulent conduct in securities issued by microcap companies, particularly those that do not regularly publicly report their financial results. The SEC noted that it expects to target "gatekeepers," such as attorneys, auditors, broker-dealers, and transfer agents, in its effort to detect fraud in the microcap market. The Microcap Fraud Task Force will bolster the efforts of the Microcap Fraud Working Group by adding staff dedicated exclusively to investigating participants in the microcap market. Finally, the SEC created a "Center for Risk and Quantitative Analytics" to enhance its analytical techniques and computing capacity in order to profile high-risk behaviors and transactions. The SEC's announcement is available **here**.
- **Falcone and Harbinger Capital Settlement:** On August 19, Philip Falcone and Harbinger Capital agreed to a settlement under which they must pay more than $18 million and admit wrongdoing, and under which Falcone is barred from the securities industry for at least five years. The settlement, which was approved by Judge Paul A. Crotty in the U.S. District Court for the Southern District of New York on September 16, requires Falcone to pay $6,507,574 in disgorgement, $1,013,140 in prejudgment interest, and a $4 million penalty. The Harbinger

entities are required to pay a $6.5 million penalty. Falcone admitted to improperly using approximately $113 million in fund assets to pay his personal taxes, granting favorable redemption and liquidity terms to certain large investors and failing to disclose those arrangements, and conducting an improper "short squeeze" in bonds issued by a Canadian manufacturing company. The SEC's announcement is available **here** and the final consent judgment is available **here**.

- **JPMorgan Chase Settlement:** On September 19, JPMorgan Chase & Co. agreed to a settlement under which it must pay a $200 million penalty and admit wrongdoing related to the trading losses associated with the so-called "London Whale." The settlement follows SEC charges against two former JPMorgan traders for committing fraud to hide massive losses in a trading portfolio. The traders were each indicted on five criminal counts in the U.S. District Court for the Southern District of New York in September. The SEC's settlement also occurred as part of a coordinated global settlement with the U.K. Financial Conduct Authority, the Federal Reserve, and the Office of the Comptroller of the Currency, under which JPMorgan must pay a total of approximately $920 million in penalties. JPMorgan admitted to misstating financial results and lacking effective internal controls to detect and prevent its traders from fraudulently overvaluing investments. The SEC's announcement is available **here** and the order is available **here**.
- **Focus on Financial Reporting and Accounting Fraud:** On September 19, Andrew Ceresney gave a speech focused on the SEC's renewed emphasis on combatting financial reporting and accounting fraud. Ceresney explained that after the financial crisis, the SEC devoted fewer resources to accounting fraud and expressed "doubts about whether we have experienced such a drop in actual fraud in financial reporting as may be indicated by the numbers of investigations and cases we have filed." In particular, he noted the recent trend of fewer companies issuing restatements. He discussed the future role of the "Financial Reporting and Audit Task Force" or "Fraud Task Force." He emphasized that the task force would take advantage of advancements in data analytics and focus on the following: the manner in which management and auditors make decisions with respect to reserves; revenue recognition; auditors, including the SEC's independence rules for auditors; Audit Committees; and companies with substantial foreign operations. The speech is available **here**.
- **"Deploying the Full Enforcement Arsenal":** On September 26, Chairman White gave a speech titled "Deploying the Full Enforcement Arsenal" in which she emphasized the SEC's need to be "aggressive and creative" when it chooses which cases to bring and when it determines how to resolve cases. [1] She warned that the SEC would bring negligence cases when it does not have evidence to bring a case charging intentional wrongdoing and that it would pursue settlements that "have teeth." She also emphasized the need for the SEC to demand public accountability and the corresponding change to the "no admit, no deny" policy. Chairman White explained that the SEC may require admissions of guilt in cases where large numbers of investors were harmed, where conduct is egregious or poses a significant market threat, where an admission of guilt would help investors decide whether to deal with that party in the future, and where the fundamental facts of a case would send an important message to the market.

[1] More recently, on October 3, 2013, Chairman White continued the aggressive tone in a speech titled "The Importance of Independence." She emphasized the need for Congress and the courts to respect the SEC's independence. In particular, she took issue with "those who seek to effectuate social policy or political change through the SEC's powers of mandatory disclosure." And, she discussed the importance of deference in judicial review of enforcement settlements and the application of "no admit, no deny" policy. The speech can be found **here**.

Chairman White reiterated her support for legislation that would enable the SEC to seek penalties "based on [the larger of] either three times the ill-gotten gains or the amount of investor losses" and would authorize the SEC to seek additional penalties against repeat offenders. She stated that the SEC will be increasing its actions "relating to sophisticated trading strategies, dark pools, and other trading platforms in the coming year." The speech is available **here**.

- **Record Whistleblower Award:** On October 1, the SEC announced its largest-ever whistleblower award: $14 million. The whistleblower requested anonymity and the specific enforcement action was not identified. The SEC stated that the whistleblower provided information that led to an SEC enforcement action in which "substantial investors funds" were recovered. The Office of the Whistleblower was established in 2011 under the Dodd-Frank Act and this is the third announcement since the unit was established. Award amounts range from 10 percent to 30 percent of the money collected. Thus, we can surmise that the actual recovery in the underlying case was at least close to $50 million and could be over $100 million, which suggests that the action did not involve a Ponzi scheme or offering fraud. According to the SEC, this particular whistleblower gave the SEC original information and assistance that allowed it to bring an enforcement action and secure investor funds less than six months after receiving the tip. The SEC's announcement is available **here** and the order is available **here**.

## Considerations for the Future

The SEC's aggressive stance under Chairman White's leadership portends a flurry of enforcement activity over the next several years. Recent developments suggest that the SEC will be vigorously pursuing breakdowns in corporate accounting systems, while occasionally seeking public admissions in the most egregious instances. Now—as the new regime's enforcement approach begins to take shape—would be a good time to brief management teams and boards of directors on this trend. Counsel should also ensure that the appropriate procedures and structures are in place to escalate compliance issues internally, so that senior management can consider the potential enforcement implications.

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