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SEC ENFORCEMENT

Fifteen Things to Expect from the SEC's Enforcement Division in 2014



BY DAVID MARDER

In April, 2013, Securities and Exchange Commission Chair Mary Jo White brought her reputation as a no-nonsense criminal prosecutor to the Commission. Since that time, she has been vocal about the direction in which she would like to take the Commission. She wants the SEC to be perceived as a “tough cop” that is “everywhere” pursuing even the smallest infractions.¹ Indeed, she has referred to the analogy of repairing “broken windows” to emphasize the need to police minor violations. At the same time, Chair White professes that the Commission will prioritize bigger cases. In other words, her priorities are to do everything.

¹ Yin Wilczek, *SEC Chairman Vows That No Violation, Big or Small, Will Escape Agency's Scrutiny*, 45 BLOOMBERG BNA SEC. REG. & L. REP. 1883 (Oct. 14, 2013).

David Marder is a partner at Robins, Kaplan, Miller & Ciresi. He represents parties in investigations and actions brought by the Securities and Exchange Commission, Financial Industry Regulatory Authority, and state securities regulators, and in private securities actions, including litigation and arbitration. He is also a former senior trial counsel and assistant district administrator at the SEC. Marder can be contacted at demarder@rkmc.com.

The SEC cannot, of course, be everywhere at once. By promising to do everything, Ms. White provides few clues about the Commission's true priorities. However, by reading between the lines, and by examining the Commission's actions, rather than its words, it is possible to draw some conclusions about the path down which the enforcement division is heading during the next year.

1. Increased Use of Whistle-blowers Chair White has conceded that any increase in the scope of the SEC's enforcement efforts will require it to leverage others to assist it, and whistle-blowers are at the top of the list. Perhaps in an effort to encourage more whistle-blowing, the SEC awarded a whistle-blower more than \$14 Million in the fall of 2013.² Expect this payment to increase awareness of the bounty program and generate additional whistle-blowing throughout 2014.

2. Decrease in Settlements Where the Defendant Does Not Admit There has been a slow and steady erosion of the SEC's willingness to accept settlements where the defendant does not admit or deny the violations. The SEC originally began insisting on admissions in cases where the defendant had a guilty plea or conviction in a companion criminal case, but announced in June that it

² Phyllis Diamond, *SEC Announces \$14M Award To Whistle-Blower; Is Largest to Date*, 45 BLOOMBERG BNA SEC. REG. & L. REP. 1823 (Oct. 7, 2013).

will require admissions in other contexts.³ The Commission has yet to articulate with specificity the situations in which an admission will be required. Staffers have referred to numerous vague factors or examples, but the ones mentioned could arguably cover every case. They are as follows: 1) significant investor harm or a large number of investors; 2) egregious misconduct; 3) conduct that poses a significant risk to market or investors, especially where accompanied by ongoing interactions with investors or some other form of ongoing risk; 4) situations where admissions would aid investors in deciding whether to deal with a particular party in the future; and 5) instances where there is a need to send a “message” to the market.

The few settlements to date that have included admissions, such as the London Whale case and the case involving Philip Falcone, have not provided any additional clarity or guidance. Look for more settlements involving admissions in 2014.

3. Increased Use of Technology In an effort to do more with the same resources, the SEC will focus increasingly on the use of technology. One example is the Commission’s development the Advanced Blue Sheet Analysis Program, an automatic program that analyzes blue sheet data about specific transactions. It is supposed to be able to ferret out insider trading by identifying suspicious trading before major events and showing the relationship between the relevant players.

4. Increased Number of Streamlined and Easy-to-Prove Cases In conformity with her “broken windows” policy, Chair White has stated that she will pursue negligence-based offenses where there is no evidence of intent. We should also expect more prosecution of prophylactic rules with no intent requirement at all. One example is Rule 105 of Reg. M, a strict liability provision that prevents manipulation through short selling. In September, the Commission brought a series of cases under that rule against 23 firms.⁴ Some of the disgorgement amounts were as small as \$4,000, which lends credence to Ms. White’s assertion that the SEC will pursue minor cases.

Ms. White has recently tried to back off her stance on small infractions by asserting that the Commission is not interested in a game of “gotcha,”⁵ but what this means is far from clear. Only time will tell how this plays out, but investment professionals need to be mindful of every potential violation, even where no intent is present, in the coming year.

5. Push to Self-Report Staff members have recently dialed up their efforts to encourage self-reporting. Expect this effort to increase in 2014. In recent publications and speeches, staff members have opined that it is always better to self-report, although they have conceded

that there are no statistics to prove that self-reporters are treated better than others. In addition to leniency at the punishment phase, violators can expect a proper internal investigation to limit the scope of the SEC’s investigation. Staff members have stated that they will usually delay taking action to wait for an internal investigation to conclude if the conduct is relatively minor and internal controls seem to be working.

6. Increased Focus on Microcaps The Commission is very concerned with wrongdoers in the microcap community that use market manipulation and misleading marketing materials. The victims of these scams are usually the less sophisticated investors. The problem has proliferated exponentially since the advent of the Internet and is compounded by the expanding popularity of social media. Expect more attention and enforcement efforts directed to this area in 2014.

7. Continued Focus on Gatekeepers Look for the SEC to continue leveraging gatekeepers as another technique to increase the scope of its enforcement efforts. Chair White has stated that gatekeepers share responsibility with the SEC to protect investors. Chair White has shown little sympathy to those who have voiced concern that a focus on gatekeepers might drive away those that would otherwise serve for fear of being second-guessed. Her simple retort is that being a director or other fiduciary is not for the “faint of heart.”⁶

Auditors are a type of gatekeeper that will receive particular attention (see point 8 below). Look for more initiatives such as operation “Broken Gate,” which probed whether auditors had ignored or violated their duties. Early this fall, the operation resulted its first three cases against auditors.⁷

8. Emphasis on Financial Accounting Expect a continuing emphasis on financial statement and accounting fraud. One subset of companies whose financial statements will see increased attention is broker-dealers. The new Public Company Accounting Oversight Board standards for broker-dealer audits promulgated pursuant to 1934 Securities Exchange Act Rule 17a-5 are part of this increased scrutiny on broker-dealer accounting.

Much of this work will be spearheaded by the Financial Reporting and Auditing Task Force. This task force consists of a small group of lawyers and accountants who use data analytics to monitor high-risk companies for evidence of accounting fraud. Members of this group do not directly prosecute cases, but rather find and incubate cases, and then hand them off to enforcement attorneys. Their cases tend to be larger and more resource-intensive.

9. Protection of Market Structure and Integrity Initiatives that protect the structure and integrity of the securities markets are high on the SEC’s to do list. Rule 15c3-5, which banned unfiltered market access, is an initiative that falls within this category. SEC staff members have stated that they anticipate increased enforcement activity to be driven by the Market Abuse Unit,

³ Yin Wilczek, *White Announces Revision of SEC ‘No Admit’ Settlement Policy*, 45 BLOOMBERG BNA SEC. REG. & L. REP. 1150 (6/24/13).

⁴ SEC Charges 23 Firms With Short Selling Violations in Crackdown on Potential Manipulation In Advance of Stock Offerings, SEC Press Release No. 2013-182, (Sept. 17, 2013), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539804376>

⁵ Mark Schoeff, *White softens stance on minor securities violations*, INVESTMENT NEWS (Oct. 22, 2013), available at <http://www.investmentnews.com/article/20131022/FREE/131029967>.

⁶ Mary Jo White, Chairman, Sec. & Exch. Comm’n, Remarks at the SEC Enforcement Forum (Oct. 9, 2013), available at <http://sec.gov/News/Speech/Detail/Speech/1370539872100>.

⁷ Phyllis Diamond & Steve Burkholder, *SEC Sues Three Auditors In Bid to ‘Hold Gatekeepers Accountable’*, 45 BLOOMBERG BNA SEC. REG. & L. REP. 1861 (10/7/13).

which specializes in the most sophisticated and hard-to-detect frauds and market abuses. Prosecuting cases against non-traditional exchanges known as Alternative Trading Systems will be another component of this set of initiatives.

10. More Activity by Specialized Units The SEC has aspired to become more efficient through the use of units that bring specialized expertise to particular fields. Look for these units to be more active in the coming year. Examples are the Market Abuse Unit and the Financial Reporting and Auditing Task Force described above. Other examples are the Structured and New Products Unit and the recently created Microcap Task Force, which is working to develop the capability of detecting and stopping scams in the early stages.

11. Attacking Insider Trading Insider trading is a perennial favorite target of the SEC. It continues to be an area of concern due to the need to bolster the public perception of the integrity of the securities markets. Look for continued emphasis in this area throughout 2014.

12. Investigating Misconduct at Hedge Funds, Private Equity Funds, and Mutual Funds From speeches and actions of the SEC staff, it is clear that the SEC is targeting misconduct by investment advisers at hedge funds, private equity funds, and mutual funds. The SEC has actively pursued private funds this year, bringing charges against such entities for engaging in insider trading, making false claims, overstating assets under management, giving preferential treatment to certain investors, and misappropriating fund assets.⁸ In August of this year, the Commission settled its first action under Rule 38a-1(c) of the Investment Company Act, which prohibits manipulating or obstructing the CCO of a fund.⁹ One notable trend in the SEC's prosecution of funds is the Commission's propensity for bringing actions against individuals.

The staff has recently focused on how fund boards approve fees, and this focus is likely to continue

⁸ Mary Jo White, Chairman, Sec. & Exch. Comm'n, *Hedge Funds – A New Era of Transparency and Openness* (Oct. 18, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539892574>.

⁹ In *First-of-Its-Kind SEC Suit, Ex-Exec Settles Allegations of Misleading CCO Over Trades*, 45 BLOOMBERG BNA SEC. REG. & L. REP. 1599 (9/2/13).

throughout 2014. The effort began with the Mutual Fund Fee Initiative in 2010, but is still continuing. In the spring of this year, the SEC launched a new initiative to examine fund distribution fees.

It is clear that the SEC views members of investment company boards as a type of gatekeeper that will come under increasing scrutiny. One recent action brought by the SEC is exemplary. It involved trustees who were required to review and approve the fund's investment advisory contracts. The Commission charged that reports to shareholders contained misleading information or omitted information about how the trustees performed their review.¹⁰

13. Winning at Trial The SEC has been stung by a number of high profile losses at the trial level, including the recent Mark Cuban insider trading case. These losses are a function of the SEC's allocation of resources. Since the SEC justifies its budget each year by touting the number of cases it brings (and is rarely asked how many cases it wins), it naturally directs funds and personnel to investigations, rather than trials. Look for a more beefed-up trial unit as the SEC seeks to bounce back from some embarrassing losses.

14. Increased Leverage of Examination Program Chair White has said that she intends to take more advantage of the National Exam Program, which provides "boots on the ground" at registered entities, to enhance the SEC's presence in the marketplace.¹¹ She has promised enhanced cooperation between the examination and enforcement staff, especially in the area of asset managers and broker-dealers, but only time will tell about the nature and scope of these efforts.

15. More Administrative Proceedings Some commentators have discerned an increased inclination by the staff to bring actions as administrative proceedings instead of federal court cases. We may see this trend increase in 2014. Given the lack of a jury, limited discovery, and the absence of an Article III judge, such a trend might concern some industry participants.

¹⁰ *Fund-Trust Gatekeepers Settle Allegations Over Disclosures About Advisory Contracts*, 45 BLOOMBERG BNA SEC. REG. & L. REP. 828 (5/6/13).

¹¹ Mary Jo White, Chairman, Sec. & Exch. Comm'n, Remarks at the SEC Enforcement Forum (Oct. 9, 2013), available at <http://sec.gov/News/Speech/Detail/Speech/1370539872100>.