A New World in SEC Compliance and the Fundamentals to Face the Challenges

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Introduction

The Securities and Exchange Commission (SEC) continued to speed up the pace of regulatory oversight during 2012, focused on its primary goal—to restore investor confidence and trust in the capital markets following the financial crisis of 2008. In addition to implementing several rules required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)\(^1\) aimed at protecting investors, such as say-on-pay clauses and the Conflicts Mineral Rule,\(^2\) the SEC proposed rules mandated by the Jumpstart Our Business Startups Act (the JOBS Act),\(^3\) which seeks to make it easier for smaller companies to raise money. Before the November 2012 elections, there was some movement toward repealing Dodd-Frank, and while there may be some revisions, the law is here to stay following the reelection of President Obama and the Democratic Party’s retention of control of the US Senate. With legal challenges to new rules under way and much of the final rulemaking under Dodd-Frank still to come, companies are faced with unprecedented uncertainty regarding what will be required for SEC compliance—which will require that they and their counsel be ready to swiftly react to regulatory changes.

Current Economic and Political Factors on Securities Compliance

While many of the same economic and political factors at issue in previous years continued to drive recent developments in SEC regulation, several new factors came into play during 2012. Most of the trends are the result of the SEC’s continued efforts to restore trust in the capital markets following the 2008 financial crisis, which caused an estimated $12.8 trillion in investor losses.\(^4\) Recent reports indicate that investors have little or no trust in our markets, with 79 percent of investors saying they have no trust in the financial system,\(^5\) and 64 percent saying they believe that corporate


\(^{5}\) Too Big To Trust, Kellogg School of Management (July 2012), available at http://www.kellogg.northwestern.edu/News_Articles/2012/FTI-too-big-to-trust.aspx.
misconduct was a significant factor in bringing about the current economic crisis.\textsuperscript{6} According to SEC Commissioner Luis Aguilar, “[N]early five years after the crisis, the public is still asking why more individuals and entities have not been held accountable. The public must have faith that the SEC and other institutions are aggressively working to protect the integrity of the securities market. And, for that faith to return, the SEC must be proactive in demonstrating that it is pro-investor.”\textsuperscript{7}

The SEC and other regulators argue that in the years leading up to the crisis, financial institutions were borrowing to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly. In addition, regulators argue that the lack of regulatory oversight permitted banking systems to use trillions of dollars in short-term debt to fund inherently risky financial activity without disclosing such activities. Lawmakers and regulators pointed to these factors, along with the ever-increasing complexity and speed of the markets, for the need for more oversight and accountability within the financial markets.

As a result, Congress took action by passing sweeping financial reform legislation designed to close regulatory gaps and bring greater transparency and access to previously opaque markets. Dodd Frank contains about ninety-five provisions that require SEC rulemaking, and dozens of other provisions that give the SEC discretionary rulemaking authority. To date, the Commission has proposed or adopted about three-quarters of the mandatory rulemaking provisions, including, as previously noted, giving investors a say-on-pay regarding executive compensation and establishing a whistleblower program that offers incentives for individuals with information regarding securities law violations to come forward.\textsuperscript{8} Financial institutions and banking were the major focus of regulatory activity during 2012. The SEC has also proposed a series of rules designed to improve the practices of credit rating agencies, including rules to limit the conflicts that may arise due to Nationally Recognized Statistical Rating Organizations (NRSROs) relying on client payments and rules to monitor rating agency

\textsuperscript{7} Luis Aguilar, supra note 4.
employees who later move to new positions with rated entities. In addition, the SEC has made a series of proposals to remove references to credit ratings contained within existing Commission rules and replace them with alternative criteria. For example, the SEC adopted rules eliminating the credit rating transaction as a condition for eligibility of an issuer to utilize registration Forms S-3 and F-3, replacing it with four new transaction requirements, the satisfaction of any one of which would permit an issuer to utilize Form S-3 or F-3 for the registration of non-convertible securities, other than common equity.

Similarly, shareholders have become increasingly more involved, enforcing their rights to monitor company activities and taking greater steps to impact management. The phrase “activist investor” no longer has the negative connotation that it used to carry; rather, a number of commentators have concluded that today’s activist investors have the ability to create additional value for shareholders, with many driven by goals such as promoting socially responsible investments. This trend does not just apply to individuals; the number of institutional investors willing to take activist positions is on the rise. According to Femke van’t Groenewout-Hendriks, an attorney and senior advisor on responsible investments at PGGM Investments, “We would like to better shape the company with corporate governance reforms that are meaningful and significant.”

Some of this activity can be attributed to Dodd-Frank, which gave the SEC the ability to promulgate rules allowing for greater shareholder proxy access and voting rights. However, shareholders are making efforts to extend their rights on their own as well. It is becoming more common for shareholders to demand governance reforms in addition to monetary damages in settling shareholder litigation. For example, as part of E-Trade Financial Corporation’s recent settlement arising from alleged non-disclosures about

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10 Id.
its business, prospects, and financial condition, E-Trade agreed to make a number of changes to corporate governance, including requiring E-Trade’s compensation committee to disclose the factors justifying each executive officer’s compensation in the company’s annual proxy statement, increasing the number of independent directors on its board and company committees, and limiting the audit, governance, and compensation committees to independent directors.\textsuperscript{13} Other popular governance upgrades in legal settlements include compensation reforms, additional voting requirements, and steps to improve corporate oversight such as splitting the chairman and chief executive officer roles or instituting risk committees at board levels.

Courtroom battles are also being waged against portions of the law that regulators have already finalized. In particular, the financial industry has already waged challenges against the Proxy Access Rule\textsuperscript{14} and the Conflicts Mineral Rule.\textsuperscript{15} It is also expected to challenge the so-called Volcker Rule,\textsuperscript{16} which went into effect the summer of 2012 and seeks to curb proprietary trading by barring banks from making certain investments with their own money.

**Recent Developments in SEC Compliance**

**Say-on-Pay and Executive Compensation**

When the economy hit rock bottom in 2008, even more frustrating than the idea that financial institutions had gambled away client funds on risky investments was the fact that their high-ranking executives had secured for themselves millions of dollars in salaries, bonuses, and other benefits while risking investors’ hard-earned cash. As such, executive pay was one of the first priorities for lawmakers in crafting reform measures, resulting in the

\textsuperscript{13} See Ama Sarfo, \textit{E-Trade Execs Accept Corporate Reforms to End MBS Suit}, LAW360, Nov. 5, 2012.


Section 951 “say-on-pay” provision of the Dodd-Frank Act,17 which covers accountability and disclosure of executive compensation and shareholders’ voting on executive compensation. Under the new rules, publicly traded companies must submit executive compensation plans to a shareholder vote at least every three years, and hold a “frequency” vote at least once every six years in order to allow shareholders to decide how often they would like to be presented with the say-on-pay vote.

In the first half of 2012, fifty-five companies reported failed say-on-pay votes, up from forty-four failures reported for all of 2011.18 But, due to specific limitations within the rule itself,19 plaintiffs have had little success in filing stockholder derivative lawsuits alleging breach of fiduciary duty after any negative say-on-pay vote.20 As a result, plaintiffs have begun using a new tactic developed from the merger cases: suing companies before the say-on-pay vote to enjoin the vote based on alleged incomplete and misleading proxy disclosures. They are also challenging disclosures in connection with any required vote in amending executive equity compensation plans, such as increasing the number of shares available for issuance.21

Other compensation rules mandated by the Dodd-Frank Act remain unfinished, including those pertaining to the “clawback” of executive compensation, the disclosure of hedging by executives or directors of company stock received as compensation, and the disclosure of the ratio of CEO pay to median employee pay.

19 Section 951 specifically provides that the say-on-pay vote: (1) “shall not be binding on the issuer or the board of directors;” and (2) does not “create or imply any change to the fiduciary duties of the board members.” 15 U.S.C. § 78n-1(c) (2013).
Dodd-Frank mandated that the SEC establish a whistleblower program to make significant monetary rewards eligible for individuals who voluntarily provide original information that leads to successful SEC enforcement actions.\textsuperscript{22} In August 2012, shortly after the program’s first birthday, the SEC issued its first (and, to date, only) whistleblower award. The award represents 30 percent of the amount collected in the resulting SEC enforcement action, which is the maximum payout permitted under the program.\textsuperscript{23} While critics believed this program would result in an avalanche of poor quality, frivolous tips, the SEC reported that it received 3,001 tips during its 2012 fiscal year, and that they are generally receiving quality information. The most common complaints related to corporate disclosures and financials (18.2 percent), offering fraud (15.5 percent), and manipulation (15.2 percent).\textsuperscript{24}

In addition to the SEC’s bounty program, Dodd-Frank provides whistleblowers the right to sue employers who retaliate against them.\textsuperscript{25} In September 2012, a federal court allowed the first whistleblower claim under Dodd-Frank’s anti-retaliation provision to proceed past a motion to dismiss and, in doing so, broadly interpreted who is entitled to protection as a whistleblower.

In \textit{Kramer v. Trans-Lux Corp.}, a federal judge rejected Trans-Lux Corp.’s narrow interpretation of who qualifies as a whistleblower, and refused to throw out a Dodd-Frank claim from a former Trans-Lux employee, who was fired after telling the company’s board of directors and the SEC that his supervisors were violating the company’s pension plan.\textsuperscript{26} In its motion to dismiss, Trans-Lux argued that the employee did not report Trans-Lux’s violations in the manner prescribed by the SEC and, therefore, did not meet the definition of “whistleblower” as the term is defined in Dodd-Frank.

\textsuperscript{22} Dodd-Frank Act § 748 (2010).
\textsuperscript{25} Id.
The former employee responded by arguing that individuals who make disclosures that are required or protected under the Sarbanes-Oxley Act\(^{27}\) or the Securities Exchange Act of 1934 (Exchange Act)\(^{28}\) meet the definition regardless of the manner in which they make their disclosure.

Judge Stefan R. Underhill agreed with the former employee, finding “Trans-Lux’s interpretation would dramatically narrow the protections available to potential whistleblowers.”\(^{29}\) Because the disclosures were required under the Sarbanes-Oxley Act and related to violations of securities laws, they were protected under Dodd-Frank regardless of the manner in which they were made. The court further clarified that the Dodd-Frank Act expands the protections of Sarbanes-Oxley, and that this expansion is a permissible construction of the statute.

**Establishment of the Investor Advisory Committee**

On April 9, 2012, the SEC announced the formation of a new Investor Advisory Committee (IAC) to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and on initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace.\(^{30}\) The IAC, a product of Dodd-Frank, is authorized to submit findings and recommendations for review and consideration by the Commission. The twenty-one-member committee replaces the advisory committee that was disbanded after the Dodd-Frank Act became law and represents a wide variety of interests, including senior citizens and other individual investors, mutual funds, pension funds, and state securities regulators. In October 2012, the IAC made its first recommendations relating to SEC’s proposed rule to permit general solicitation and general advertising in private offerings made in reliance on Rule 506 of Regulation D of the Securities Act of 1933 as mandated by the


\(^{29}\) *Trans-Lux Corp.*, No. 3:11-cv-01424, 2012 WL 4444820 at *4.

JOBS Act discussed below. In short, the IAC made clear that the proposed Rule 506 did not sufficiently “address the risk of potential harm to investors.” The IAC’s recommendations include (i) requiring that all materials used in a Rule 506 offering be submitted to the SEC and made available to the public so that the public may report suspected fraud to the SEC and (ii) requiring more investment sophistication be shown beyond the long-standing net worth and income tests to establish an individual as an accredited investor. How many of the IAC’s recommendations get accepted is unknown, but the IAC’s recommendations indicate that it will pursue aggressive measures to protect investors that could place more burdens on issuers making exempt offerings.

The JOBS Act

Not all of the notable recent developments in this area are products of Dodd-Frank. On August 29, 2012, the SEC proposed rules to eliminate the prohibition against general solicitation and general advertising in offerings pursuant to Rule 506 under Regulation D of the Securities Act, provided all of the purchasers of such securities are accredited investors. The proposal is a product of the Jumpstart Our Business Startups (JOBS) Act signed into law by President Obama on April 5, 2012, which seeks to make it easier for smaller companies to raise money.

Under the proposed rules, fund managers conducting Rule 506 offerings would be permitted to use general solicitation and general advertising to market the underlying securities, provided that the issuer takes reasonable steps to verify that the investors are accredited investors, and all investors are accredited investors, because either they come within one of the

categories of persons who are accredited investors under existing Rule 501, or the issuer reasonably believes that they meet the categories at the time of the sale of the securities. The rule will preserve the existing portions of Rule 506 as a separate available exemption, allowing issuers who elect to conduct Rule 506 offerings without the use of general solicitation and general advertising to avoid becoming subject to the new verification rules.

“I believe that the proposed rules fulfill Congress’ clear directive that issuers be given the ability to communicate freely to attract capital, while obligating them to take steps to ensure that this ability is not used to sell securities to those who are not qualified to participate in such offerings,” said SEC Chairman Mary Schapiro.

The SEC’s release offers little guidance on how companies will take “reasonable steps” to ensure that they are dealing with accredited investors, merely stating issuers are to consider the facts and circumstances of the transactions, including: the type of purchaser and the type of accredited investor that the purchaser claims to be; the amount and type of information that the issuer has about the purchaser; and the nature of the offering—meaning the manner in which the purchaser was solicited to participate in the offering and the terms of the offering. According to the SEC, adopting specific verification methods that an issuer might use “would be impractical and potentially ineffective in light of the numerous ways in which a purchaser can qualify as an accredited investor.”

This leaves issuers in a state of limbo regarding what constitutes “reasonable steps” to verify accredited investors. As such, until the SEC provides further clarification—which will hopefully be included in the final rule—managers relying on the new exemption are advised to err on the side of caution by requiring as much information from qualifying investors as the issuer can reasonably request. Issuers should follow this issue closely, as it is likely that, as issuers begin to engage in general solicitation and general advertising activities, the rules and surrounding interpretations will be

37 Id.
further refined in response to common practices.

**Emerging Trends in Securities Case Law**

*Role of the SEC in Recent Developments*

Interestingly, some of the most notable securities case law developments in the past couple of years have been challenges against the SEC itself in the implementation of the Dodd-Frank reform measures. While regulations of other federal agencies are challenged in court on a regular basis, this sort of litigation is relatively new for the SEC because, historically, its rules were seldom challenged. Since the mid-2000s, the SEC’s regulations have been challenged six times and the SEC has lost each time. Four of those lawsuits were brought by the same individual—Eugene Scalia. Mr. Scalia is continuing to lead the charge and earning his reputation as the scourge of federal agency rule makers, representing industry groups in challenges to rules implementing the Dodd-Frank financial reform measures—namely the Proxy Access Rule and Conflicts Mineral Rule.

*Arguments Being Made*

Opponents of the reform measures have a common argument—agencies cannot merely point to Dodd-Frank mandates, cite the financial crisis, and impose new rules without exercising independent judgment about the need for and the impact of those rules. In 1996, President Clinton signed legislation requiring the SEC to consider the effect of its rules on “efficiency, competition, and capital formation.” Opponents of the reform rules are using this heightened responsibility to argue that the SEC’s economic analyses were flawed in that it failed to adequately weigh the rule’s costs and benefits. A new bill in Congress would also subject other independent regulators to these heightened rule-writing standards, possibly opening the courtroom door for new challenges.

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**Decisions Being Made**

**Proxy Access Rule**

One of the first challenges against the SEC’s implementation of Dodd-Frank was waged against the Proxy Access Rule, which gave the SEC the ability to promulgate rules allowing for greater shareholder proxy access. Accordingly, on August 25, 2010, the SEC implemented Rule 14a-11 that gave shareholders the right to have their director nominees included in a corporation’s proxy materials if the shareholder held at least 3 percent of the voting shares and had held such shares for at least three years. Within about a month, however, a suit was filed challenging the rule.

In July of 2011, a three-judge panel of the District of Columbia Circuit Court of Appeals struck the rule down, finding the SEC had not properly considered the impact on capital markets when it promulgated the Proxy Access rule. The SEC did not appeal the decision.

**Conflicts Minerals Rule**

More recently, the SEC faced challenges against its “Conflicts Minerals Rule,” which was approved in August 2012. Mandated by Section 1502 of Dodd-Frank, the rule requires disclosure of “conflict minerals,” meaning tin, tungsten, tantalum, and gold mined from Central Africa that are considered to be the source of funding for militant groups, in a company’s supply chain. Critics argue purging their supply chains of these substances, or even just tracking their origin, would be an extremely costly challenge.

Less than two months after the rule’s final approval, the manufacturing industry and the US Chamber of Commerce filed a complaint, putting the Conflicts Minerals Rule in limbo. According to the Chamber of Commerce’s July 11, 2012 comment letter, the SEC failed to consider the

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42 Dodd-Frank Act § 1502.
true impact of the proposed rule on all businesses, materially undermining its analysis and resulting estimate of the actual cost of the proposed rule. For example, the SEC estimated that the proposed rule would affect between 1,199 and 5,551 companies, representing those public companies directly subject to the proposed rule. Analysts believe the impact and cost of the rule extends far beyond reporting companies, to vendors and suppliers of those companies—meaning as many as 60,000 to 100,000 non-reporting companies, including small private businesses. Accordingly, the SEC’s estimated compliance costs of $71,234,000 are significantly understated.

The legal challenge is likely to buy companies more time on compliance, as many believe the court will stay the effective date of the rule, which could delay its implementation until at least 2014. However, companies will be poorly served by putting off compliance completely until the legal challenge is resolved. For instance, electronic equipment manufacturers may use thousands of parts that will have to be examined for conflict material content, which will be a daunting, but probably eventually required, task.

**Janus and the Future of “Scheme Liability”**

A Supreme Court opinion issued in June 2011 had an immediate impact on how the SEC pleads and attempts to prove its cases. In *Janus*, the Court considered whether separate legal entities within the Janus corporate group (advisor and parent) had exposure to primary liability for the statements of the entity issuing the securities and related disclosures. The Court ultimately interpreted the person who makes a statement very narrowly, finding that a defendant may be liable for making an alleged misstatement under Section 10(b) of the Exchange Act only if he had “ultimate authority” or “control” over both the content and dissemination of the statement.

In the immediate wake of Janus, the SEC shifted the focus of its cases against non-speakers and non-signers from the “misstatements” prong of Rule 10b–(b) to the “scheme liability” provisions of Rules 10b-5(a) and (c) under the Exchange Act and to Section 17 of the Securities Act.

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45 *Id.*
46 Exchange Act, § 10(b).
47 *Id.* § 10b-5(a), (c).
According to the SEC, Janus addressed only liability under Rule 10b-5(b), but “scheme liability” claims under subsections (a) and (c) of Rule 10b-5, as well as claims under Section 17(a), survived Janus, because unlike Rule 10b-5(b) claims, these claims were not dependent on the word “make.” 49 The lower courts are already grappling with how to apply Janus, with one court (and the SEC’s own Chief Administrative Law Judge) rejecting the SEC’s scheme liability and Section 17(a) theories, 50 while two others found Janus did not apply to claims brought under Section 17(a). 51

The SEC’s Pursuit of Negligence-Based Claims

The SEC has shown an increased willingness to proceed against alleged negligent or nonscienter-based conduct as opposed to scienter-based fraud, especially in the context of Collaterized Debt Obligation (CDO) related cases. For example, in 2011 the SEC charged Citigroup Global Markets, Inc. with misrepresenting to investors the quality of fund assets and with failing to disclose its short position against the assets. 52 Although the allegations appeared to be based on knowing and fraudulent intent, the SEC charged Citigroup only with negligence-based fraud under Section 17(a)(2) and (3) of the Securities Act. 53

Negligence-based claims are easier to prove; thus, the new focus in this area should encourage companies to tighten their controls, deterring fraud before it happens, and leading to more stringent enforcement tactics. However, the penalties available for negligence-based misconduct are much lower than with scienter-based claims. Also, by focusing on negligent conduct, the SEC must divert its already scarce resources away from more flagrant, intentional conduct, running the risk of another “Madoff miss.”

Expanded Aiding and Abetting

Dodd-Frank expanded the SEC’s authority to bring aiding and abetting

50 Id.
53 Securities Act of 1933, ch. 38, 48 Stat. 74, § 17(a)(2), (3).
claims under the Securities Act of 1933\textsuperscript{54} and to obtain civil penalties for aiding and abetting violations of the Investment Advisers Act of 1940.\textsuperscript{55} Congress also reduced the SEC’s burden to prove aiding and abetting liability to a “recklessness” standard.

In August 2012, the SEC obtained a major victory, expanding its power to bring “aiding and abetting” cases against secondary actors who contribute to securities fraud. In \textit{SEC v. Apuzzo},\textsuperscript{56} the Second Circuit held that the SEC is not required to prove an alleged aider and abettor “proximately caused” the fraud, rejecting a contrary decision from the district court and effectively lowering the bar for SEC aiding and abetting claims. Private litigants cannot bring aiding and abetting claims, but the SEC is expressly permitted to do so.

To establish aiding and abetting liability, the SEC must prove that:

1. A primary securities violation occurred
2. The aider and abettor had knowledge of the primary securities violation
3. The aider and abettor provided substantial assistance in the securities violation

The Second Circuit’s decision in \textit{Apuzzo} dealt with the third element, addressing the standard of proof to show “substantial assistance.” Reaching back to a 1938 decision written by the famous jurist Learned Hand, the Second Circuit held that substantial assistance requires only that the alleged aider associated himself with the venture, participated in it as something that he wished to bring about, and sought by his action to make it succeed. Applying this standard to the facts alleged, the court had little difficulty in determining that Apuzzo’s actions met this standard, particularly in light of the allegations that he had actual knowledge of the fraud.

This case is a significant victory for the SEC, and it follows on the heels of another change in the law designed to make it easier for the SEC to bring aiding and abetting cases. The Dodd-Frank Act reduced the SEC’s burden

\textsuperscript{56} \textit{S.E.C. v. Apuzzo}, 689 F.3d 204 (2d Cir. 2012).
of proof required to establish that an aider and abettor acted with “scienter” (i.e., fraudulent intent), lowering the bar from “knowing” to “reckless” misconduct. The Dodd-Frank amendment did not apply to the Apuzzo case, which was filed before the effective date of the amended statute. In future cases, however, the SEC will have two new arrows in its quiver, and it is likely to pursue aiding and abetting cases with increased frequency.

Securities Cases Recently Litigated By the SEC

During its 2012 fiscal year that ended on September 30, 2012, the SEC brought 734 enforcement actions, only one shy of 2011’s record 735 actions. The SEC also announced that it obtained orders in fiscal year 2012 requiring the payment of more than $3 billion in penalties and disgorgement for the benefit of harmed investors. It represents an 11 percent increase over the amount ordered last year. In the past two years, the SEC has obtained orders for $5.9 billion in penalties and disgorgement. This unprecedented performance comes on the heels of the most significant reorganization of the Division of Enforcement in its nearly forty-year history, most notably through the creation of special investigative units and multi-agency working groups dedicated to high-priority areas of enforcement.

The SEC’s actions during the last two years have been driven in large part on its increased focus on individual accountability, more effective deterrence strategies, and punishing recidivism, all in the wake of the 2008 financial crisis.

- Individual Accountability: During the last two-and-a-half years, the agency has filed actions related to the financial crisis against 117 defendants—nearly half of whom were CEOs, CFOs, and other senior corporate executives, resulting in approximately $2.2 billion in disgorgement, penalties, and other monetary relief obtained or agreed to. The SEC continues to be creative and aggressive in looking for ways to hold every responsible

58 Id.
individual, regardless of title, accountable. According to Aguilar, “When an entity is charged with a violation of the federal securities laws, it is clear that there are human beings who are responsible for the misconduct.” Accordingly, we are seeing fewer cases in which the SEC is only charging an entity with wrongdoing without also charging an individual.

• More Effective Deterrence Strategy: The SEC has the ability to use a variety of sanctions available to deter and punish misconduct, and continues to expand their tool chest thanks, in part, to the Dodd-Frank Act. Of particular importance is the SEC’s increased use of permanent officer and director bars. The SEC realizes this is one of the sanctions that defendants fear the most—and rightfully so—which it feels is precisely what makes it one of the most effective sanctions available. Thanks to Section 925 of Dodd-Frank, the SEC now also has the authority to impose collateral industry bars, meaning suspensions or bars from association with brokers, dealers, municipal securities dealers, municipal advisors, transfer agents, or nationally recognized statistical rating organizations. Thus the SEC can effectively bar a defendant across the board from the regulated securities industry.

• The SEC is now also pushing to increase the limits on monetary penalties it can impose in both administrative proceedings and federal court actions. Currently, the law provides two methods for calculating the maximum amount of penalties. Defendants negotiating settlement can expect the SEC to insist on more robust sanctions, including potential post-sanction monitoring such as unscheduled office visits, access to phone records, bank records, and state and federal income tax returns.

• Recidivism: Specific efforts are also being dedicated to monitoring recidivists, as the SEC has noticed that many offenders, particularly Ponzi scheme offenders, have long track records of similar fraud schemes. The Commission is re-evaluating the strength of its initial

settlements and working to design to ensure the remedies and penalties effectively deter offenders from once again engaging in egregious fraud.

- **Defendants:** This increase in settlements is almost entirely attributable to the SEC’s efforts to fulfill its promise to hold more individuals accountable. While its final statistics for 2012 are not yet available, during the first half of 2012, the SEC brought 286 enforcement actions against individuals—which, if that trend continued during the second half of 2012, would mean nearly a 20 percent jump over fiscal year 2011 (FY11). Overall, settlements with companies are projected to decline slightly from 196 in FY11 to 186 in FY12.

- **Issues Being Decided:** There is a continued focus on addressing misconduct that led to or arose from the financial crisis, charging 117 entities and individuals since the crisis began. While insider trading and Ponzi scheme cases represent the largest year-over-year increases, neither category is expected to have the most settlements. Rather, the resolution of cases involving public company misstatements will predominate, with a projected 142 settled actions compared to 139 the prior year. Insider trading cases rank second in the number of settlements. The primary areas of activity included:

  - Concealing from investors risks, terms, and improper pricing in CDOs and other complex structured products
  - Making misleading disclosures to investors about mortgage-related risks and exposure
  - Concealing the extent of risky mortgage-related and other investments in mutual funds and other financial products

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63 *Id.*

64 Supra note 53.


• Insider Trading: Allegations of insider trading are largely driving the increase in individual SEC settlements, with the Commission on pace for 120 insider trading settlements in FY12, after sixty-three in FY11. These actions mainly involved financial professionals, hedge fund managers, corporate insiders, and attorneys who purportedly traded on non-public information, “undermining the level playing field that is fundamental to the integrity and fair functioning of the capital markets,” according to the SEC.

• Ponzi Schemes: The SEC also continues to focus on matters relating to Ponzi schemes. Since fiscal year 2010, the SEC has brought more than one hundred enforcement actions against nearly 200 individuals and 250 entities for carrying out Ponzi schemes, resulting in more than sixty-five individuals being barred from working in the securities industry. The SEC has also worked with the US Department of Justice and other criminal authorities on parallel criminal and civil proceedings against Ponzi scheme operations.

• FCPA: While enforcement of the Foreign Corrupt Practices Act (FCPA), which prohibits US companies from bribing foreign officials for government contracts and other business, continues to be a high priority area for the SEC, settlement activity with matters relating to FCPA violations are actually expected to decrease in FY12.

• On August 7, 2012, the SEC announced settlements with Pfizer, Inc. and Wyeth LLC, a company Pfizer acquired in 2009, that required Pfizer and Wyeth to pay a combined total of over $45 million in disgorgement and prejudgment interest. The conduct

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underlying the settlement involved alleged bribes paid by Pfizer employees and agents to officials in Bulgaria, China, Croatia, Czech Republic, Italy, Kazakhstan, Russia, and Serbia to obtain regulatory and formulary approvals, sales, and increased prescriptions for the company’s pharmaceutical products. There were also allegations that employees and agents attempted to conceal these activities by falsely describing the payments in nooks and records as legitimate expenses for promotional activities, marketing, training, travel and entertainment, clinical trials, freight, conferences, and advertising.

- Another notable matter is the SEC’s Aug. 16, 2012 settlement with Oracle Corporation.\textsuperscript{72} The underlying conduct involved the alleged “parking” of excess funds generated by inflated prices charged to customers by distributors so that those funds could be used to make marketing and development payments to nonexistent third party vendors. This settlement, which includes payment by Oracle of a $2 million penalty, is significant, because the SEC did not allege that the company made any actual improper payments, but rather that an Indian subsidiary of Oracle “created the risk that the funds could be used for illicit purposes such as bribery or embezzlement.” The basis of the settlement was thus Oracle’s failure to keep accurate books and records rather than the FCPA’s bribery proscriptions. It is likely that the SEC will continue to aggressively utilize this tool even in cases where actual bribery cannot be shown.

The Principles of an Effective Compliance Program

As discussed above, under Dodd-Frank, the SEC is in the midst of unprecedented rulemaking reform, much of which is unsettled, as most of the new rules (forty-two as of November 1, 2012) have not been finalized. The SEC’s enforcement program is as strong as ever, with historical number of cases and penalties. To say the least, companies are faced with what seems an ever-changing enforcement environment and uncertainty on how and which new rules may affect them.

It is axiomatic that SEC compliance must be focused on timely and accurate disclosures, as well as adhering to, and avoiding violations of, applicable laws. Of course, the key question is, how do you achieve your compliance goals? While it may be a cliché, the truth is that there is no one-size-fits-all approach. A mid-size public company in a heavily regulated industry is going to face different challenges than a large manufacturer with international operations. But, in my experience, there are several keys to a successful compliance program.

A successful compliance program can only be achieved through a meaningful commitment throughout the organization to compliance. Most have heard about setting the right “tone at the top” (meaning a commitment to compliance from the head of the organization), but the right “tone of compliance” has to permeate throughout the organization—not only from the CEO, but also from down-the-line middle managers. A chief compliance officer of a large, multinational company once told me that a key measure of his company’s compliance program was whether the vast majority of complaints came from employees through their supervisors rather than through anonymous hotline tips. The point was that if the executives and middle managers effectively displayed a commitment to compliance, employees would feel encouraged to bring issues directly to management. A commitment to compliance cannot be achieved solely through words, but through sustained actions that include:

- **Written, tailored, and updated policies.** Public companies need written policies that are designed to address that company’s requirements and unique risks, and those policies should be reviewed periodically and updated as needed. The policies need to be clear on what is expected from the company’s officers, employees, and other stakeholders, and what is prohibited. Those policies should include a written, clear code of conduct that sets forth the expectations of ethical behavior, the spirit and details of which are consistently embraced and adhered to by all levels within the organization.

- **Communication of policies to stakeholders.** Companies must effectively and meaningfully communicate their policies to employees and provide training when necessary. All too often, companies only communicate policies by directing new employees to review a litany of corporate policies and having them sign an acknowledgement.
Communication should not stop there. There is no one way to do it, but employees should be routinely reminded about important policies, such as insider trading prohibitions, and should receive training and refreshers on more complex issues, such as anti-corruption and export control policies.

- **Compliance is not a one-person job.** Many companies make the mistake of believing that compliance is only the responsibility of the chief compliance officer. Instead, management should be responsible for compliance as well. Usually, more than anyone, management can impact compliance on a day-to-day basis. The CCO is a resource to management, to help them understand and to comply with applicable laws and regulations, through communication of policies, training, and timely addressing any issues that arise. But it is the managers that likely will either spot an issue or have one reported to them. Managers must be vigilant about understanding risks within their responsibility, be in regular communication with their reports on what is expected, look for and be receptive to any issues that arise, and then be proactive about seeking guidance to deal with any issues that arise.

- **Board Oversight and Meaningful Resources.** The board of directors or governing authority of an organization should independently understand and evaluate the company’s compliance program. They should get reports of monitoring and testing, incidents that have occurred and how those were resolved, and should have regular contact with those responsible for the organization’s compliance. The head of compliance should also have direct contact with the board or an appropriate subcommittee rather than having communication filtered through others. The board must also ensure that those responsible for compliance have the needed resources—whether staffing, technology, or outside professionals—because the best written program is not worth much if there are not sufficient resources for it.

- **Monitoring and testing.** My experience is that most companies have written compliance policies, but where they fail is in the area of monitoring and testing of their compliance program. How to monitor various programs is a subject in itself. However, technology is providing resource-stretched compliance departments with tools to help effectively monitor company
activity. For instance, there is a slew of new software to assist companies in the continuous monitoring of financial transactions as part of an anti-corruption program. Not only must a company monitor its compliance activities, it should also test the effectiveness of its compliance program. This can be accomplished in various ways, including: exit interviews; anonymous employee surveys; auditing selected transactions such as employee reimbursements or payments to a particular vendor; intentionally attempting to process an improper payment; and reviewing employee complaints and hotline tips to detect trends or common issues.

Other key metrics include:

- How many compliance failures were detected internally versus externally (e.g., auditors, vendors, regulators, etc.)?
- How many compliance failures were detected internally and how (e.g., internal audit, employee complaints, hotline tips, etc.)?
- How many hotline tips versus those in a particular industry or similar companies?
- How much financial loss was averted due to compliance monitoring?

- Accountability, enforcement, and remediation. This is where a company can really put its words into action. Nothing can more easily destroy a compliance culture than ignoring a compliance violation. Consider an employee who reports an ethical violation of a superior and nothing is done—that employee will lose faith in the compliance system and will likely tell other employees about what happened as well. Instead, there must be accountability from the board level down to the employee level. While there are different views on a reporting structure, the head of compliance should have a direct line of communication with the board or appropriate board committee. When there is a violation, there needs to be enforcement of the policy (including counseling and/or discipline of the violator) and remediation of any systemic issues. Building a
correct, sustained tone of compliance occurs when management and employees see that a compliance program is consistently and fairly enforced and that problems are fixed. When this does not occur, the compliance program is severely undermined.

Conclusion

We are in the midst of unprecedented securities rulemaking and enforcement. On top of that, the rules that will dramatically affect companies are being challenged or are not finalized, so there is substantial uncertainty of what will be required by issuers and reporting companies. A robust, effective compliance program will, however, lay the compliance foundation within an organization so that when a company must adhere to a change in the law or respond to a new enforcement priority that affects the organization, it can do so quickly and effectively. Counsel should not only stay abreast of new changes, but should ensure that their clients have the proper foundation to adapt to this ever-changing securities regulation environment.

Key Takeaways

- Dodd-Frank has resulted in unprecedented rulemaking by the SEC, the goal of which is to restore investor confidence in the markets through, among other things, regulation of complex products and providing investors more transparency.
- But delays and legal challenges surrounding the implementation of the rules required by Dodd-Frank have led to a substantial uncertainty regarding what will be required for SEC compliance. As such, companies and their counsel must stay abreast of regulatory changes and be ready to swiftly react.
- The SEC continues to pursue actions based on the conduct at the heart of the 2008 financial crisis, including increased focus on individual accountability, more effective deterrence strategies, and punishing recidivism. These trends are not likely to change as the SEC remains committed to restoring investor confidence and trust in the capital markets.
- The avalanche of new rules and the uncertainty of what is to come require that companies of all size have formalized, defined, and
robust compliance programs. A compliance program must be
tailored to the business and risks of the organization and there
must be a fundamental commitment to compliance that permeates
the company from the top down.

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