SEC TO EMPLOY LITTLE-KNOWN TOOL TO HOLD INDIVIDUALS ACCOUNTABLE

In a speech to the New York City Bar Association’s White Collar Crime Institute on May 19, 2014, SEC Chair Mary Jo White announced that the SEC will begin employing a little-known tool to charge individuals with violations of the federal securities laws. This new approach employs what was formerly a relatively obscure section of the Exchange Act, Section 20(b), to impose primary liability on a person who, directly or indirectly, does anything “by means of another person” that would be unlawful for that person to do on his or her own.

This is analogous to the “innocent instrumentality” doctrine in the criminal context, which provides liability as a principal for anyone who “willfully causes an act to be done which if directly performed by him or another would be” against the law.

CERESNEY SAYS SEC WILL TAKE HARD-LINE APPROACH IN APPLYING NEW SETTLEMENT POLICY

According to SEC Enforcement Director Andrew J. Ceresney, when the SEC decides to require an admission as a part of a settlement, the defendant can take it or leave it. As was discussed in prior editions of the SEC Enforcement Quarterly, in June 2013, SEC Chair Mary Jo White announced that the Commission would begin to require admissions of wrongdoing in certain settlements. (See “Chair White articulates the SEC’s New Settlement Policy,” Sidley SEC Enforcement Quarterly 3Q 2013). A year later, there remains a great deal of confusion regarding when and how the SEC will employ the policy. But on April 25, 2014, Ceresney provided a glimpse of how the relatively young policy will play out during settlement discussions. Speaking at the Practising Law Institute’s Enforcement 2014 conference, Ceresney announced that the SEC staff will not negotiate with a defendant over the decision to require an...
The federal securities laws already equip the SEC with other ways to hold a person responsible for the primary violations of another, even when they themselves did not directly engage in the misconduct. For example, “control person” liability under Section 20(a) of the Exchange Act and “aiding and abetting” liability under Section 20(e) of the Exchange Act are common SEC enforcement tools. Unlike Sections 20(a) and 20(e), however, the SEC has rarely used Section 20(b) in past enforcement actions, primarily because there was no real need for it. But that may have changed three years ago when, in Janus Capital Group, Inc. v. First Derivative Traders, the Supreme Court held that for purposes of Section 10(b) liability in private securities litigation, “the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” The Court analogized this rule to the relationship between a speechwriter and a speaker. “Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it.” Id. Thus, under Janus, only the speaker and not the speechwriter can be liable under Section 10(b).

It is important to emphasize that Janus involved claims brought by private investors. It is not entirely clear whether the Supreme Court’s analysis also applies to SEC enforcement actions or whether it is limited to private securities fraud cases, and the lower courts have split on the question. But it is clear that Chair White is taking no chances either way, as Section 20(b) avoids the obstacle imposed by Janus. As she explained, Section 20(b) represents a powerful tool to reach individuals who “have engaged in unlawful activity but attempted to insulate themselves from liability” by using an innocent intermediary, and therefore might not be liable under Rule 10b-5 following Janus. And just as in the “innocent instrumentality” doctrine in the criminal context, Section 20(b) is a form of primary liability, rather than secondary liability. As such, a Section 20(b) charge does not require proof of a separate violation by someone other than the defendant, as is necessary to charge an individual with aiding and abetting or control person theories of liability. Therefore, to revisit the speaker–speechwriter analogy, the SEC can use Section 20(b) to charge the speechwriter with fraud, even though there was no underlying Rule 10b-5 violation by the innocent speaker since he lacked knowledge that his statement was false.

Chair White’s announcement also raises the question of whether the plaintiff’s bar will begin to invoke Section 20(b) to effect a similar end-run around Janus. Notably, the Janus majority declined to address “whether Congress created liability for entities that act through innocent intermediaries” in Section 20(b). There is no clear consensus on the question among lower courts. However, in Fiero v. FINRA, the Second Circuit held, without providing any analysis, that private parties could bring actions for damages pursuant to Section 20(b). 660 F.3d. 569, 574 (2d Cir. 2011). And the statutory language of Section 20(b) is identical to Section 10(b), namely, “it shall be unlawful for any person, directly or indirectly....” Therefore, despite the lack of authority construing Section 20(b), courts could find that it is available not only to the SEC but to private securities litigants as well.

Given the SEC’s heightened focus on charging individuals and Chair White’s commitment to looking “for ways to innovate in order to further strengthen [its] ability to charge individuals,” the development of Section 20(b) as a theory of primary liability may increase the focus by both the SEC and plaintiffs’ attorneys on individual directors and officers of public companies. And as individuals come under increased scrutiny, Section 20(b) provides both the SEC and private litigants a powerful new tool to pursue them for conduct that currently lies at the edge of the securities laws.
admission of wrongdoing, once that decision has been made. Although he did not speak for the Commission, Director Ceresney said that defendants will not be able to trade an admission for a reduction in penalties or sanctions. Director Ceresney did say that the Staff would be willing to discuss whether to require an admission when the SEC was still considering the issue, but once the decision has been made, “[i]t only works one way.”

After announcing this hard-line approach to requiring admissions, Director Ceresney repeated his prior-stated belief that admissions would continue to be the exception to the neither-admit-nor-deny settlement; however, he opined that the number of settlements that include admissions may “well increase” as the practice becomes more accepted and less of a sticking point during negotiations. Moreover, he attempted to head off the argument that the admissions policy is likely to cause an increase in litigation because defendants would rather fight than admit wrongdoing and expose themselves to derivative civil suits. Ceresney and the SEC may be particularly wary of litigation in light of the continued string of trial losses, including the May 30, 2014 loss in the high-profile insider trading case, *S.E.C. v. Obus*, and the June 6, 2014 loss in *S.E.C. v. Moshayedi*, another insider trading case. (See “SEC Loses Another Case At Trial, SEC Enforcement Quarterly 1Q 2014”.)

Since Chair White announced the policy shift in June 2013, the SEC has entered into seven settlements in which a corporate defendant publicly admitted to wrongdoing, and many are concerned about the lack of a consistent, transparent framework to guide the SEC’s use of admissions. Ceresney’s comments may have raised the cost of this ambiguity as potential defendants not only lack meaningful guidance on what might trigger the admissions policy, but they are also powerless to defend against it once the decision has been made. As is discussed on page 5, the Second Circuit’s recent decision to overturn Judge Rakoff’s 2011 rejection of the neither-admit-nor-deny SEC-Citigroup settlement epitomizes this disconnect. In overturning a ruling that appeared to be a major motivation for the SEC’s decision to begin requiring admissions, the Second Circuit held that “[t]he decision to require an admission of liability before entering into a consent decree rests squarely with the S.E.C.” Whatever ambiguity persists in the policy’s implementation, the Second Circuit’s ruling and Ceresney’s statements suggest that the Commission is able and willing to continue to require defendants to admit wrongdoing.
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SEC ANNOUNCES FRAUD CHARGES AGAINST THREE INDIVIDUALS AND A DEFERRED PROSECUTION AGREEMENT WITH REGIONS FINANCIAL CORP.

In June 2014, the SEC announced fraud charges against three former senior managers of Regions Bank for intentionally misclassifying loans for accounting purposes. As a result of the misclassification, the bank’s publicly-traded holding company overstated its income and earnings per share in its financial reporting. The SEC also entered into a deferred prosecution agreement (“DPA”) with Regions Financial Corp., which cooperated with the agency’s investigation and undertook extensive remedial actions.

According to the SEC’s press release announcing the charges, the three managers took intentional steps to circumvent internal accounting controls and improperly classified $169 million in nonperforming commercial loans as performing so Regions could avoid recording a higher allowance for loan and lease losses. Nonperforming Loans (“NPLs”) typically were placed on non-accrual status when it was determined that payment of all contractual principal and interest was 90 days past due or otherwise in doubt. The SEC alleged that when personnel within Regions initiated procedures to place approximately $168 million in NPLs into non-accrual status during the first quarter of 2009, the senior managers arbitrarily and without supporting documentation required the loans to remain in accrual status. The SEC alleged that, by failing to classify the impaired loans in accordance with its policies, Regions’ financial statements for the first quarter of 2009 were materially misstated and not in conformity with GAAP. The SEC alleged that, in furtherance of the scheme, the senior managers knowingly provided misleading NPL data for the quarter to senior executives at Regions.

Two of the managers agreed to settle the SEC’s charges by each paying penalties of $70,000 and consenting to bars from serving as officers or directors of public companies. The Division of Enforcement is continuing to litigate its case against the third individual.

The DPA that Regions entered into with the SEC relates to the bank’s failure to maintain adequate accounting controls at the time. The agreement credits Regions’ cooperation and imposes a $26 million penalty that will be offset provided the company pays a $46 million penalty assessed in a related Federal Reserve action. In the DPA, Regions is required, among other things, to produce all requested documents, make available pertinent witnesses, respond to all inquiries and testify at trial when requested to do so. In addition, Regions took extensive remedial actions including ending its employment relationship with the senior managers, creating an ethics council, revising and enhancing its ethics policy and code of conduct, and creating a new organizational structure for its credit group.

The SEC announced the use of DPAs in 2010 and at the time the Director of the Division of Enforcement said “this is a potential game-changer for the Division of Enforcement. There is no substitute for the insiders’ view into fraud and misconduct that only cooperating witnesses can provide.” Under a DPA, if a party agrees to cooperate with the SEC’s investigation, the SEC agrees to forego an enforcement action against that party. According to the SEC Enforcement Manual, the individual or company must agree to, among
SECOND CIRCUIT VACATES JUDGE RAKOFF’S REJECTION OF SEC-CITI SETTLEMENT

On June 4, 2014, in SEC v. Citigroup Global Markets, Inc., the Second Circuit held that Judge Jed S. Rakoff abused his discretion and applied the wrong legal standard when he refused to approve a settlement in the case in 2011. Judge Rakoff’s decision had ignited a public debate over the efficacy of the SEC’s policy of agreeing to settlements in which the parties “neither admit nor deny” the SEC’s allegations—a policy that the SEC publicly modified in June 2013—and some have now wondered how the Second Circuit’s decision will impact the SEC’s enforcement approach moving forward. Yet instead of serving as a check against the SEC’s power to require an admission of wrongdoing in future settlement agreements, the Second Circuit’s decision arguably preserves the agency’s authority to do so while limiting the courts’ ability to intervene.

Judge Rakoff rejected the Citigroup settlement in 2011 primarily because he believed that it was impossible to determine whether the settlement was “fair, reasonable, adequate and in the public interest.” The lack of any admission of wrongdoing in the settlement was central to Judge Rakoff’s reasoning. Judge Rakoff reasoned that, without that admission—and absent additional fact-finding—the court ran the risk of becoming “a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance.” Although the SEC has historically relied on neither-admit-nor-deny settlements as an effective way to impose penalties on defendants without exposing them to the type of civil claims that an admission of wrongdoing could generate, observers at the time...

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SEC ANNOUNCES FRAUD CHARGES AGAINST THREE INDIVIDUALS AND A DEFERRED PROSECUTION AGREEMENT WITH REGIONS FINANCIAL CORP. CONTINUED FROM PAGE 4

other things: 1) cooperate truthfully and fully in the Commission’s investigation and related enforcement actions; 2) enter into a long-term tolling agreement; 3) comply with express prohibitions and/or undertakings during a period of deferred prosecution; and 4) under certain circumstances, agree either to admit or not to contest underlying facts that the Commission could assert to establish a violation of the federal securities laws.

DPA’s are a useful prosecutorial tool for the SEC to efficiently gather truthful information from individuals, especially when paired with whistleblower incentives. Entering into a DPA with a bank in order to build a case against employees is an interesting use of this tool, especially when it could encourage firms to sacrifice individuals in order to protect the corporation. In this case, the senior managers deliberately misled the bank, and as a result of the DPA, the SEC can focus on the guilty individual actors and not hold the firm itself responsible. There has been a limited use of DPAs to date and it remains to be seen whether the SEC will disproportionately utilize DPAs against individuals or firms.
wondered whether Judge Rakoff’s decision—and the public sentiment that it embodied—would lead the SEC to change its policy. Sure enough, in June 2013, SEC Chair Mary Jo White announced that the SEC would more frequently require an admission of wrongdoing as a condition of settlement, based on “how much harm has been done to investors [and] how egregious is the fraud.”

Yet despite the fact that Judge Rakoff’s decision played such a seemingly central role in the SEC’s policy change, the Second Circuit held that he had gone too far in the case. According to the Second Circuit, courts simply have no authority to require admissions of liability in settlements and no proper place demanding a review of the truthfulness of the allegations supporting those settlements. Further, the court applied a more deferential standard of review when analyzing a settlement agreement that did not review the adequacy of the relief obtained by the agency.

The decision will likely have a profound impact on judicial review of settlement agreements in general—regardless of whether they include admissions of liability. While Judge Rakoff’s 2011 refusal to accept the Citigroup settlement was based on his belief that courts must not be “mere handmaiden[s]” that rubber stamp previously negotiated settlements, the Second Circuit took a softer approach, noting that “[t]rials are primarily about the truth. Consent decrees are primarily about pragmatism.” According to the Second Circuit, a judge’s responsibility in evaluating an agreement should be limited to determining whether the public “would not be disserved” by the settlement. This standard, in practice, will give the agency wide discretion in reaching settlements with companies and individuals, without the fear of judicial second guessing.

Indeed, in an August 5, 2014 order, Judge Rakoff approved the $285 million Citigroup settlement, applying the standard set forth in the Second Circuit decision, but made clear that he was doing so under protest. Judge Rakoff said, “It would be a dereliction of duty for this court to seek to evade the dictates of the court of appeals.” And of the Second Circuit, he wrote: “That court has now fixed the menu, leaving this court with nothing but sour grapes.”

Although this particular settlement was approved without any admission of wrongdoing, the decision will probably not deter the SEC from successfully pursuing such admissions in the future. In a statement released in the immediate wake of the Second Circuit ruling, Andrew J. Ceresney, the Director of the SEC’s Enforcement Division, stated that the SEC “has and will continue to seek admissions in appropriate cases.” And given the deferential standard of review that courts are to employ when reviewing settlements under Citigroup, it will be difficult for courts to reject settlement agreements that include admissions of liability.
SEC FORMS PRIVATE FUND UNIT TO FOCUS ON PRIVATE EQUITY AND HEDGE FUNDS

In April 2014, the SEC’s Office of Compliance Inspections and Examinations formed a dedicated unit to enhance scrutiny of private funds, including private equity and hedge funds. The new private fund unit is co-chaired by Igor Rozenblit and Marc Wyatt. Wyatt co-headed the London office of hedge fund Stark Investments before joining the SEC in 2012 as a private funds examiner. Rozenblit was a private equity specialist before joining the asset management unit of the SEC’s enforcement division in 2010.

While the SEC has had staff who specialized in funds, to this point, the agency has focused primarily on public asset managers, such as mutual funds, which, unlike private equity and hedge funds, have been heavily regulated for decades. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act requires most midsized and large private equity and hedge funds to register with the SEC, leading to increased transparency and greater oversight. Accordingly, private equity and hedge funds have undergone increased scrutiny since the passage of this Act.

Private funds have certain features that have created the need for specialized SEC examiners. Such funds frequently hold complex and illiquid investments that are more difficult to value than those of traditional asset managers, such as mutual funds. Furthermore, private funds frequently have complex fee structures that are more difficult for investors to comprehend. In response to these and other concerns, the private funds unit’s current examination initiatives include how private equity and hedge funds communicate with investors, value their assets, mitigate conflicts of interest, comply with the funds’ stated investment strategy, and disclose their fees.

The formation of the private fund unit sends a clear signal that there are likely to be significant changes to the examination process for private funds. Accordingly, private equity and hedge funds should follow the private fund unit’s activity as this will provide insight into its examination goals. Moreover, given that transparency and communication appear to be the larger goals of the private fund unit, private equity and hedge funds should keep these principles in mind in reviewing and updating their compliance programs.

SEC Enters Into First Non-Prosecution Agreement With An Individual

In April 2014, the SEC broke new territory by entering into its first non-prosecution agreement (“NPA”) with an individual. As a relatively new tool in the SEC’s arsenal, and one historically used by the Department of Justice, this was the first time the SEC extended the use of NPAs beyond the corporate context.

The case involved insider trading by Christopher Saridakis, a former executive of GSI Commerce, Inc. In 2011, eBay engaged in discussions with GSI Commerce regarding eBay acquiring GSI Commerce. The SEC alleged that Saridakis was privy to information about the acquisition and tipped off several friends and relatives with confidential information regarding the pending acquisition. These individuals obtained illegal profits exceeding $300,000. Cooperation by some of the tippees led to the unraveling of the scheme.

Saridakis and five other defendants were forced to disgorge their trading profits. Saridakis received an officer and director bar and paid a civil penalty of twice his tippees’ profits. Penalties for the tippees ranged from no civil penalties for a tippee who cooperated with the SEC’s investigation to penalties three times the trading profits.

The SEC also entered into an NPA with an unnamed trader who cooperated in the SEC’s investigation. The SEC has stated that it entered into the agreement with the unnamed trader in recognition of the trader’s “early, extraordinary, and unconditional cooperation.”

Andrew J. Ceresney, director of the SEC’s Division of Enforcement, has stated that “[t]he reduction in penalties for those tippees who assisted us, together with the non-prosecution agreement for one of the traders, demonstrate the benefits of cooperating with our investigations. The increased penalties for others highlight the risks of impeding our work.” The implicit message is that those who cooperate will benefit from a reduction of penalties and extraordinary cooperation may lead to a non-prosecution agreement.
FCPA FOCUS

The Foreign Corrupt Practices Act continues to be a high enforcement priority of the SEC. Here are some highlights of FCPA enforcement from the past quarter. For more information on the FCPA, please see Sidley’s Anti-Corruption Quarterly.

**4/2/2014:** Six foreign nationals, including a government official in India, were charged with an alleged racketeering conspiracy to bribe officials in India to win titanium mining rights. The DOJ stated that, starting in 2006, the defendants allegedly conspired to pay $18.5 million in bribes to obtain mining licenses in an Indian coastal state.

**4/7/2014:** Latvia completed the necessary steps to become a member of the OECD Anti-Bribery Convention, becoming the 41st party to the Convention, effective May 30, 2014. Latvia was invited to join the OECD Working Group on Bribery in September 2013.

**4/9/2014:** Hewlett Packard’s Russian subsidiary pleaded guilty to substantive FCPA offenses for its role in a scheme to bribe officials of the Office of the Prosecutor General of the Russian Federation in order to secure a technology contract. The contract was worth over $100 million and was viewed as a “golden key” capable of unlocking many other opportunities with the Russian government.

**4/14/2014:** Two former employees, Benito Chinea and Joseph DeMeneses, of Direct Access Partners, a New York-based broker-dealer were charged with FCPA violations for allegedly bribing an official at Venezuela’s state-owned economic development bank.

**5/8/2014:** The SEC asked Quanta Services Inc., an engineering, procurement and construction infrastructure services company, to preserve documentation from its FCPA compliance program. The SEC is specifically looking into the company’s operations in South Africa and the United Arab Emirates, but has not alleged to date any violations by Quanta or its employees.

**5/8/2014:** PTC Inc., a software company, disclosed in its Form 10-Q that it had received a subpoena from the SEC in connection with an FCPA investigation for payments and expenses by its China business partners and PTC’s Chinese subsidiary’s employees. PTC Inc. had previously stated it was in settlement talks with the DOJ and SEC.

**5/9/2014:** Joseph Sigelman, former CEO of a South American oil and gas services company, was indicted for bribing an official at Columbia’s state-controlled oil company, Ecopetrol SA, to secure approval for a $39 million oil services contract, and for defrauding the company by taking kickbacks. Sigelman’s co-CEO, Knut Hammerskjold, pleaded guilty to the same charges in February.

**5/19/2014:** The U.S. Court of Appeals for the 11th Circuit upheld the convictions of Joel Esquenazi and Carlos Rodriguez, thereby validating the DOJ’s expansive definition of “foreign official” under the FCPA. Esquenazi and Rodriguez’s sentences, at 15 and 7 years, respectively, are the longest prison sentences ever imposed in an FCPA case. For more information on Esquenazi, please see our prior alert.

**6/19/2014:** The DOJ issued a declination for Smith & Wesson ending its FCPA investigation of the company, which was launched in 2010 after the indictment of its Vice President of Sales. Smith & Wesson also stated that the SEC civil investigation, also launched in 2010, was nearing a resolution.
Sidley’s Securities & Derivatives Enforcement and Regulatory group advises and defends clients in a wide range of securities- and derivatives-related matters. With more than 150 lawyers in 10 offices worldwide, we provide comprehensive regulatory, enforcement, and litigation solutions in matters involving the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), self-regulatory organizations (SROs), state attorneys general, and state securities regulators. Our team is distinctive in that it combines the strength of nationally recognized enforcement lawyers with the skills of equally prominent counseling lawyers. We work collaboratively to provide our clients with informed, efficient, and effective representation.

Our team features many prominent practitioners and former officials from the SEC, FINRA, and CFTC, as well as state regulators. Our lawyers include a former associate director of the SEC’s Division of Enforcement, a former co-head of enforcement and associate regional director of the SEC’s Northeast Regional Office, a former deputy director of the SEC’s Division of Trading and Markets, a former SEC senior trial counsel, the former head of enforcement for FINRA, and the former chief of the Massachusetts Securities Division. We also understand the “inside” perspective. Our team includes former general counsels of Charles Schwab and UBS Financial (Paine Webber), as well as the former global head of compliance at J.P. Morgan.

Our team has earned acknowledgement in numerous industry publications, including being named in the 2011 U.S. News – Best Lawyers “Law Firm of the Year” for Securities Regulation. In its 2014 edition, Chambers USA ranked us among the best U.S. law firms for Securities. In a recent edition, that publication noted the firm’s “well-regarded enforcement practice with a considerable depth of resources.” Sources told that publication that our practice “is highly thought of for public company representations and advisory work.”

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