Forging Ahead on Multiple Fronts

From "Broken Windows" Enforcement to Innovative Technologies, the SEC Pursues Several Strategic Initiatives Amid Fractured Leadership

By Abe Alexander

Under Mary Jo White, the agency's new initiatives represent an aggressive expansion of its enforcement regime and infrastructure, which faces opposition and obstacles.

Under Chairwoman Mary Jo White, the SEC has rolled out a variety of initiatives exploiting new powers granted to the agency by the Dodd-Frank Wall Street Reform and Consumer Protection Act and utilizing new technologies to bring its investigative capabilities up to speed with the modern realities of electronic trading. While the SEC has promised that its new initiatives will enhance the agency's policing power and benefit investors, a number of the programs have proven controversial, with one initiative facing a constitutional challenge. What's more, Chairwoman White's pledge to "expeditiously" finalize a variety of post-crisis rules, complete probes into financial misconduct, and push forward enforcement matters has been thwarted by political discord among the Commission's five members. Consequently, several big-ticket projects remain uncompleted two years into Ms. White's tenure.

"Broken Windows" Enforcement

In an October 9, 2013 speech, Chairwoman White announced that the SEC would pursue a "broken windows" approach to securities enforcement. The "broken windows" theory of law enforcement posits that aggressive prosecution of relatively petty crimes (*e.g.,* vandalism, vagrancy, public intoxication) helps set broad norms of lawfulness, order, and compliance in a particular community, thereby reducing the incidence of more serious offenses. As Chairwoman White explained, "when

a window is broken and someone fixes it — it is a sign that disorder will not be tolerated. But, when a broken window is not fixed, it 'is a signal that no one cares, and so breaking more windows costs nothing.'" In White's view, "[no] infraction is too small to be uncovered and punished."

Under the "broken windows" enforcement philosophy, the SEC has pursued broader, more comprehensive enforcement action for a wider range of misconduct that, in many cases, would likely have gone largely unpunished in past years. By focusing on minor but systemic violations, the agency is attempting to force change at an institutional level in a way that will yield an industrywide culture of compliance.

Following its new "broken windows" enforcement philosophy, the SEC has pursued broader, more comprehensive charges for a wider range of ostensibly non-fraudulent misconduct that, in many cases, may have gone largely unpunished in past years. For instance, in 2014, for the first time, the SEC filed numerous actions targeting a variety of non-fraud violations, including enforcement actions against a broker-dealer for failing to protect a client's confidential information, and against a private equity firm for misallocated fees and expenses. According to SEC Enforcement Director Andrew Ceresney, this approach is "not about turning every violation into an enforcement action," but rather "targeting important rules [where] we've seen *a pattern* of lack of compliance," and using these cases to foster "compliance across the board." In other words, by focusing on minor but systemic violations, the SEC is attempting to force change at an institutional level and yield an industrywide culture of compliance.

The SEC's new approach has its critics, including former agency officials. In their view, pursuing "minor" infractions squanders already scarce agency resources. Additionally, these critics worry that the SEC's commitment to punishing ostensibly victimless, non-fraud offenses, such as late or incomplete filings not made in bad faith, might deter issuers from voluntarily reporting and correcting such deficiencies for fear of being penalized. Finally, critics have questioned whether the Agency is as hard on large companies as it is on smaller entities — noting, for example, the increasing number of reprieves granted to large financial institutions, allowing prominent financial firms to continue to participate in capital market activities from which they would be otherwise barred as a result of repeat violations.

Whether the SEC's broken windows enforcement policy engenders an enduring industrywide culture of compliance, and whether the Agency will be as tough on large companies as it is on low-level offenders, remains to be seen. In the short-term, at least, the agency has attributed its recovery of a record $4.16 billion in disgorgement and civil penalties in 2014, in part, to its aggressive prosecution of minor violations.

Administrative Courts

The Dodd-Frank Act greatly expanded the SEC's power to seek financial penalties in administrative proceedings, allowing the agency to avoid more costly and cumbersome litigation in federal courts. The SEC's use of these administrative tribunals has increased significantly during Chairwoman White's tenure. Indeed, nearly half of the agency's enforcement actions in 2014 were filed as administrative proceedings.

The SEC's new power to seek monetary penalties against a wide range of wrongdoers in administrative proceedings has been a tremendous boon to the agency, as the forum provides the SEC with considerable advantages it would not have in federal court. For example, hearings are held on an accelerated schedule; pre-hearing discovery is not permitted; and federal courts reviewing the agency's determinations must grant a substantial degree of deference to its factual findings and legal conclusions. The procedural simplicity and expediency of administrative enforcement actions allow the SEC to conserve scarce resources, while the substantial deference the Commission's determinations receive when reviewed by federal courts provides the agency with considerable leverage to quickly extract settlements on favorable terms.

The SEC's increased use of administrative courts for enforcement proceedings, however, has engendered criticism and prompted serious legal challenges. Preliminarily, gridlock among the Commission's five members — two of whom are Republicans, two of whom are Democrats, and one of whom is an independent (Ms. White) — have troubled the initiative and resulted in public discord. For example, nearly one-third of high-profile cases the SEC filed with administrative law judges between November 2014 and April 2015 drew dissents from the SEC's two Republican commissioners, according to a *Wall Street Journal* study.

Moreover, defendants in SEC administrative enforcement proceedings have increasingly argued that the proceedings are unconstitutional. For instance, in *Bebo v. SEC*, the former CEO of Assisted Living Concepts, a senior living operator, sought to enjoin the SEC from bringing an accounting fraud claim against her in its administrative forum. Bebo argued that the forum deprived her of a constitutional jury trial right and, given the absence of discovery and accelerated timetable, her ability to adequately prepare a defense. The district court found Bebo's claims "compelling and meritorious," but ruled that it lacked subject matter jurisdiction over the case because Bebo had not yet exhausted her other remedies. Bebo has appealed the court's decision to the Seventh Circuit Court of Appeals. The Seventh Circuit agreed to hear Bebo's appeal on an expedited basis. Oral argument was held early June, and the Seventh Circuit's decision on the threshold jurisdictional question is expected soon.

Additional challenges pending in the Second and Eleventh Circuits have attacked the SEC's new policy on a different ground, arguing that an administrative enforcement proceeding represents an unconstitutional delegation of the President's authority to enforce the law to individuals — namely, administrative law judges ("ALJ") — who are not sufficiently answerable to the President. While such challenges continue to mount, the results have been mixed. For example, in April a New York federal court refused to block an administrative enforcement proceeding pending against a former Standard & Poor's executive, rejecting her argument that such proceedings are unconstitutional. In contrast, in June, an Atlanta federal district halted an SEC administrative proceeding, finding that the defendant's constitutional challenge to the agency's use of in-house courts was likely to succeed.

In addition, Judge Jed S. Rakoff (S.D.N.Y.) is a prominent critic of the SEC's flight to administrative fora. In a 2011 case, *Gupta*

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v. SEC, Judge Rakoff ruled against the SEC and sided with the defendant, who alleged he would be deprived of his equal protection rights if the case were allowed to proceed in the administrative court, rather than in federal court. According to Judge Rakoff, the SEC's increased use of administrative proceedings raises the danger that divergent and inconsistent bodies of securities jurisprudence will develop in parallel, one framework evolving in federal court, the other in administrative court. Judge Rakoff notes that this concern is compounded by the fact that an ALJ's interpretations of controlling statutes are relatively insulated from federal court review, yet those same statutes must be applied by federal judges in criminal securities cases. Judge Rakoff also fears that ALJs, as SEC appointees, are less likely to impartially adjudicate cases brought by their own agency than federal judges. Indeed, the SEC has won nearly all of its recent enforcement proceedings brought before ALJs, but has not fared nearly as well when its cases are decided by federal juries. Whether this disparity is a function of the relative sophistication and subject-matter expertise of administrative judges or an artifact of institutional bias, as Judge Rakoff suggests, remains unclear.

Whistleblower Program

To encourage the reporting of potential securities violations, the Dodd-Frank Act entitles whistleblowers to receive between 10 and 30 percent of any penalties over $1 million recovered by the SEC based on information they have provided, and protects those whistleblowers from retaliation by their employers.

Since the inception of the whistleblower program in August 2011, the SEC has authorized awards to seventeen whistleblowers, with nine of those awards made in 2014. The SEC claims that "[i]n each instance, the whistleblower provided high-quality original information that allowed the Commission to more quickly uncover and investigate the securities law violation." Larger bounties are also being paid as the program matures. In October 2013, one whistleblower was paid a then-record $14 million. In September 2014, this record was broken when another tipster received more than $30 million. According to the SEC, this jump reflects the growing quality and significance of the tips it has received.

Likewise, the number of tips the agency has received from whistleblowers has increased each year since the program's inception. In 2014, the SEC received 3,620 tips, up 21 percent from two years earlier. According to the SEC, every tip is reviewed by the agency's Office of Market Intelligence, which forwards the most specific, credible, and timely tips to the Division of Enforcement for more extensive investigation.

At the same time, the SEC is experiencing significant backlog in paying awards to the vast majority of those tipsters: of the 297 whistleblowers who have applied for awards since 2011, 247 — about 83 percent — have yet to receive a decision on their claim. In some cases, award claims have been delayed for more than two years. Thus, while the SEC has indeed paid outsized bounties to a handful of tipsters, most claimants have yet to receive any remuneration from the agency, and

have complained about the bounty program's lack of transparency.

Notwithstanding the delays in doling out whistleblower awards, the SEC has vigilantly enforced the whistleblower law's anti-retaliation provisions. In June 2014, the agency brought its first anti-retaliation enforcement action against Paradigm Capital Management, asserting that the company retaliated against its head trader for reporting that it had engaged in prohibited transactions. Ultimately, Paradigm paid $2.2 million to settle the charges. The SEC took its efforts to police retaliation a step further in early 2015, when the agency sent letters to a number of companies, asking for years of non-disclosure agreements, employment contracts, and all other "documents that refer to or relate to whistleblowing," along with lists of terminated employees. Further, on April 1, 2015, the SEC reached a settlement with KBR, Inc., which used improper tactics to prevent its employees from reporting possible violations of the securities laws. Specifically, the SEC settled claims with KBR for $130,000 arising out of allegations that the company prohibited its employees from reporting any potential misconduct to the government, and threatened to terminate employees if they reported anything to the SEC.

Focus on Accounting Fraud

In 2007, the SEC filed more than 200 enforcement actions for accounting fraud. In every year since, the agency has filed progressively fewer such cases, with only 79 accounting fraud actions filed in 2012. Historically, the SEC has relied heavily on restatements to identify accounting malfeasance, and when restatements, which peaked in 2006, began to decline, the SEC lost a principal tool for detecting wrongdoing. In late 2013, with Chairwoman White's support, the Division of Enforcement announced it would refocus its efforts on identifying, investigating, and prosecuting accounting fraud proactively. The Division's plan has two central components: (1) the creation of a Fraud and Audit Task Force devoted solely to proactively identifying accounting irregularities; and (2) the use of sophisticated analytic tools to identify potential accounting fraud.

The SEC's Financial Reporting and Audit Task Force, made up of lawyers and accountants from across the agency working in close consultation with several of the agency's accounting and corporate finance departments, dedicates full-time resources to identifying securities-law violations relating to the preparation of financial statements, issuer reporting and disclosure, and audit failures. In an effort to be more efficient and effective, the Task Force focuses on specific accounting areas that are particularly susceptible to fraudulent reporting.

Complementing the SEC's initiatives under White's tenure has been the utilization of more advanced technology in its monitoring and enforcement functions. Its Market Information Data Analytics System, or MIDAS, collects more than one billion records, time-stamped to the microsecond, every day, from each of the thirteen national equity exchanges.

Key to the Task Force's mission is the implementation of sophisticated analytic tools to preemptively identify unusual accounting treatments. Among the most critical of the Task Force's tools is its Accounting Quality Model, a predictive model that attempts to identify firms that have made unusual accounting choices relative to their peer group, such as an unusually high number of off-balance sheet transactions. In addition, the agency is also developing a groundbreaking text analytic tool that looks for potentially false or misleading disclosures in financial statement footnotes and the "Management Discussion and Analysis" portions of firm filings.

With the economy improving, and incentives for companies to engage in "earnings management" on the rise, the SEC's Task Force could play an important role in uncovering accounting misconduct in the near term. That is, of course, if resulting enforcement proceedings and attendant policy matters are not hampered by political dissent among the SEC's commissioners.

MIDAS

Complementing the SEC's initiatives under White's tenure has been the Commission's utilization of more advanced technology in its monitoring and enforcement functions. Chief among these is its Market Information Data Analytics System ("MIDAS"). Initiated in response to the Flash Crash of May 26, 2010, and unveiled in January 2013, MIDAS collects more than one billion records, time-stamped to the microsecond, every day, from each of the thirteen national equity exchanges. Through MIDAS, the SEC has access to almost real-time data about every displayed order posted in the national exchanges. This information enhances the SEC's forensic capabilities, allowing the agency to investigate and understand one-off events in the market, like the 2010 Flash Crash that served as the impetus for the program. For example, if a particular stock or symbol dropped five percent in a matter of seconds, then skyrocketed, only to settle back to its original price a few seconds later, MIDAS would allow the SEC to reconstruct this anomalous activity and better understand whether it was caused by market forces or manipulative trading.

In sum, the SEC's new initiatives represent an aggressive expansion of the agency's enforcement regime and infrastructure. However, these initiatives face internal and external headwinds, and only time will tell whether they are effective, and, in some circumstances, legally viable.

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