Lead Director Network ViewPoints

December 7, 2015

A dialogue with Andrew Ceresney, director of the SEC's Division of Enforcement

On October 7, 2015, members of the Lead Director Network (LDN) were joined by chief legal officer and general counsel (GC) guests in Washington, DC, for a discussion with Andrew Ceresney, director of the Division of Enforcement at the Securities and Exchange Commission (SEC).[1] For further information about the LDN, see "About this document," on page 6. For a list of participants, see the appendix on page 7.[2]

The SEC's Division of Enforcement is charged with protecting investors by investigating possible violations of securities laws and prosecuting civil cases in federal courts and administrative proceedings. Mr. Ceresney joined the SEC in 2013 as co-director of the Division of Enforcement and became the sole head of enforcement in 2014.

This *ViewPoints* provides background information and perspectives that lead directors and GCs shared before and during the meeting on the following topics:[3]

- **SEC enforcement priorities**
- **The SEC's cooperation program**

SEC enforcement priorities

Mr. Ceresney said that the Enforcement Division recently concluded a strong fiscal year that included several first-time cases in high-priority areas and a record of litigation success. Lead directors and GCs noted the very public spotlight now shining on the SEC and its enforcement results. Mr. Ceresney acknowledged the heightened attention but emphasized that the enforcement division must do what is right, notwithstanding the pressure from its constiuents.

Lead directors, GCs, and Mr. Ceresney discussed three particular areas where the Enforcement Division has pursued high-profile cases related to public companies:

- **Financial reporting.** Mr. Ceresney said that the Sarbanes-Oxley Act had a positive impact on financial reporting, with more testing, more certifications, more responsibility lodged with boards, and ultimately better audits. Notwithstanding this progress, financial reporting remains an SEC enforcement priority. For example, earlier this year, the SEC charged audit firm BDO USA and five of its partners with "dismissing red flags and issuing false and misleading audit opinions" related to a

[1] The Lead Director Network comprises lead independent directors, presiding directors, and non-executive chairs. LDN documents use the term "lead director" to refer to all three roles unless otherwise stated. Likewise, this document uses the abbreviation GC to refer to general counsel, chief legal officers, or any other officer charged with leading a company's legal department or function.

[2] In another session of this meeting, lead directors and their GC guests discussed oversight of corporate culture. See Lead Director Network, "Oversight of Corporate Culture," *ViewPoints*, December 7, 2015.

[3] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

company's financial statements.[4] The SEC also charged a number of the company's executives with making materially misleading statements or omissions.[5]

- **Foreign Corrupt Practices Act (FCPA).** In a speech earlier this year, Mr. Ceresney said, "International bribery has many nefarious impacts, including sapping investor confidence in the legitimacy of a company's performance, undermining the accuracy of a company's books and records and the fairness of the competitive marketplace."[6] And in the meeting with lead directors and GCs, Mr. Ceresney emphasized that new industries, including financial services, have become targets of FCPA investigations.
- **Insider trading.** In Congressional testimony delivered earlier this year, Mr. Ceresney said, "Policing insider trading has long been central to the Commission's mission of ensuring confidence in the markets. The Division has been very active in pursuing insider trading and has charged more than 590 defendants in civil insider trading cases over the last five years."[7] Lead directors, GCs, and Mr. Ceresney discussed the Supreme Court's decision not to review *U.S. v. Newman*, in which the Second Circuit Court of Appeals held that certain tips were not unlawful because the tippers did not receive sufficient personal benefit.[8] Mr. Ceresney suggested that while *Newman* adjusts the standard of proof for insider trading, it does not radically reshape insider trading law.

Mr. Ceresney also discussed the following policies and priorities that guide the Enforcement Division:

- **Individual defendants.** In September, Deputy Attorney General Sally Yates released a memorandum highlighting the Department of Justice's focus on prosecuting individual executives, not just corporate entities.[9] Lead directors and GCs asked whether the SEC has similar priorities, and Mr. Ceresney confirmed that individuals are also a focus for the SEC. He added that the Enforcement Division engages in separate settlement talks with corporations and their employees, rather than negotiating omnibus settlements.
- **Gatekeepers.** The SEC's emphasis on individual liability includes a closer look at the role of gatekeepers in circumstances involving fraud. In his Congressional testimony, Mr. Ceresney said, "A common thread … is an emphasis on the importance of gatekeepers to our financial system: attorneys, accountants, fund directors, board members, transfer agents, broker-dealers, and other industry professionals who play a critical role in the functioning of the securities industry … When gatekeepers fail to live up to their responsibilities, the Division has held – and will continue to hold – them

[4] US Securities and Exchange Commission, "SEC Charges BDO and Five Partners in Connection With False and Misleading Audit Opinions," news release, September 9, 2015.

[5] Ibid.

[6] Andrew Ceresney, "FCPA, Disclosure, and Internal Controls Issues Arising in the Pharmaceutical Industry" (speech, CBI's Pharmaceutical Compliance Congress, Washington, DC, March 3, 2015).

[7] Andrew Ceresney, "Testimony on 'Oversight of the SEC's Division of Enforcement'" (Washington, DC, March 19, 2015).

[8] Matthew Goldstein and Adam Liptak, "Supreme Court Denies Request to Hear Insider Trading Case," *DealBook* (blog), *New York Times,* October 5, 2015.

[9] Matt Apuzzo and Ben Protess, "Justice Department Sets Sights on Wall Street Executives," *New York Times*, September 9, 2015.

accountable."[10] Lead directors raised concerns about the prospect of holding non-executive directors – structurally removed from management and daily operations – personally liable for failure to discover fraud at their companies. Mr. Ceresney told directors that when faced with difficult decisions they should solicit and follow the advice of experts but they do not need to be experts.

- **Appropriate penalties.** Some lead directors and GCs expressed concern that the SEC seems to be too focused on outdoing itself in assessing record-setting disgorgement and penalties. They added that these penalties often appear as *"piling on"* from the standpoint of shareholders who bore the brunt of the underlying misconduct. Mr. Ceresney explained that the SEC considers the impact of penalties on shareholders, but balances that against the need for deterrence, recognizing the influence penalties have on individual conduct. He also emphasized that penalties do not fall solely on shareholders, because companies often make adjustments to compensation, targeted or otherwise, in the wake of an SEC settlement.
- **Resolving cases in a timely manner.** Lead directors and GCs were troubled by SEC investigations that linger for long periods without resolution. Mr. Ceresney agreed with this sentiment: *"Pace is important. There is a greater deterrent impact when we bring an action quickly. Likewise, if we aren't going to bring an action, our desire is to close the case. Sometimes, there are good reasons why we can't close matters, even if the reasons are not entirely apparent at the time."*
- **Cooperation with other government agencies.** One GC asked, *"How does the SEC ensure collaboration and transparency during investigations that include different voices of the US government?"* Mr. Ceresney said that in most cases the cooperation among agencies is excellent, citing examples like the SEC's work with the Justice Department on FCPA cases and with the Public Company Accounting Oversight Board on investigations of audit firms. However, he acknowledged that there are times when perfect harmony is elusive because regulators always cannot impose their wills on each other.
- **Culpability thresholds.** Some lead directors and GCs expressed the opinion that the SEC is too concentrated on cases where there is no evidence of intentional misconduct. One GC said, *"I am concerned that a negligence standard makes it harder to identify what constitutes wrongful behavior."* Mr. Ceresney explained that unlike criminal statutes, federal securities laws permit the SEC to bring many cases without proof of intent or willful disregard. He added that there are a lot of factors, including the level of culpability of the perpetrator, that go into the decision to pursue a case.
- **Broken windows.** Another SEC enforcement priority is pursuing smaller securities law violations, on the theory that doing so prevents much larger ones. Mr. Ceresney noted that the "broken windows" approach has sometimes been misinterpreted. He described the policy as one where the SEC can bring a number of cases at the same time to draw attention to repeated infractions and thereby send a strong message that the SEC takes compliance seriously. Some examples he cited include the SEC's cases

[10] Andrew Ceresney, "Testimony on 'Oversight of the SEC's Division of Enforcement.'"

against respondents and defendants for improperly participating in public stock offerings after short-selling those same stocks, and cases alleging violations of the beneficial-ownership reporting requirements of securities laws.

The SEC's cooperation program

In 2001, the SEC began granting formal credit to companies that cooperate in its investigations and exhibit good corporate citizenship; that practice was expanded in 2010 to credit individuals who cooperate.[11] Lead directors and GCs were interested in the incentive dynamics of cooperating with the SEC.

Corporate cooperation

The SEC considers four categories when assessing corporate cooperation: (1) self-policing prior to the discovery of misconduct; (2) self-reporting of misconduct when it is discovered; (3) remediation to prevent recurrence of misconduct; and (4) cooperation with law enforcement.[12]

One GC put the question frankly: *"Do companies really get rewarded for self-reporting?"* Mr. Ceresney said that companies get substantial benefits, and he provided examples of cases in which self-reporting led to penalties that were well below those levied in similar cases where there was no self-reporting. He added that it is sometimes difficult to demonstrate the benefits of self-reporting because the SEC does not (and companies would not want the SEC to) disclose what the penalties would have been had they learned about the case in some other manner. Other lead directors and GCs said that the SEC's emphasis on self-reporting has turned what was once a difficult choice into a de facto requirement. Mr. Ceresney emphasized that the decision to self-report should not be difficult for a board or GC that learns about unlawful conduct.

Lead directors and GCs also asked at what stage of an investigation cooperation should begin. One GC described the challenge: *"The facts are often not that clear, certainly early in the investigation. The company might believe there is not a violation. Do we need to alert you as soon as we launch an internal investigation?"* Mr. Ceresney responded, *"We don't expect you to pick up the phone immediately, but we do expect you to report when you have some indication of wrongdoing. We have no problem with advocacy. It is fine if you tell us the facts, then claim you are innocent. I am confident that after our investigation, we will make a decision based on the facts."* However, he cautioned, *"We live in a different world with the Dodd-Frank whistleblower program. If you don't tell us right away, you are gambling, because someone else might tell us first."*

[11] "Enforcement Cooperation Program," Securities and Exchange Commission, accessed November 2, 2015.
[12] Ibid.

The Dodd-Frank Act whistleblower program

Lead directors and GCs discussed whistleblowers both in the dialogue with Mr. Ceresney and in a separate discussion with four panelists: Carmen Lawrence, Jeff Bucholtz, and John Richter of King & Spalding, and Justin Brooks of Guttman, Buschner, & Brooks, a boutique firm that represents whistleblowers.

In 2011, the SEC adopted whistleblower rules mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act. These rules state that a person who informs the SEC about a securities law violation is eligible for a bounty of between 10% and 30% of the sanctions collected for the violation.[13] Last year, the SEC received 3,620 whistleblower tips and paid awards to nine whistleblowers, including one award of over $30 million, the largest to date.[14]

In a speech earlier this year, SEC Chair Mary Jo White said, "It is past time to stop wringing our hands about whistleblowers. They provide an invaluable public service, and they should be supported. And, we at the SEC increasingly see ourselves as the whistleblower's advocate."[15] Some lead directors and GCs questioned this apparent change from the SEC's mission as the investor's advocate, and asked whether the SEC's focus on whistleblowers – most of whose claims are ultimately disregarded – comes at the expense of investors. Mr. Ceresney responded, *"We are not changing the mission of the SEC. We don't just accept what they say as given, but whistleblowers are an important source of information about misconduct. Investors benefit when the truth comes out."*

Lead directors and GCs asked about the profile of a typical whistleblower and how companies might encourage them to raise concerns in house. The panelists said that the perception of a whistleblower as a disgruntled employee or former employee is not always true. Mr. Brooks said, *"Our best cases do not come from terminated employees but from people who are viewed as stars within the company. They have legitimate information about wrongdoing but do not trust the system for reporting internally."* Ms. Lawrence added, *"Most employees report internally first and only go to the government when they are disappointed with the internal process or outcome."*

Individual cooperation

As of August 2015, the SEC had signed 91 cooperation agreements in the five years since it extended its cooperation program to include individuals.[16] The four considerations the SEC takes into account when assessing individual cooperation are (1) assistance provided by the cooperator; (2) importance of the

[13] "Frequently Asked Questions," SEC Office of the Whistleblower, accessed November 2, 2015.

[14] Securities and Exchange Commission, *2014 Annual Report to Congress on the Dodd-Frank Whistleblower Program* (Washington, DC: Securities and Exchange Commission, 2014), 10, 20.

[15] Mary Jo White, "The SEC as the Whistleblower's Advocate" (speech, Ray Garrett, Jr. Corporate and Securities Law Institute-Northwestern University School of Law, Chicago, April 30, 2015).

[16] Jean Eaglesham, "SEC Tries Flipping Witnesses," *Wall Street Journal*, August 5, 2015.

underlying matter; (3) interest in holding the individual accountable; and (4) the profile of the individual.[17] Mr. Ceresney recently said that cooperators provide "a bird's-eye view of the misconduct," which allows the SEC to develop stronger cases.[18] The SEC recently began calling cooperators to testify in civil enforcement actions. For example, in a case where one individual was charged with a fraudulent trading scheme, a cooperating witness who was a counterparty to the trades testified about how the scheme worked.[19]

In a recent speech, Mr. Ceresney described the range of benefits for those who cooperate. First, in cases where "an individual is on the bubble," cooperation can lead to lesser charges or no charges at all. Second, cooperation can also lead to smaller monetary penalties. Finally, cooperation may influence the SEC's decision to seek remedial relief such as an industry suspension or bar.[20] In the example cited above, the cooperating trader who testified agreed to a three-year ban from the securities industry but was not required to pay a fine; the party he testified against was ultimately fined $82,500.[21]

Conclusion

The SEC's Division of Enforcement has a long list of priorities in pursuit of protecting investors. To fulfill that mandate, the SEC seeks to cooperate with individuals and corporations and to make it worth a company's while to self-report misconduct. Boards and managers must therefore remain vigilant both in preventing misconduct before it occurs and in mitigating it once it is discovered.

About this document

The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

[17] "Enforcement Cooperation Program," Securities and Exchange Commission.

[18] Andrew Ceresney, "The SEC's Cooperation Program: Reflections on Five Years of Experience" (speech, University of Texas School of Law's Government Enforcement Institute, Dallas, May 13, 2015).

[19] Jean Eaglesham, "SEC Tries Flipping Witnesses."

[20] Andrew Ceresney, "The SEC's Cooperation Program: Reflections on Five Years of Experience."

[21] Jean Eaglesham, "SEC Tries Flipping Witnesses."

Appendix: Meeting participants

The following network members participated in the meeting:

- Sandy Cloud, Lead Trustee, Eversource Energy
- Peter Currie, Lead Director, Schlumberger and Twitter
- Ann Maynard Gray, Non-Executive Chair, Duke Energy
- Linda Fayne Levinson, Non-Executive Chair, Hertz
- Sam Nunn, Lead Director, Coca-Cola Company
- Pam Reeve, Lead Director, American Tower and Frontier Communications
- Ed Rust, Presiding Director, Caterpillar
- Tom Wajnert, Non-Executive Chair, Reynolds American

The following general counsel participated in the meeting:

- Eileen Akerson, Executive Vice President, General Counsel, and Corporate Secretary, KBR
- Sheila Cheston, Corporate Vice President and General Counsel, Northrop Grumman
- Lucy Fato, Executive Vice President and General Counsel, McGraw Hill Financial
- Cam Findlay, Senior Vice President, General Counsel, and Secretary, Archer Daniels Midland
- John Finneran, General Counsel and Corporate Secretary, Capital One
- Ed Gallagher, Acting General Counsel and Secretary, NCR
- Bernhard Goepelt, Senior Vice President and Chief Legal Counsel, Coca-Cola Company
- Barry Goldman, Senior Vice President and General Counsel, Acuity Brands
- Mark Holton, Executive Vice President, General Counsel, and Assistant Secretary, Reynolds American
- Alex Juden, Secretary and General Counsel, Schlumberger
- Mark Nielsen, Executive Vice President, General Counsel, and Secretary, Frontier Communications
- Tom Sabatino, Senior Executive Vice President, Chief Administrative Officer, and General Counsel, Hertz

The following network members took part in pre- or post-meeting discussions:

- Dick Auchinleck, Lead Director, ConocoPhillips
- Peter Browning, Lead Director, Acuity Brands
- Loren Carroll, Non-Executive Chair, KBR
- Don Felsinger, Lead Director, Archer Daniels Midland and Northrop Grumman
- Ed Kangas, Non-Executive Chair, Tenet Healthcare and United Technologies
- Doug Steenland, Non-Executive Chair, AIG

The following general counsel took part in pre- or post-meeting discussions:

- Kevin McCarthy, Senior Executive Vice President and General Counsel, Bank of New York Mellon

The following King & Spalding attorneys participated in all or part of the meeting:

- Jeff Bucholtz, Partner; National Appellate Practice Group
- Dixie Johnson, Partner; Special Matters and Government Investigations Practice Group
- Carmen Lawrence, Partner; Special Matters and Government Investigations Practice Group
- John Richter, Partner; Special Matters and Government Investigations Practice Group
- Cal Smith, Partner; Corporate Practice Group
- Michael Smith, Partner; Co-Chair, Securities Litigation Practice Group
- Chris Wray, Partner; Chair, Special Matters and Government Investigations Practice Group