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“Carrots and Sticks” of SEC Enforcement

Three recent SEC enforcement cases demonstrate the Commission’s “carrot and stick” approach of rewarding or punishing companies and individuals depending on their level of cooperation during an investigation.

- On April 11, Xerox Corporation settled an injunctive action by agreeing to pay a \$10 million penalty designed, in part, to reflect the company’s “lack of full cooperation” in the investigation. <http://www.sec.gov/news/press/2002-52.txt>
- On March 13, the SEC rewarded IGI Inc.’s cooperation in a financial fraud investigation by foregoing monetary penalties and fraud charges, while filing an injunctive action against a former IGI officer seeking disgorgement of earnings-based compensation and unexercised stock options for his alleged involvement in the fraud. <http://www.sec.gov/litigation/admin/34-45553.htm>
- And on April 18, the SEC paid a \$29,000 bounty to a former corporate officer for providing information leading to the imposition of SEC insider trading sanctions against other officers in a financial fraud case. <http://www.sec.gov/litigation/litreleases/lr17476.htm>

For those now (or soon-to-be) enmeshed in SEC investigations, these cases reflect current SEC enforcement priorities. When assessing this new environment, here are some points to consider.

1. **SEC “Sticks” Can Leave Even Blue-Chip Companies Black and Blue.** The *Xerox* settlement epitomizes a “big stick” approach. The allegations describe a four-year scheme accelerating over \$3 billion in revenue and increasing pre-tax earnings by roughly \$1.5 billion. The press release also cites a “lack of full cooperation” in the investigation. In response, a Xerox spokesperson reportedly described the company’s approach to the investigation as merely acting “in good faith in exercising its legal rights to defend itself.” The sanctions included the largest fine ever imposed by the SEC against a public company in a financial fraud case, as well as a four-year restatement, additional adjustments to previously announced 2001 results and a requirement that Xerox establish an independent committee of its board of directors to review material accounting controls and policies. <http://www.sec.gov/litigation/litreleases/lr17465.htm>

The proceeding departs markedly from the SEC’s traditional reluctance to impose significant monetary sanctions on public companies whose shareholders themselves are victimized by a financial fraud. The SEC’s Enforcement Director foreshadowed this policy shift in February, asserting that the SEC was justified in seeking such penalties when confronted by recalcitrant company management. According to Mr. Cutler, “[t]o those who say this results in costs to shareholders, I say, they are costs imposed by

wrongheaded management, not the SEC.” (<http://www.sec.gov/news/speech/spch538.htm>) While Mr. Cutler’s remarks appear intended to encourage subsequent derivative claims by shareholders against management, it remains unclear whether, outside the context of a settled proceeding, an SEC effort to impose such a penalty would be upheld.

Corporate officers managing SEC investigations often strive to protect the company while cooperating with the SEC Staff. The Xerox sanction provides added incentive to strike the right balance. It also serves as a reminder to request an advance copy of the SEC’s proposed press and litigation releases, to minimize surprise if, as here, the contents of the release differ from the underlying settlement papers.

2. SEC “Carrots” Can be Bittersweet. In contrast to the SEC’s use of a penalty “stick” against Xerox, the SEC used a “carrot” of reduced charges, and no penalties, to reward IGI’s response upon learning of possible financial misreporting in its animal vaccine and cosmetic manufacturing business. Specifically, the company immediately launched an internal investigation, shared the results of its review with the SEC (waiving attorney-client privilege), terminated the responsible executives and implemented additional internal controls. Although IGI allegedly had materially misstated its assets and earnings for nearly three years, the cooperation prompted the SEC to settle the case through a cease-and-desist order, without any fraud allegations or fines.

Even though IGI’s response closely tracked the roadmap for cooperation outlined in the SEC’s Seaboard 21(a) Report (<http://www.sec.gov/litigation/investreport/34-44969.htm>), the company did not receive a complete pass. Perhaps different treatment occurred because Seaboard’s misconduct involved the controller of a subsidiary and had no discernible impact on the share price, while the IGI’s misconduct allegedly involved the company’s president and the share price dropped after the restatement. Even a cease-and-desist order carries negative collateral consequences that can follow a company for years, but if a sanction was required, the result for IGI obviously was better than other alternatives.

3. Incentive Pay is at Risk. SEC officials have warned recently that executive bonuses and stock option awards linked to a company’s achievement of financial targets are subject to disgorgement if the SEC later concludes that the company artificially inflated its financial results. The SEC acted on that warning in the unsettled portion of the *IGI* matter, alleging in federal court that IGI’s former president deliberately ordered other employees to engage in fraudulent accounting. The SEC is seeking not only an officer-and-director bar and a monetary penalty against the ex-president, but also the disgorgement of his trading profits, performance-based compensation and unexercised stock options. Almost 20 years ago, a corporate officer forfeited unexercised stock options in connection with an SEC settlement, but *Gallo* may be the first case in which the SEC’s authority to seek the remedy is actually litigated in federal court. For now, we are likely to see this approach in other cases where the SEC believes senior management profited from financial frauds.

4. Whistleblowers May Receive Bounties. In the wake of Enron, both corporations and the SEC have seen an increase in whistleblower allegations. Last week, the SEC awarded a \$29,000 bounty to a former officer of Assix International, Inc. who informed the SEC of possible financial fraud and insider trading. This may indicate that the SEC is reviving its rarely-exercised statutory authority to pay bounties to reward whistleblowers who provide the agency with roadmaps to wrongdoing.

The SEC can make bounty payments of up to 10% of any insider trading penalties recovered as result of the information provided to the SEC. Congress awarded the SEC this authority in 1988, but it has been used only sparingly. Although the SEC may use bounties as an additional “carrot” to encourage people

with knowledge of potential wrongdoing to approach the SEC, the “carrot” is probably better viewed as a reward in extraordinary cases rather than as a routine inducement. Indeed, the SEC’s release confirms that the former Assix officer, whose name is now publicly known, spent considerable time helping the government, providing investigative testimony as well as a deposition during related litigation. In some cases, the SEC can maintain a whistleblower’s identity as confidential, but the bounty application procedures confirm there are no guarantees.

Looking Forward. These cases provide more insight into how the SEC approaches cooperation. Internal investigations that enhance the SEC’s knowledge of what took place, and streamline the SEC’s need to conduct an inquiry of its own, get rewarded with “carrots.” Conduct during an investigation that appears, even in hindsight, as artificially circumscribed or as an exercise in damage control may result in (or prove insufficient to avoid) “sticks.” And the SEC remains fully prepared to litigate to prove a point.

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