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Outside Counsel

Expert Analysis

SEC's New Enforcement Program: Rewriting the Rules of Engagement

On a quiet August evening when most of Wall Street and corporate America was departing for vacation, the Securities and Exchange Commission's (SEC) new Director of Enforcement, Robert Khuzami¹ gave a speech before the New York City Bar where he announced what is perhaps the most radical reorganization of the enforcement program since the creation of the Enforcement Division in the mid-70s. Based upon a top to bottom review of the program during his first 100 days, Mr. Khuzami described a series of initiatives to bring cases faster, with greater impact and, most importantly, to secure litigation victories at trial.

To achieve these goals, the SEC will incorporate some of the key strategies utilized by U.S. Attorney's Offices in investigating and prosecuting criminal cases, including: the creation of specialized units, flattening the management structure by eliminating an entire supervisory level, delegating the authority to issue formal orders conferring subpoena authority to field supervisors; creating an Office of Market Intelligence; hiring more

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trial attorneys to build a credible trial threat; and pursuing policies to foster and incentivize individuals and whistleblowers to come forward and cooperate with investigations.

In the face of these dramatic efforts to create an accelerated, more aggressive SEC enforcement program, the unprepared company, individual or practitioner will be placed at a critical disadvantage. This article examines the announced initiatives with the goal of providing some insight into the new rules of engagement.

A primary focus of new initiatives at the Enforcement Division is to accelerate the process for investigating violations and initiating enforcement actions.

The 'Need for Speed'

Fast Tracked Subpoenas. Shortly after her appointment, SEC Chairwoman Mary

Schapiro reversed two important constraints previously placed upon the staff relating to obtaining Formal Orders of Investigation, which allow the issuance of subpoenas, and to negotiating corporate penalty settlements without prior commission approval. The new initiatives further streamline the process for the staff to obtain formal orders and subpoena power.

With regard to Formal Orders, Enforcement Division staff do not have authority to issue subpoenas for testimony and documents until the commission approves and issues a Formal Order of Investigation. Under Chairman Christopher Cox, the Enforcement Division was required to submit a memorandum requesting the issuance of a Formal Order to the entire commission and to await approval of a majority of the commissioners in a closed commission meeting before it could obtain a Formal Order of Investigation.

Recognizing that time is of the essence and delay can be quite costly to an investigation in which subpoena power is necessary, Ms. Schapiro reinstated a prior policy under which Formal Order requests could be considered and acted upon in the seriatim process or, where appropriate by a single commissioner acting as duty officer.

The recently announced initiatives dramatically streamline further the process for the staff to obtain Formal Orders which confer subpoena authority. According to Mr. Khuzami, the commission, with certain limited exceptions, has agreed to delegate authority to issue Formal Orders of Investigation to Mr. Khuzami, who has in turn delegated the

authority to lower level supervisors throughout the Division of Enforcement.

Division staff will no longer have to obtain advance commission approval in most cases to issue subpoenas, rather they will be able simply to obtain the approval from a local supervisor in order to gain subpoena power. Mr. Khuzami explained the import of this significant policy change: “this means that if defense counsel resist the voluntary production of documents and witnesses, or fail to be complete and timely in responses or engage in dilatory tactics, there will very likely be a subpoena on your desk the next morning.”

In the area of corporate penalties, Ms. Schapiro streamlined the process for the staff to negotiate corporate penalties in settlement discussions by discontinuing the Corporate Penalty Pilot Program, which required the staff to obtain special approvals from the commission before negotiating corporate monetary penalties in settlements.²

Accelerated Enforcement. There is little doubt that a primary focus of new initiatives at the Enforcement Division is to accelerate the process for investigating violations and initiating enforcement actions. Mr. Khuzami emphasized the need to investigate and prosecute cases swiftly and urgently:

A sense of urgency is critical. Long gaps between conduct and atonement undermine the deterrent impact of our cases, and result in missed opportunities to achieve a permanent change in behavior and culture.

Creation of Specialized Units

In a major departure from a historic reliance upon generalist enforcement lawyers to investigate cases involving a large variety of potential securities law violations, Mr. Khuzami announced the formation of national specialized units dedicated to particular highly specialized and complex areas of the securities laws. Each unit will be led by a unit chief and will be staffed with individuals who already have specialized expertise or have a desire to develop such

expertise. Unit staff will receive specialized training, and individuals with practical market experience or other expertise will be hired into these units whether from private industry or elsewhere.

According to Mr. Khuzami, the following five specialized units will be created *to start* (emphasis added), implying that other specialized units will be formed in the future:

- The Asset Management Unit will focus on Investment Advisors, Investment Companies, Hedge Funds and Private Equity Funds, and will handle issues such as disclosure, valuation, portfolio performance, due diligence and diversification, transactions with

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affiliates, misappropriation, and conflicts of interest.

- The Market Abuse Unit will focus on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals and others. The Unit intends to build proprietary technological tools and screening programs to ferret out suspicious trading activity by analyzing trading and other activity across markets such as the equities, derivatives and debt securities markets.
- The Structured and New Products Unit will focus on complex derivatives and financial products, including CDS, CDOs and securitized products.
- The Foreign Corrupt Practices Act (FCPA) Unit: will focus on new and proactive approaches to uncovering violations of the FCPA, will work more closely with foreign regulators, and take a more global approach.
- The Municipal Securities and

Public Pensions Unit will focus on offering and disclosure issues, tax and arbitrage driven activity, unfunded and underfunded liabilities, and pay-to-play schemes in which money managers and advisors pay kickbacks and give other favors in return for the right to advise the funds.

According to Mr. Khuzami, these specialized units will enhance the ability of the staff to develop expertise which will assist it in more efficiently and effectively conducting specialized investigations, and in proactively deciding on an informed basis where to focus investigations and resources.

Structure and Processes

One of the significant deficiencies of the division identified in the March 2009 GAO report to Congress, was a process for supervisory review of enforcement cases that was too burdensome, and unnecessarily redundant.³ Mr. Khuzami announced the following significant initiatives to flatten the SEC’s management structure and streamline the SEC’s internal processes:

- The branch chief line supervisory position is being eliminated, and branch chiefs will be redeployed to conduct investigations. The Elimination of a layer of management will empower line attorneys and result in other efficiencies.
- Authority to approve routine case decisions such as issuing Wells notices, opening investigations or making settlement demands will be delegated to senior officers throughout the country rather than residing only with the Deputy Director. This reverses a prior trend towards concentrating such authority in the hands of the Deputy Director.
- The internal action memorandum to the commission recommending specific enforcement actions will be shorter, subject to fewer reviews and require quicker turn around times.
- The staff will be required to obtain the Director’s personal approval before

entering into tolling agreements, which allow investigators to investigate conduct more than five years old without being barred from prosecuting such conduct by the statute of limitations. Mr. Khuzami indicated that tolling agreements will be the exception rather than the rule, signaling a strong mandate to the staff to conclude investigations well before the running of the statute of limitations.

Fostering Cooperation

Taking a page out of the Department of Justice play book for building prosecutions through the use of cooperators and whistleblowers, Mr. Khuzami announced several groundbreaking initiatives for the SEC to create incentives for individuals and whistleblowers to assist the SEC in investigations. Khuzami cautioned that the following initiatives were to reward “extraordinary cooperation” and not for the purpose of providing “leniency for the sake of leniency.”

First, the SEC will create a “Seaboard Report” for individuals which will set forth standards under which an individual’s cooperation with the SEC will be evaluated and considered with relation to enforcement decisions.⁴ Second, the division is seeking an expedited process by which the Director of Enforcement is delegated the authority to submit immunity requests to the Department of Justice. Third, the division is exploring ways to provide witnesses in appropriate cases with oral assurances early on in a case that the division does not intend to file charges against them.

Fourth, the division will be prepared to recommend to the commission in appropriate cases that the SEC enter into Deferred Prosecution Agreements, in which the division agrees to forego an enforcement action against an individual or entity subject to certain conditions including full cooperation, a waiver of the statutes of limitation, and compliance with certain undertakings.

Finally, although not mentioned in the speech before the New York City Bar, Mr. Khuzami has previously indicated plans to present a request to Congress for authority to compensate whistleblowers who bring the commission well-documented evidence of fraudulent activity.

Hiring Additional Trial Lawyers

Mr. Khuzami emphasized in testimony before Congress on May 7, 2009, that the division needs to maximize the capacity and ability of its trial unit to convey to all defendants that “not only do we assemble winning cases against them, but also we are prepared to go to trial and we will win.” “Only then can [the SEC] expect to secure the type of settlements that both achieve justice for investors and save resources to be used in pursuing the next case.” It is therefore not surprising that in his speech before the New York City Bar Mr. Khuzami reported that the SEC had added to its trial unit and intended to hire additional trial litigators.

Strategic Choices, Initiatives

Mr. Khuzami informed Congress in his testimony that the division needed to “be as strategic as possible” in using “resources as efficiently as possible and in a manner that achieves the greatest impact.” This means a focus on cases involving the greatest and most immediate harm and on cases that send an outsized message of deterrence, and not investigating cases or individuals past the point of diminishing returns.

Office of Market Intelligence. Mr. Khuzami announced the creation of an Office of Market Intelligence which will be responsible for the collection, analysis, risk-weighting, triage, referral and monitoring of hundreds of thousands of tips, complaints and referrals that the SEC receives each year.

Streamlining the Wells Process. Although not raised by Mr. Khuzami in his recent speech, experienced practitioners have noticed an apparent effort by the staff to streamline the Wells process. The staff

deadlines for making Wells submissions have been shorter, and the staff has been less flexible in granting extensions of deadlines for making submissions.

Increasing Resources

In addition to the dramatic initiatives the Division of Enforcement is implementing to make its enforcement program faster, more aggressive, and more efficient, it is clear that the SEC will have significantly increased resources to investigate and litigate its cases. In the fiscal 2009 budget, Congress increased the SEC’s budget by \$37 million.⁵ In addition, lawmakers gave Ms. Schapiro approval to use \$17 million in unspent funds from prior years—virtually all of which was allocated to the enforcement division for this year.⁶

Fiscal year 2010 similarly promises to be a year of significant increased resources for the SEC. The White House proposed increasing the SEC’s 2010 budget by 13 percent from its 2008 budget, when it submitted a \$1.026 billion budget for 2010.⁷ In addition, Senators Charles Schumer and Richard Shelby proposed an amendment to the Fraud Enforcement Recovery Act, to provide the SEC with an additional \$20 million for its enforcement division during fiscal years 2010 and 2011.⁸

Compliance Program

Fast-tracked subpoena power, specialized units, delegated penalty authority, incentivized cooperating witnesses, and more trial lawyers to take the SEC’s case to court—what does all this mean? What it likely means is a marked increase in new investigations, increased use of the compulsory process, pressure to produce documents and provide testimony faster, and less oversight of line staff attorneys from supervisors. Experienced practitioners will be challenged more than ever in an environment of less staff supervision to advocate to, educate and persuade line staff attorneys of their positions. It also likely means increased enforcement

actions, higher settlement demands and increased fines for corporations and individuals.

While the goal of every public corporation and individual is to avoid an SEC investigation in the first place, the realities of the current legal and economic environment make it increasingly likely that they could find themselves embroiled in an SEC investigation as a witness or as a target. Few public companies are immune from rogue employees, regulatory mistakes, or disgruntled competitors or employees who may forward even baseless allegations to the SEC. Accordingly, it should be a primary goal for any public company or individual to do everything possible to avoid or minimize the impact of an SEC investigation.

The best strategy for a company to accomplish this result is to assure that the company has a vibrant and effective compliance program. Find potential problems now, and proactively conduct internal investigations prior to the call from the SEC:

- Institute measures to investigate the problems or allegations on a real-time basis, while the ability to address them internally still exists.
- Tighten up compliance procedures: initiate a review of all policies regarding financial reporting, securities compliance, and Sarbanes-Oxley.
- Pay special attention to whistleblower policies to avoid turning a small inquiry into a retaliation investigation. Engage counsel to design and test how well your procedures work.

Individuals aware of potential problems should seek independent legal representation and advice early. The expected initiatives to foster the cooperation of individuals may present unique opportunities for those individuals to resolve matters early with reduced or no penalties.

The Need to Be Proactive

In the past, many weeks or months could pass from the initiation of an SEC inquiry to the issuance of an Order of Formal Investigation and the delegation of subpoena power. Now, it can be just days from the first phone call from the SEC staff to the first subpoena. With the SEC's emphasis on speed, it is more important than ever for companies to have thorough internal investigations conducted at the first sign of a problem. Proactive internal investigation into the suspected problematic conduct allows the company to get its arms around the facts first; to produce documents voluntarily quickly; and to properly frame the issue. In addition, the rapid investigation and reporting of the conduct to the SEC will best position the company to argue for a reduced fine, or no fines at all.

Conclusion

With less direct control and oversight of the investigation process, the SEC's commissioners will face the challenge of assuring that diminished review and supervision combined with the focus upon speed and aggressive enforcement does not result in the bringing of marginal cases or in significant litigation defeats. Hopefully, a leaner enforcement program will produce a more effective regulator and safer markets rather than result in unnecessary litigation—a scenario where no one wins.

1. Mr. Khuzami is a former in the trenches federal prosecutor who served as Chief of the Securities and Commodities Fraud Unit in the U.S. Attorney's Office for the Southern District of New York. He is the former General Counsel for the Americas at Deutsche Bank.

2. Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006).

3. GAO Report to Congressional Requesters: Securities and Exchange Commission—Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement. (March 2009), GAO-09-358.

4. In the "Seaboard Report," the SEC set forth the standards under which a corporation's cooperation with an SEC investigation would be evaluated and considered with relation to enforcement decisions. See, Report of Investigation Pursuant to 21(a) of the Securities and Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Rel. No. 44969 (Oct. 23, 2001).

5. "Senators to Seek to Bolster SEC Enforcement Budget," Wall Street Journal, April 21, 2009.

6. Id.

7. Id.

8. Id.

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