

SEC Announces New Enforcement Initiatives

On August 5, 2009, Robert Khuzami, Director of Enforcement of the Securities and Exchange Commission (SEC), announced changes and new initiatives that the Enforcement Division will implement in an effort to streamline SEC procedures and accelerate the SEC's ability to identify, pursue and resolve cases. The Enforcement Division underwent a "rigorous self-assessment" during Mr. Khuzami's first 100 days as director, resulting in new initiatives that reflect the most sweeping changes in the operation of the Enforcement Division in decades, and focus on speed, less supervision, and greater incentives to cooperate. The old rules for defending targets of SEC investigations will need to be reevaluated in light of these sweeping changes, each of which is discussed below.

Specialization

Mr. Khuzami introduced five new Enforcement Division units, each dedicated to a specialized and complex area of securities law. Each unit will be led by a unit chief and staffed by people around the country in the areas described below.

- *Asset Management.* This unit will focus on investment advisers, investment companies, hedge funds, and private equity funds. The unit will work together with the Office of Compliance Inspections and Examinations and focus on a range of areas including disclosure, valuation, portfolio performance, transactions with affiliates, due diligence and diversification, misappropriation, and conflicts of interest.
- *Market Abuse.* This unit will focus on preventing market abuses and complex manipulation schemes by institutional traders, market professionals and others. The unit will build analytical tools to target suspicious activity by looking at activity across markets, including equities, debt securities and derivatives, and across different corporate announcements and market events.
- *Structured and New Products.* This unit will focus on complex derivatives, including credit default swaps, collateralized debt obligations, and new financial products as they develop.
- *Foreign Corrupt Practices Act.* This unit will focus on new approaches to identifying violations of the Foreign Corrupt Practices Act. The unit will take a more global approach to these violations by working with both U.S. and foreign investigators to identify and pursue potential violations.
- *Municipal Securities and Public Pensions.* This unit will focus on potential abuses in municipal securities, including offering and disclosure issues, tax and arbitrage activity, unfunded or underfunded liabilities, and "pay to play" schemes.

It is notable that there are no new units dedicated to financial fraud or broker-dealer sales practice abuses. These areas have traditionally been especially active during recessions and have been among the most common enforcement actions. These areas are also among the more complex types of SEC enforcement actions, and thus would seem suited to the specialization concept.

The focus on municipal securities and public pension plans reflects a relatively new focus of attention for the SEC. It would appear that these areas will receive far more attention than they have received in the past.

Streamlining Management and Internal Process

Mr. Khuzami also announced several changes to the Enforcement Division's existing management structure in an effort to move cases along more quickly and to free up time and resources to tackle new matters with greater urgency and impact. These changes include:

- *Flattening Management Structure:* The division will be “redeploying” its branch chiefs to eliminate an additional layer of management and to permit current branch chiefs to focus full-time on investigations. Branch chiefs are the first line supervisors in the division and have traditionally played an active and important role in supervising investigations. According to Mr. Khuzami, this change will “encourage autonomy and accountability throughout the organization by pushing more decision-making to the front-line staff.”
- *Delegating More Authority to Local Senior Officers:* The SEC issued an order giving the division director authority to issue formal orders of investigation, and the Director in turn has delegated this authority to senior officers throughout the Division. According to Mr. Khuzami, “[t]his means that if defense counsel resist the voluntary production of documents or 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.” Similarly, the requirement that a deputy director approve all routine case decisions has been repealed and, in its place, supervisory powers have been delegated to senior officers located throughout the country. These changes provide greater authority to senior officers in local offices, including subpoena power, the power to enter into routine settlement negotiations, the power to make Wells calls, and the power to open investigations.
- *Tolling Agreements:* The division director must now approve all tolling agreements. Mr. Khuzami indicated that he would seldom approve such agreements.

Office of Market Intelligence

Mr. Khuzami announced the creation of an office that will be dedicated to collecting, processing, monitoring, and responding to the numerous complaints, tips and referrals the division receives.

Fostering Cooperation by Individuals

Mr. Khuzami outlined changes to encourage individuals to report wrongdoing and cooperate with the staff in its investigations, emphasizing that the SEC would reward only extraordinary cooperation and not merely compliance with routine or expected requests. Included in the initiatives are:

- a proposed public policy statement on standards to evaluate cooperation for individuals, analogous to the SEC's 2001 Seaboard guidance for corporate issuers;
- an expedited and streamlined process of submitting immunity requests to the Department of Justice;
- ways to provide individuals with oral assurances early in an investigation that the SEC does not intend to pursue charges against an individual cooperator; and
- the possible use of deferred prosecution agreements in which the SEC would agree to forego enforcement actions against individuals or entities in exchange for cooperation, waivers of statutes of limitations, and compliance with certain undertakings.



Current Enforcement Priorities

Finally, Mr. Khuzami discussed many of the SEC's ongoing enforcement priorities. He indicated that the Division's Subprime Working Group would continue its efforts to bring appropriate enforcement actions related to the financial crisis by working with the newly-formed specialized groups. The Division would also continue its emphasis on Ponzi schemes and cross-market misconduct (identified as using two or more of the equity, fixed-income and derivative markets to engage in wrongdoing). Other priorities for the division include:

- pursuing placement agents and others for seeking kickbacks related to public pension investments;
- pursuing hedge fund consultants for breaches of fiduciary duties in recommending inappropriate hedge fund investments;
- bringing Sarbanes Oxley section 304 clawback actions;
- investigating proxy disclosure violations;
- bringing accounting and financial statement fraud actions; and
- pursuing naked short sale rule violations.

Summary and Observations

The old rules for defending targets of SEC investigations will need to be reevaluated in light of the sweeping changes at the Division of Enforcement. At a minimum, counsel defending a client that wants to cooperate will need to pursue the new protections available to a cooperating witness and will need to be vigilant to avoid being accused of failure to cooperate. Counsel seeking to advocate a client's case will have less time and few opportunities for such advocacy, and thus will need to be more creative in asserting positions.

The creation of specialized units has traditionally been resisted at the SEC because, prior to the creation of the Division of Enforcement in the early 1970s, the enforcement function operated within each of the main regulatory divisions of the SEC—Corporation Finance, Trading and Markets, and Investment Management. Although Mr. Khuzami does not appear to be seeking a return to that structure, the SEC's lack of experience with specialized units in the Division of Enforcement makes it difficult to assess the impact of this change. There does seem to be an institutionalization, through the creation of these units, of certain current enforcement priorities, particularly directed at new and complex products and trading practices. In the past, enforcement priorities have tended to last only a few months or, at most, a couple of years; a structure that perpetuates enforcement priorities would reflect a major shift in SEC practice.

Finally, new leadership is emerging throughout the Division of Enforcement. Their styles and priorities will shape the division's work and defense counsel's advocacy in ways that are still emerging.

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