Implications of Recent Developments in SEC Enforcement

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The authors review some recent SEC developments of note and discuss their significance.

Events from almost the earliest days of the Obama administration, including a new Securities and Exchange Commission ("SEC") chair, signaled more aggressive SEC enforcement activity. These changes included dropping a practice requiring full Commission approval before Commission staff began negotiating civil monetary penalties with public companies; dropping the requirement for full Commission review of formal orders of investigation; and proposed legislation to expand SEC resources.

In the months since the new SEC chair was sworn in, a number of notable developments have occurred. The SEC has demonstrated heightened aggressiveness, both in particular enforcement actions (including the announcement of three settlements during the first week of August 2009, each involving penalty payments over US$10 million) and public announcements, including a speech by the Director of the Enforcement Division to the New York City Bar Association on August 5, 2009. This article discusses further significant developments.

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FORMAL ORDERS AND SUBPOENAS PUSHING DOWN AUTHORITY

The formal order of investigation gives the Commission staff authority to subpoena documents and witnesses. Without a formal order, the Enforcement Division staff is limited to making voluntary requests (other than requests directed to regulated entities[1]) — though, as a recipient, you refuse a voluntary request at your peril. Historically, formal orders were issued only by the full Commission, who would consider approval of such orders upon staff request at a meeting. Early in her tenure, on February 6, 2009, Chairman Shapiro announced a change: henceforth, formal orders would be approved either by *seriatum* vote of Commissioners, without a meeting, or even by a single Commissioner acting as the "duty officer."

In his speech to the New York City Bar, Enforcement Director Robert Khuzami announced that authority to issue formal orders will now be delegated to the Division Director, and Director Khuzami has indicated that he plans to further delegate his authority to "senior officers throughout" the Enforcement Division.

In practical terms, Khuzami said, staff attorneys will now be able issue subpoenas with "approval from their senior supervisor." Any informal request, therefore, will be backed by a threat of immediate subpoena. Khuzami was clear on the impact he believed this would have: "If defense counsel resists 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."

TOLLING AGREEMENTS: PUSHING UP AUTHORITY

While formal orders and subpoenas will be easier to obtain, tolling agreements will be harder. In his speech, Khuzami stated that his approval will be required for any tolling agreement, and he intends to make them the "exception, not the rule." In the past, tolling agreements were often sought during settlement negotiations or early in complex cases involving dated conduct, and required approval at the Assistant Director level or above. With the change in approval policy, their frequency will be dimin-

ished and the staff will be moving to conclude investigations with greater speed.

"REDEPLOYING" BRANCH CHIEFS

Historically, the Enforcement Division's organization below the Director has consisted of Deputy and Associate Directors, Assistant Directors, and "below them" Branch Chiefs. Each Branch Chief traditionally was a more experienced attorney who served as the direct line supervisor for five to eight enforcement attorneys. Early press reports stated that the Branch Chief position was being abolished. Director Khuzami's speech referred to "redeploying" the Branch Chiefs so that their "excellence and talents" could be "focused full- time on investigations." While it is too early to say exactly what this will mean in practice, putting former Branch Chiefs in the position as line attorneys on investigations may mean that counsel for clients that are subjects of investigation or informal inquiry may find themselves dealing in the first instance with more experienced staff than was the case previously.

SPECIALIZED UNITS

Director Khuzami announced that five specialized units within the Enforcement Division are being created:

1. An "Asset Management" unit to focus on investment advisors, investment companies' hedge funds, and private equity funds;
2. A "Market Abuse" unit to focus on conduct of institutional traders and market professionals;
3. A "Structured and New Products" unit to focus on derivatives and other complex financial products;
4. A "Foreign Corrupt Practices Act (FCPA)" unit to signal increased enforcement of FCPA anti-bribery provisions; and
5. A "Municipal Securities and Public Pensions" unit to focus on both the disclosure issues as well as so-called "pay-to-play" practices.

Khuzami also announced additions to the existing "Trial Unit" staff to signal the Division's resolve to take cases to trial.

INCENTIVES FOR INDIVIDUAL'S COOPERATION — OR ELSE!

In 2001, in connection with a settlement sanctioning the former controller of a subsidiary of Seaboard Corp., the Commission issued a report indicating that, under the circumstances, no action would be taken against Seaboard itself.[2] The report praised Seaboard's actions, which included prompt investigation, involvement of the Board and the Audit Committee, firing culpable employees, and, importantly, notifying the Commission and giving "complete cooperation to our staff." The Seaboard release went on to indentify, in 13 separate paragraphs, a non-exclusive list of factors that might influence a decision not to sanction a public company. The Seaboard Report only addressed corporate conduct, and did not address circumstances under which an individual subject to an SEC investigation might be credited for their cooperation.

In his speech, Director Khuzami said the Enforcement Division is now working on a Seaboard type policy statement for individuals which will set forth standards to evaluate cooperation by individuals in enforcement actions. No further details were offered.

Director Khuzami also referred to three other initiatives he described as "fostering cooperation" by individuals: expediting immunity requests to the US Department of Justice; developing the concept of "deferred prosecution agreements"; and the possibility of giving witnesses "oral assurance early on in the case" that there is no intention to file charges.

It is too soon to know what these changes will mean. While current Division practice provides procedures for the enforcement staff to seek immunity requests from the Department of Justice and to provide witnesses with assurance letters[3] in practice, both of these procedures require specific Commission approval and require the staff to follow extensive procedures. The thrust of Director Khuzami's remarks suggests that there is much more "stick" than "carrot" in this approach to fostering cooperation. The references to immunity requests, possible "deferred prosecution agreements," and even "oral assurances" sound like they are designed to

give SEC's Enforcement staff tools and resources more comparable to federal prosecutors.[4]

ENFORCEMENT ACTIONS TARGETING INDIVIDUALS

In addition to several recent, highly publicized settlements involving payments of eight-figure penalties, one recent enforcement action embodies the new, more aggressive approach of SEC Staff. On July 22, 2009 SEC sued Maynard Jenkins, former CEO of CSK Auto Corporation, seeking to claw back bonuses Jenkins received for three years when CSK was falsely inflating its earnings. CSK restated its financial results for the periods involved, and SEC charged CSK and other insiders with securities fraud. But in seeking to claw back bonuses from Jenkins, SEC is not alleging that Jenkins himself engaged in any wrongful conduct and SEC's release announcing the complaint indicates that SEC does not intend to make any such allegation.

The suit against Mr. Jenkins thus becomes a test case for a strict liability interpretation of Section 304 of the Sarbanes Oxley Act of 2002. The title of the section is "Forfeiture of Certain Bonuses and profits." The label "forfeiture" usually denotes punishment imposed on someone who engaged in wrongdoing. However, whether Section 304 requires a showing of wrongful conduct by the original bonus recipient — or instead, merely misconduct by someone else at the issues — has been a much-debated topic in the wake of Sarbanes-Oxley's enactment.

NOTES

[1] The staff can require production from regulated entities, such as broker-dealers and investment advisers.

[2] Release No. 34-44969 (Oct. 23, 2001).

[3] *See* Division of Enforcement manual §§ 3.3.5.3.2 & 3.3.5.3.1.

[4] The possibility of giving witnesses "oral assurances" is intriguing, but it is unclear how this practice will comport with the staff's procedures for providing witness assurance letters, or with general staff practice that it does not have "targets" and, accordingly, is not required to provide "any type of target notification when it issues subpoenas." Enforcement Manual § 3.3.2