
SEC Director of Enforcement Outlines Significant Changes Signaling Tougher, More Efficient Enforcement Environment

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Last week, in his first speech as Director of Enforcement at the SEC, Robert Khuzami outlined several new initiatives designed to make the Division of Enforcement tougher and more efficient. Khuzami detailed significant structural and policy changes meant to enable line investigators to initiate and conduct inquiries more quickly and to provide the Division with more resources to target potential misconduct.¹

The changes announced by Khuzami are further evidence of Chairman Mary Schapiro's pledge to support the Enforcement Division² and expand on the changes that have been implemented since January. Some of these changes include termination of a two-year pilot program that required Commission pre-approval for the Enforcement Division Staff to negotiate corporate penalty settlements and plans to eliminate the branch chief position (the Division's first-line supervisors) so that more lawyers can focus on carrying out investigations.³ Khuzami characterized the changes as the fruit of "a top-to-bottom scrub of our structure and operations" and explained that they follow on the heels of guidance he provided to the Enforcement Staff on his first day in office—to be as (i) *Strategic*, (ii) *Swift*, (iii) *Smart*, and (iv) *Successful* as possible. These changes might also be viewed as an effort by Khuzami, a former federal prosecutor, to bring the Enforcement Division closer to the model of a U.S. Attorney's Office in terms of processes, procedures, and the degree of autonomy and discretion afforded to line attorneys.

The initiatives announced by Khuzami are some of the most sweeping changes to the Enforcement Division in recent years. They indicate a willingness to try new approaches, but exactly how they will affect subjects of SEC investigations remains to be seen. At a minimum, it seems quite clear that the Enforcement Division will be making every effort at each stage of an investigation to move more quickly, and it will have more immediate tools available to obtain compliance with requests for documents, information, and testimony.

Some of the most noteworthy developments are discussed below:

Issuance of Formal Orders

One of the most significant changes is that the Commission has delegated to the Enforcement Staff the power to issue formal orders of investigation, which grant the Enforcement Staff the power to subpoena documents and testimony. Before the delegation, only the Commission had that power. Now, the Director and, through a sub-delegation from him, "senior officers throughout the division,"⁴ will have authority to issue formal orders and invoke the subpoena power of the government, enabling the Staff to more quickly escalate informal inquiries to formal investigations.

The delegation of formal order authority is a major departure from decades of agency practice and eliminates one of the few formal occasions for the Commission's early involvement in the use of the Division's resources. Notwithstanding that almost all requests for formal orders by the Enforcement Staff are approved by the Commissioners, the need for Commission approval had always operated as a discipline on the use of the subpoena power and provided the Commission with valuable, timely information about the Staff's use of its investigative powers and resource allocation. At the stage of authorizing formal investigations, Commissioners have traditionally raised both legal and policy questions when proposed inquiries were perceived to venture too far afield from Commission priorities or to allocate scarce resources in less than efficient or optimal ways. Those salutary checks by the presidential appointees will now be absent at the time when they are most relevant, although the Division may intend to make the Commission aware of new or significant investigations through a reporting process after the Division has decided to commence the formal investigation. This procedural change, coupled with Khuzami's reference to "dilatory tactics" resulting in a "subpoena on your desk the next morning," makes clear that Khuzami expects speed and perceived toughness to be of paramount importance to the Enforcement program.

Streamlined Case Management Processes

In addition to "flattening" the management structure in the Division by eliminating the branch chief position, Khuzami announced that the decision-making process will also be streamlined by delegating authority to approve "routine case decisions" from the Deputy Director to Associate Directors and Regional Directors. Khuzami emphasized that these senior officers are "on the scene and closest to the facts," and therefore should have autonomy to make routine case decisions. While this change likely will result in a more efficient Enforcement machine, it remains to be seen what impact this new policy will have on the consistency of the decision-making process, given the risk that important issues arising during investigations and charging decisions could be treated differently by each of the regional offices and the Washington office. It also remains to be seen what steps the Division (and ultimately the Commission) will take to ensure consistency.

Equally important to those who are subject to the investigative process is the ability to seek review of decisions made during the course of the investigation. In some instances, being "closest to the facts" may result in judgment calls on issues that might be better decided through an established "up-the-ladder" vetting process by Enforcement Division personnel who may have different perspectives and are less involved in the day-to-day details of the case. In addition, preserving review of important issues by more senior Division officials helps maintain consistent policies and

treatment throughout the Division.

At the end of the day, pushing down the decision-making process to experienced senior officials should lead to less red tape and quicker decisions that are informed by the developments in the particular investigation. Hopefully, this change will not come at the expense of limiting the ability of a person being investigated to seek a review of decisions and/or input from other offices or divisions within the agency having relevant expertise.

Fewer Tolling Agreements

Khuzami also announced that the practice of granting tolling agreements—that is, agreements to extend the running of the statute of limitations—will be the exception rather than the rule going forward and that approval of the Division Director will be required for all such agreements. Khuzami opined that tolling agreements (which, far more frequently are a result of requests from the Staff rather than defense counsel) have "become far too common" and emphasized the significant cost and delay they engender. While this change will not likely meet resistance from the defense bar, it sends a strong message to the Enforcement Staff—investigate now and investigate quickly. Under Khuzami, investigations are expected to be "nimble and quick." This directive could prompt more urgent and aggressive requests from the Enforcement Staff, although the result also might be narrower and more targeted requests for documents and information. There is also a risk that issuing fewer tolling agreements also could lead to cases being filed prematurely—and without the benefit of sufficient fact-finding and deliberation—to avoid statute of limitations concerns. On a related note, it is also worth mentioning that Khuzami said the Division plans to add to the ranks of the trial units (which are located in each of the regional offices as well as in the home office) to send a message to potential defendants that the Division is prepared to go to trial in every case.

Cooperation

Khuzami stressed the importance cooperation by individuals plays in the Enforcement Staff's work, especially given the limited resources of the Commission when compared to the tens of thousands of issuers, broker-dealers, and other entities that fall within the Commission's jurisdiction. To promote cooperation, Khuzami announced four new initiatives being pursued by the Division:

- Creation of a policy setting forth the standards for evaluating cooperation by individuals, akin to the "Seaboard report," which applies to corporations.⁵
- Delegation of authority to the Division Director to submit immunity requests to the Department of Justice.
- Provision of oral assurances to witnesses—in appropriate cases—that the Enforcement Staff does not intend to file charges against them.
- Use of Deferred Prosecution Agreements with individuals or entities, in which the Commission would agree to forego enforcement actions subject to certain terms, including full cooperation, a waiver of statutes of limitations, and compliance with certain undertakings.

The Enforcement Staff's new focus on cooperation by individuals is perhaps the most significant development. The Commission historically has not provided the same incentives for individuals to cooperate as it has to corporations. The new initiatives outlined by Khuzami presage a move toward the DOJ/USAO model, in which individuals can receive significant benefits for cooperating in a government investigation. Until now, culpable individuals might have been fearful that exposing potential violations could lead to career-ending charges against them. With the prospect of assurances from the SEC Staff that charges will not be pursued, however, such individuals may be more inclined to report misconduct.

Moving the SEC enforcement process more toward a criminal model might well produce benefits of increased compliance and deterrence. At the same time, however, the potential effects on individuals and companies involved in an investigation must not be overlooked. To the extent the SEC's civil enforcement program takes on characteristics historically associated with criminal investigations, providing corresponding procedural and other safeguards afforded those subject to a criminal matter should be considered.

Although proposing these new initiatives to induce cooperation, Khuzami said he intends to reward only "extraordinary cooperation" and expects investigation subjects to be responsive. Hinting that the bar for garnering credit for cooperation has been raised, Khuzami noted, "I don't believe in being lenient for the sake of leniency, or for rewarding persons for simply complying with routine or expected requests." In light of this comment, the defense bar should expect claims of cooperation to be carefully examined by the Enforcement Staff.

Specialized Units

Another structural change in the Enforcement Division is the creation of five specialized units designed to enable the Division to "get smart" on products, markets, regulatory regimes, practices and transactions. Each unit be staffed with employees who have a special expertise in the designated areas, and who will be provided specialized and advance training. Khuzami said that the Division also intends to add resources from the outside who have practical market experience. The first five units to be established are as follows:

- Asset Management Unit – focus on investment advisors, investment companies, hedge funds, and private equity funds.
- Market Abuse Unit – focus on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals and others.
- Structured and New Products Unit – focus on complex derivatives and financial products, including CDS, CDOs and securitized products.
- Foreign Corrupt Practices Act Unit – focus on new and proactive approaches to identifying violations of the FCPA.

Municipal Securities and Public Pensions Unit – focus on municipal securities markets and public pension funds.

The establishment of these specialized units reflects a push by the Enforcement Division to identify potential risk areas and to "attack problems systemically, swiftly and thoroughly and on an industry-wide basis where appropriate." These units will likely lead to more "sweep" investigations of certain industries, markets, or products, but may also result in more efficient investigations given the expertise the front-line investigators are expected to have.⁶

Office of Market Intelligence

The Enforcement Division also plans to create an Office of Market Intelligence. This office will be responsible for processing the tips and referrals received by the Enforcement Division, which, according to Khuzami, number in the hundreds of thousands annually. The office will establish a set of risk analysis criteria meant to identify substantive areas of focus for the Division and to better direct front-line investigators in uncovering potential misconduct.

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In the wake of the criticism of the SEC after the Madoff fraud came to light, change in the agency's overall approach to its law enforcement responsibilities was probably inevitable. Indeed, as markets have expanded and the challenge to the SEC has grown more complex, the agency simply had to adjust its approach if it was to keep up with the magnitude of the issues it faces. These changes may indeed make the agency's law enforcement program more efficient, more nimble, and more effective. And the clear influence of Rob Khuzami's experience as an Assistant United States Attorney is reflected throughout these initiatives, from the quick and easy resort to subpoena power, to the clear impatience with bureaucracy and delay in the process, to the plan to offer civil immunity to individuals for cooperation.

The many sorry scandals, from Enron to Madoff, that have occurred in the past few years are just cause for skepticism about much behavior in the securities markets, but the SEC must not lose sight of important considerations other than efficiency and speed when it re-examines the Enforcement program. The enormous power wielded by this agency and its Staff is difficult to overstate. Merely being subjected to the investigative process can ruin individuals and businesses. Accordingly, the Enforcement Staff and the Commission must always bear in mind that subjects of the investigative process might not have committed violations and deserve fair opportunities to present their views on the facts and the law. The agency must achieve the difficult but critical balance of vigorous enforcement through the use of fair procedures.

The initiatives announced by the new Director portend an aggressive law enforcement climate for the foreseeable future. The challenge for the SEC will be not only to deliver on its "get tough" message, but to do so in a fashion that pays equal attention to fairness, consistency, and the overall costs and consequences from the exercise of its law enforcement powers. It is precisely in times of perceived crisis, and the inevitable law enforcement response that follows, that procedural fairness and discipline can suffer.

¹See Robert Khuzami, Director, SEC Division of Enforcement, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, available [here](#) (Aug. 5, 2009).

²See Mary Schapiro, Chairman, SEC, Testimony Before the U.S. Senate Banking, Housing, and Urban Affairs Committee (Jan. 15, 2009).

³See Robert Khuzami, Director, SEC Division of Enforcement, Testimony Before the U.S. Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment, available [here](#) (May 7, 2009); Mary Schapiro, Chairman, SEC, Testimony Before the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, available [here](#) (July 14, 2009).

⁴ The term "senior officers" includes the Deputy Director, Associate Directors, Regional Directors, and Associate Regional Directors.

⁵See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship and Cooperation to Agency Enforcement Decisions, SEC Release No. 34-44969, available [here](#) (Oct. 23, 2001) (explaining factors to be taken into consideration by Commission when considering a respondent's cooperation). See *also* Statement of the Securities and Exchange Commission Concerning Financial Penalties, available [here](#) (Jan. 4, 2006) (identifying cooperation as factor to be considered in assessing penalties against corporations).

⁶ Khuzami also noted that the credit crisis remains the highest priority in the Enforcement Division and that, accordingly, the Subprime Working Group established in 2007 will remain intact and work in tandem with these specialized groups.

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