SEC Division of Enforcement Details Restructuring, Priorities; Talks Cooperation, Settlements and Whistleblowers

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On February 4, 2011, Practising Law Institute hosted "The SEC Speaks in 2011," a day-long series of panel discussions featuring key Securities and Exchange Commission ("SEC" or "Commission") personnel and commentators. One such panel focused on the SEC's Division of Enforcement ("Division"), discussing the Division's reorganization and restructuring; its current approach to giving credit for cooperation; aspects of the Dodd-Frank Act expected to influence the Division's efforts going forward, including its whistleblower provisions; the increased judicial scrutiny to which settlement agreements have become subject; a continuing emphasis on investigations related to the credit crisis; and the Division's need for resources to carry out its mission.

Division Restructuring and Procedural Changes

Lorin Reisner, Deputy Director of the Division of Enforcement, discussed the Division's national specialized units, which are staffed by approximately 25% of the Division's enforcement staff and include personnel located across the country. The units, which have been up and running since March 2010, are working very efficiently, according to Reisner, leading dozens of investigations and acting as "think tanks" for others. The units have also spearheaded specialized training.

The asset management unit consists of a staff of 60. The market abuse unit has 50 staffers. The structured and new products unit consists of 45 staffers. The Foreign Corrupt Practices Act ("FCPA") unit is staffed by 30, and 25 staffers form the municipal securities and public pensions unit. Reisner explained that these units have been bolstered by the hiring of individuals with relevant expertise and specialized knowledge, including hedge fund managers and private equity professionals (asset management unit), credit risk analysts and a structured product trader from an investment bank (structured and new products unit), and municipal securities experts from an investment bank, as well as a financial institution trader (municipal securities and public pensions unit).

Separately, Reisner noted that approximately 18 months ago, the Commission delegated formal order and subpoena authority to the Director of Enforcement, who sub-delegated that authority to various senior officers. He noted that important checks on the process remain, despite the delegation, in the form of weekly reports to the Commission on the status of investigations and by the Staff's efforts to seek input on especially sensitive matters. According to Reisner, the change has helped move investigations along more quickly. He noted that over the last two fiscal years, 67%-70% of cases have resulted in a complaint being filed within two years of the opening of the investigation, as compared to 54%-62% in 2007-2008. Reisner noted that a quicker start to investigations has also been a byproduct of the change, and this means that investigations are occurring closer in time to the alleged wrongdoing.

Cooperation Initiatives

Over the last year, the Division has entered into approximately 20 cooperation agreements across a wide range of cases, including those related to financial statements and accounting, insider trading, investment advisers, issuers, market manipulation and the FCPA. As part of the initiative, the SEC is making an effort to act on cooperation requests within 48 hours, Reisner said.

Regarding the non-prosecution agreement entered into in late 2010 with Carter's Inc. (see Client Alert, January 11, 2011), Reisner said the SEC's decision to forego prosecution in that matter was based on the isolated nature of the misconduct, the company's self-reporting and thorough internal investigation—including the fact that the results of the investigation were made available to the Staff—and the extensive remedial action that Carter's undertook. Reisner said the Staff intends to be transparent about the kind of credit that is available for cooperation.

Impact of Dodd-Frank Act Forecast

George Canellos, Regional Director of the SEC's New York office, spoke about the Dodd-Frank Act. Canellos suggested that the most significant provisions of the Act for the Division may not be those related directly to enforcement, instead highlighting provisions dealing with transparency in the swaps market and hedge fund and muni advisers. He noted that there has only been a single insider trading case related to credit default swaps, despite the fact that such instruments can be used to take advantage of insider information. He predicted greater scrutiny of credit default swaps going forward as a result of Dodd-Frank.

Other significant provisions, according to Canellos, concern the *mens rea* standard for aiding and abetting claims (recklessness); the overriding of the

Supreme Court's holding in *Morrison v. National Australia Bank, Ltd.*, 130 S.Ct. 2869 (2010), that Section 10(b) of the Securities Exchange Act cannot reach outside the United States; and the extension of the ability to bar or suspend defendants to all regulated entities, rather than, for example, only broker-dealers in the case of a defendant broker-dealer employee.

Canellos also noted that he considered Dodd-Frank provisions permitting the SEC to share privileged information with other law enforcement agencies (and vice versa) as significant, pointing out that in the past, the sharing of FBI reports has been controversial. Now, he said, the SEC believes it can provide the comfort other law enforcement agencies need to encourage them to share information with the SEC.

Canellos also touted the fact that Dodd-Frank permits control persons to be held vicariously liable for the acts of persons they control, insofar as the provision means that control persons can be subject to the same disgorgement and other penalties as the controlled person.

Canellos also spoke about the changes to the scope of administrative proceedings brought by Dodd-Frank. For example, he noted that such proceedings previously were limited to individuals associated with regulated entities, but that restriction has been removed by Dodd-Frank. In general, the changes to administrative proceedings will give the SEC greater choice of venue, which Canellos suggested will have an impact on settlement discussions.

Later in the discussion, Matthew Martens, chief litigation counsel, noted that he expects that the Dodd-Frank provision permitting nationwide service of process will be of significant assistance to the Division's trial group going forward.

Tom Sporkin, Chief of the Office of Market Intelligence ("OMI"), spoke about OMI generally and the coming whistleblower regulations under Dodd-Frank (see Client Alert dated November 17, 2010, updated December 7, 2010). Sporkin described an "onslaught" of high-value tips since Dodd-Frank's enactment, saying that the Staff was receiving one to two such tips each day. Many of the tips are coming from whistleblowers represented by attorneys and the tips are well-organized and often arrive with supporting attachments. Sporkin said that tips are coming from a variety of sources, including insiders, competitors, and even "jilted spouses."

OMI is handling intake and referral and building a whistleblower office to prioritize and track whistleblower claims and administer the whistleblower claims process. Sporkin said the SEC will form a committee to decide whether investigations were the result of whistleblowers' tips and, if so, who is eligible for a bounty, and to recommend awards (which will be shared among tipsters if there are multiple whistleblowers in a given case).

Sporkin said that the whistleblower regulations will be presented to the Commission for approval in the next few months. He described the various arguments around the most hotly contested issue—whether to require whistleblowers to report to internal company compliance staff first—but did not indicate what approach the rules will take. He did appear to signal that the 90-day grace period for reporting to the SEC that applies to those who report in-house will be extended, given that both whistleblower and corporate advocates agreed the period should be longer.

Increased Scrutiny of Settlements

Martens, Chief Litigation Counsel, spoke about the activities of the

Division's trial group. He began by hailing the group's success rate in 2010, saying that 92% of cases were resolved successfully, with the SEC prevailing against 76% of defendants in judicial proceedings and against a higher percentage in administrative proceedings.

Martens also discussed the increased judicial scrutiny that settlements received during 2010, but downplayed the extent of that scrutiny, saying it occurred in only four to five of the 700 cases handled and noting that all of the settlements ultimately were approved. He said that the increased scrutiny has not changed the SEC's approach to settlements, but parties need to understand that courts may ask for more information and defendants may have to appear at hearings to answer questions from the court—a development that has to be handled carefully in settlements where defendants are neither admitting nor denying liability. Martens acknowledged that the SEC anticipates that settlements of high-profile cases will be subject to increased scrutiny.

Reisner added that defense counsel should be cautious about asking for the inclusion of less detail in complaints because doing so makes it more difficult for courts to evaluate settlements. He pointed out that the Staff has begun to attempt to anticipate judicial questions about settlements and has sometimes filed letter briefs with courts to explain the factors that were considered by the SEC in the settlement process.

Developments in Section 304 Clawback Cases

Rhea Dignam, regional director of the SEC's Atlanta office, spoke about clawback proceedings, primarily under Section 304 of Sarbanes-Oxley but also discussed the related language in Dodd-Frank. She focused on two stand-alone Section 304 actions, the first of which, against CSK CEO

Maynard Jenkins in Arizona, led to a finding that the clawback penalty can be imposed based on the misconduct of an issuer and does not require misconduct on the part of the person from whom the clawback is sought. A partial summary judgment motion is pending in the case. The other stand-alone clawback case, against Diebold CEO Walden O'Dell, was settled.

Dignam noted that in the shareholder derivative case concerning DHB Industries, Inc., *Cohen v. Viray*, 622 F.3d 188 (2d Cir. 2010), the Second Circuit held that companies may not indemnify executives for clawback payments.

Dignam also noted that Section 954 of Dodd-Frank requires exchanges to delist any company that does not have a compliant clawback policy and allows the reach of such a clawback to extend to three years before a restatement, longer than the one-year period under SOX Section 304.

Credit Crisis Cases Still a Priority

Division Director Rob Khuzami closed the panel discussion by defending the Division's performance with respect to cases related to the credit crisis, noting that it has brought cases related to mortgage originators, mutual funds with mortgage-based portfolios, structured products and disclosure. He said that those cases have resulted in more than $1.1 billion in disgorgement and charges against 19-20 senior officers. Credit crisis cases continue to be a priority, he said.

As a general matter, Khuzami said that in 2010, the SEC's numbers for cases, penalties and disgorgement, trader suspensions, and closed cases all rose as compared to 2009. He also reported that the Staff was making greater use of risk analytics, looking for "odd" or "curious" results or performance, and paying close attention to things like auditor turnover and hard-to-value asset levels.

Earlier in the session, in response to a question from former SEC Commissioner Harvey Goldschmid, Khuzami spoke about the challenge of limited resources at the SEC. Khuzami lamented that the SEC's budget pales in comparison to bank regulators, for example. However, he pledged to make the SEC "lean" and to focus on the "right places." He argued that the amount of additional resources sought by the SEC for technology, for example, was "marginal," but would yield tenfold returns.

Conclusion

This recent panel discussion serves to highlight the areas of focus for the Division of Enforcement, an always-important insight for regulated entities. It is plain from the discussion that the Division expects to utilize its new structure, new technology, and the new tools provided by Dodd-Frank to enhance its enforcement activities. At the same time, it is equally clear that the Division is serious about acknowledging cooperation and in justifying its settlements to the bench and the public. All of these developments will be important to bear in mind as regulated entities interact with the Division going forward.

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