

KIRKLAND ALERT

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The SEC's Division of Enforcement: The Promise and Uncertainty of Sweeping Reform

The U.S. Securities and Exchange Commission's Division of Enforcement is currently undergoing what has been called the "biggest reorganization in at least three decades." Promising a Division that is strategic, swift, smart, and successful, Director Robert Khuzami has articulated a bold new agenda and implemented sweeping structural changes.

These changes go well beyond the cosmetic. In addition to removing an entire layer of management, the Division has created five new specialized investigative units focused on high priority areas of enforcement, the heads of which were just announced on January 13, 2010. And this new structure also has been empowered with changes to its policies and procedures that are intended to stream-line the Division's investigative and prosecutorial process, all with an eye toward a swifter and nimbler enforcement program.¹ In line with this vision, there were signs of an increase in Commission enforcement activity in 2009, including a dramatic uptick in the number of Formal Orders of Investigation issued, and several high-profile matters signaling the Commission's new-found willingness to aggressively test the limits of its enforcement authority. Indeed, now that the Commission and the Division have so publicly staked out their bold new vision, the pressure is on to produce prompt and tangible results. The Division's restructuring and other recent initiatives are discussed in detail below.

With the reorganization under way and new initiatives becoming operational, one would expect a significant increase in enforcement activity, especially in the high priority areas identified by Director Khuzami. However, the structural and procedural changes envisioned by the Division Director also come at the cost of distracting the Division staff from its core mission as these changes are implemented. More importantly, this period of transition will create a less-predictable and less-certain landscape for entities and individuals subject to the Division's scrutiny, and will make the choice of informed and sophisticated securities enforcement counsel even more critical. In this period of uncertainty — as the Division's visionary initiatives are implemented — the stakes for potential defendants, witnesses and others snared in the Commission's investigative web have never been higher. In the discussion below, we will identify some of the points of tension arising from sweeping reform and the uncertainty it creates.

I. Restructuring of the Division of Enforcement

The so-called biggest reorganization in at least three decades involves flattening of the Division to get "more cops on the beat," empowering line attorneys with greater authority, streamlining internal procedures, and moving towards greater specialization and training. The key characteristics of these reforms are as follows:

Specialization

The Division has created five new national specialized investigative units dedicated to "high priority" areas of enforcement. The five specialized units are:

- *Asset Management*: largest of the new units; will focus on Investment Advisers, Investment Companies, hedge funds and private equity funds.

- *Market Abuse*: will focus on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals and others and will make use of new technological tools to analyze trading data across debt, equity and derivatives.
- *Structured and New Products*: will focus on complex derivatives and financial products, including credit default swaps, collateralized debt obligations and other securitized products.
- *Foreign Corrupt Practices Act*: will focus on FCPA enforcement and will work to develop new approaches to identifying FCPA violations and increase cooperation with foreign counterparts.
- *Municipal Securities and Public Pension*: will focus on offering and disclosure issues, tax- or arbitrage-driven activity, under-funded liabilities, and “pay-to-play” issues in the municipal securities and public pension arena.

Each Specialization Unit will be headed by a Unit Chief, and will be staffed across the nation by people in the Division who already have expertise in these topics, or have a desire to learn. They will receive specialized and advanced training. The Division will also hire into these units individuals with practical market experience and other expertise, whether from private industry, other SEC Divisions, or elsewhere. The units will be “proactive” in deciding on an informed basis where to best allocate the Division’s investigative resources, which will enable the Division “to attack problems systematically, swiftly and thoroughly and on an industry-wide basis where appropriate.”

On January 13, 2010, the Division announced the Chiefs of the five new units, each of whom are seasoned and aggressive prosecutors who share the Division Director’s vision for an invigorated enforcement program:

- Bruce Karpati and Robert B. Kaplan will jointly run the Asset Management Unit, the biggest of the units charged with imposing greater investigative scrutiny to a resistive hedge fund and private equity community. Mr. Karpati, who has served as Assistant Regional Director of the New York office, was the founder and head of the Hedge Fund Working Group. The group was formed in 2007 and has brought several actions against hedge funds and their advisers, including the first insider trading case concerning credit default swaps, which was filed in May 2009. Mr. Kaplan, as Assistant Director of the Division of Enforcement, has a long history of complex enforcement cases, and led the Division’s investigation of the so-called “Octopussy” insider trading case.
- Daniel M. Hawke will oversee the Market Abuse Unit. Mr. Hawke is the Regional Director of the Philadelphia office, and was instrumental in the Division’s then-groundbreaking fraud case against Arthur Andersen and its senior management. More recently, Mr. Hawke has been involved with the development of innovative investigative techniques that the SEC is using to identify patterns of unlawful trading and suspicious relationships. The Deputy Chief of the Market Abuse Unit will be Sanjay Wadhwa, who has served as Assistant Regional Director of the New York office and has been involved in the Galleon insider trading case.
- Kenneth R. Lench has been named Chief of the Structured and New Products Unit. Mr. Lench recently has served as Assistant Director of the Division of Enforcement, and will be charged with paving the way for the Commission’s stated goal of aggressively regulating a broader swath of securities products. Reid A. Muoio, who also recently served as Assistant Director of the Division of Enforcement, will step in as Deputy Chief of this Unit.
- Cheryl J. Scarboro will head up the FCPA Unit. Ms. Scarboro, most recently as Associate Director of the Division of Enforcement, has been involved in numerous high profile investigations of corruption including, for example, those concerning the United Nations Oil for Food Program. Working closely with the U.S. Department of Justice, the Division’s FCPA program has seen dynamic change over the last several years, and it is anticipated that Ms. Scarboro and the unit staff will continue to expand this program in an innovative and creative fashion.
- Elaine C. Greenberg is the Chief of the Municipal Securities and Public Pensions Unit. Ms. Green-

berg is the Associate Regional Director of the Philadelphia office, and in over 20 years at the Commission has investigated and supervised enforcement actions involving municipal securities, insider trading, accounting fraud, and securities industry conflicts of interest. Most recently, Ms. Greenberg has served as Co-Chair of the Division's national Municipal Securities Working Group. Marc R. Zehner, who also served as Co-Chair of the Division national Municipal Securities Working Group, has been named as Deputy Chief of the Unit.

The creation of these specialized units will undoubtedly lead to heightened Commission scrutiny of market participants within the various groups. Having so publically staked out these five areas as key areas for reform, the Division will likely look to issue more subpoenas and bring cases within these new groups. Indeed, the expectations will be high for the new units to show results, and quickly.

Several questions remain however as to exactly how this important structural change will be implemented. It remains to be seen how these units will be staffed, and what impact, if any, the creation of the national units will have on the Commission's Associate Director and Regional Office structure. The Division must decide how individual case investigative and charging decisions will be made upon integration of the specialized units, and the potential for substantive overlap between and among these units is significant.

These are important details that will affect the interests of individual and entities, and in the absence of clear direction will subject defendants, witnesses and others to the vagaries of a still-evolving system responding to over-heated public demand for aggressive enforcement. It is also important to keep in mind that the concept of specialized units within the Division has been considered — and consistently rejected — for many years, and it is critical that the Division draw from the lessons learned from its earlier efforts at specialization, such as the Financial Fraud (Accounting) Task Force.

Management Restructuring and Streamlining of Internal Processes

The Division is eliminating the entire layer of first-

line supervisory oversight — the Branch Chiefs — and has announced its intention to reallocate this personnel to the “mission-critical work of conducting front-line investigations.” In conjunction with this change, the next-most senior management level — the Assistant Directors — will take on a role similar to that of the traditional Branch Chiefs. The number of Assistant Directors will be roughly doubled, and rather than manage a group of fifteen to twenty lawyers, it is anticipated that the Assistant Directors will manage units of six to eight lawyers. The Division has not yet announced the final details of this reorganization, including how this change will intersect with the creation of the specialized units discussed above and the traditional Associate Director and Regional Office model. It is clear, however, as the primary and initial management layer overseeing the investigative staff, the Assistant Directors will continue to have considerable decision-making authority, and working effectively within this new structure will be important to preserving the interests of clients.

Senior Division officers are permitted to authorize the issuance of Formal Orders of Investigation, without having to secure advance formal authorization from the Commission. (The Commission delegated this authority to the Division Director, who then in turn further delegated this authority to the Associate Directors, Regional Office heads, and presumably to the heads of the specialized units.) The immediate impact of this change is that Division staff — as opposed to the Commission itself — now has direct control over whether its lawyers have the authority to issue subpoenas requiring the production of documents and testimony. As a result, the Division has already seen a dramatic uptick in the number of Formal Orders, and therefore has put in the hands of its staff greater investigative power.

In order to expedite the investigative process, senior officers located throughout the country will have more autonomy to approve routine case decisions rather than being required to seek approval from the Deputy Director. Internal memoranda to the Commission recommending specific enforcement actions “will be shorter and will be subject to fewer reviews and require quicker turn-around times.” Tolling agreements will require approval by the Director, who “will grant tolling agreements as an exception, not the rule.”

All of this means that going forward there will be more front-line investigators with greater authority to push for swifter results. As we have noted, greater authority in the hands of the investigative staff in the midst of sweeping structural and procedural change is a volatile mixture that is best handled by experienced and well-respected defense counsel.

Cooperation Tools

The Commission will begin using cooperation tools similar to those used by criminal law enforcement authorities to secure the cooperation of persons who are on the “inside” or otherwise aware of organizations engaged in fraudulent activity in order to “build stronger cases and to file them sooner.” These tools include:

- *Cooperation Agreements*: formal written agreements in which the Division agrees to recommend to the Commission that a cooperator receive credit for cooperating in investigations or related enforcement actions if the cooperator provides substantial assistance such as full and truthful information and testimony.
- *Deferred Prosecution Agreements*: formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution.
- *Non-Prosecution Agreements*: formal written agreements, entered into under limited and appropriate circumstances, in which the Commission agrees not to pursue an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and comply with express undertakings.²

The Commission has streamlined the process for submitting witness immunity requests to the Justice Department for witnesses who have the capacity to assist in its investigations and related enforcement actions.

In addition, the Commission has issued a new policy statement regarding the factors it will take into con-

sideration when evaluating whether, how much and in what manner to credit cooperation on the part of individuals. Four general considerations identified by the Commission are: (1) the assistance provided by the cooperating individual; (2) the importance of the underlying matter in which the individual cooperated; (3) the societal interest in ensuring the individual is held accountable for his or her misconduct; and (4) the appropriateness of cooperation credit based upon the risk profile of the cooperating individual.

The Division’s policy encouraging cooperation may breed a greater expectation of cooperation on the part of individuals and companies, and seeks to motivate individuals to cooperate as early as possible. Also, according to Director Khuzami, “this new program could pose heightened ethical concerns for counsel representing more than one person who could potentially benefit from cooperating in a Commission investigation. It is something that counsel and their clients should carefully consider.” This is a critically important point to anyone involved in the Commission’s investigative process, and as a result, the Division may need to rethink its traditional reluctance to designate anyone as anything other than a “witness” in its investigations. The Division may need to adopt the target / subject / witness categories used by criminal prosecutors in order for participants in the Commission’s investigative process to fully and accurately assess whether attempting to avail themselves of these new cooperation tools is in their interest.

Other Reforms

Additional policy and structural changes recently adopted by the Division include:

- Release of a revised Enforcement Manual, which includes the cooperation tools and policy statement referred to above;
- Creation of a formal training unit;
- Hiring a Managing Executive to focus on the Division’s operations;
- Hiring experienced former federal prosecutors to serve as Deputy Director of the Division of Enforcement and Director of the New York Regional Office; and

- Establishment of an Office of Market Intelligence, which will serve as a central office for the handling of complaints, tips and referrals that come to the attention of the Division, coordinate the Division's risk assessment activities, and support the Division's strategic planning activities. On January 13, 2010, the SEC announced that Thomas A. Sporkin, who was previously the Deputy Chief in the Office of Internet Enforcement, will lead the new Office of Market Intelligence.

II. Reallocation of Resources upon Receipt of Additional Funding

In addition to changes brought about by structural reform, the Division's budget will benefit from increased funding in 2010. On May 20, 2009, the President signed the Fraud Enforcement and Recovery Act of 2009, which "authorized to be appropriated to the Securities and Exchange Commission, \$20,000,000 for each of the fiscal years 2010 and 2011 for investigations and enforcement proceedings involving financial institutions." This additional funding should allow the Division of Enforcement to bolster its staff significantly as it gears up for 2010. Director Khuzami proposed allocating additional resources in order to, among other things, grow the Division's unit of trial lawyers as well as to increase administrative and support staff, with the goal of freeing up the Division's lawyers' and accountants' time for "high-value investigative tasks."

III. Strengthened Interagency Cooperation

Furthermore, the SEC's coordination of efforts with other agencies is likely to be enhanced as a result of the creation of the Financial Fraud Enforcement Task Force by Executive Order dated November 17, 2009. The Task Force will be led by the Department of Justice, while the Securities and Exchange Commission, the Department of the Treasury and the Department of Housing and Urban Development will serve on its steering committee. The Task Force includes a "Securities Working Group," which will promote cooperation and exchange of information between the Division of Enforcement's 12 offices nationwide, the United States Attorney's Offices, the FBI, the CFTC and the U.S. Postal Inspection Service. As we have seen with respect to the role of the FBI in the Galleon insider trading case, interagency cooperation already has played a key role in enforcement efforts. We expect the trend of increased interagency cooperation to continue.

Conclusion

As the Commission continues to implement the above-referenced initiatives, and adjusts to the structural reforms that began to take hold in 2009, we are likely to encounter in 2010 a more resourceful Division of Enforcement that acts more quickly and more often. Market actors should be prepared for increased scrutiny in this new regulatory environment, and should acquit themselves accordingly with seasoned counsel equipped to preserve and protect their interests.

¹ Since taking charge in April 2009, Director Khuzami has articulated his agenda in speeches, congressional testimony, and press conferences. See, e.g., Press Release No. 2010-5, *SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence* (Jan. 13, 2010); Testimony of Robert Khuzami, Director, Division of Enforcement, before the United States Senate Committee on the Judiciary (Dec. 9, 2009); Testimony of Robert Khuzami, Director, Division of Enforcement, before the United States Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment (May 7, 2009).

² Press Release No. 2010-6, *SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations* (Jan. 13, 2010).

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