

OUTLOOK 2010: SEC ENFORCEMENT

The Securities and Exchange Commission's Enforcement Division began 2010 on a good note, announcing the start up of the national specialized units and cooperation initiatives for individuals and companies. However, the jury is still out on whether the division has recovered from its Madoff missteps, and this year could prove an important test of the division's new and improved capabilities.

2010 Important for SEC Enforcers as Division Continues to Rebuild Reputation

This year will be an important one for the Securities and Exchange Commission's Enforcement Division, as it continues to put in place changes announced to prevent the systemic shortcomings brought to light by its embarrassing failure to uncover the \$50 billion Ponzi scheme run by Bernard Madoff.

The kinds of cases the division pursues in 2010, as well as how it fares in several ongoing high-profile proceedings--some of which involve aggressive positions taken by the SEC in 2009--could go a long way towards restoring the agency's reputation, attorneys said. In addition, two cases pending before the U.S. Supreme Court could have important ramifications for the SEC's enforcement reach.

Reorganization.

The division, in a *mea culpa* for overlooking Wall Street financier Madoff's decades-long fraud, is undergoing its biggest reorganization in more than 30 years. The changes announced by SEC Chairman Mary Schapiro and Enforcement Director Robert Khuzami include:

- a flatter bureaucratic structure;
- streamlining the process by which the commission approves formal orders of investigation;
- the creation of national specialized units to target specific market segments;
- the setting up of an Office of Market Intelligence to collect and analyze the hundreds of thousands of tips, complaints, and referrals that the division receives each year; and
- offering incentives to encourage individuals and corporations to help in SEC investigations and enforcement actions.

On the last point, New York lawyer Mark Schonfeld, formerly head of the SEC's New York regional office and currently a member of Gibson Dunn & Crutcher LLP, commented that historically, the agency "has not been good at giving people sufficient incentives to cooperate." The publication of policies alone is not enough, Schonfeld emphasized: "The real question is going to be how the SEC does in actual cases over an extended period of time" in showing people "that they really do benefit from cooperating."

What specific incentives does Schonfeld have in mind? "The big area of concern is for people who are in ... the securities industry. The SEC has typically demanded career-ending sanctions against people in the industry, even when they cooperate. Yet these are the people they want to come forward with information. The question is whether the SEC will be willing to give such people sufficient incentives to cooperate, which might require giving them a free pass."

In a Jan. 13 announcement on the reorganization, the division identified the new chiefs of the national specialized units, and unveiled new cooperation agreements and initiatives for individuals and companies (42 SRLR 79, 1/18/10).

Half the Story.

Meanwhile, structural and organizational changes that were set in motion in 2009 already have resulted in an increase

in enforcement activity, according to fiscal year 2009 statistics cited by SEC officials. In FY 2009, the SEC sought 71 emergency temporary restraining orders, which represented an 82 percent jump over FY 2008. The agency sought 82 asset freezes in FY 2009, an increase of 78 percent compared to FY 2008. In addition, the SEC issued 496 orders opening formal investigations in FY 2009, which represented a 100 percent increase over the orders issued in FY 2008. The SEC also reported a significant increase in disgorgement, with more than \$2 billion in such sanctions ordered, plus \$345 million in penalties, which was up almost \$100 million from the year before (41 SRLR 2216, 12/7/09).

Although he acknowledged that statistics tell only half the story, Khuzami noted in a speech in December that the data “provide real evidence that we are fulfilling our core mission of investor protection” (41 SRLR 2258, 12/14/09).

Statistics kept by others confirmed the rigorous pace set by SEC enforcers last year. A Gibson Dunn year-end report on SEC enforcement found that although the total number of enforcement actions brought in FY 2009--664 cases--is less than the 671 cases brought in FY 2008, there was an increase of almost 10 percent in the number of civil injunctive actions filed in FY 2009. The law firm said this could indicate that the agency is filing more enforcement actions as injunctive actions in federal courts rather than as administrative proceedings.

Gibson Dunn also found that a comparison by calendar year showed that the SEC brought 38 percent more civil injunctive actions in 2009 than in 2008. In addition, the number of defendants charged in 2009 rose 58 percent compared to 2008.

However, one lawyer, Lewis Lowenfels, Tolins & Lowenfels, New York, expressed concerns about “overreaction--too much regulation, too much enforcement.”

“Why do we measure success in enforcement by how many cases the regulators bring?” Lowenfels queried. “It's the quality, not the numbers of cases, that is crucial. It's superficial and misleading to compare the number of actions and conclude people are doing a more effective job because they are bringing more actions. What is important is initiating actions where action is justified, using good judgment,” he concluded.

Nonetheless, Lowenfels said that while the revitalized enforcement program is “still in progress,” the division appears to be on the right track--especially its focus on specialized enforcement units.

Streamlined Process.

A separate report by Gibson Dunn said that in core enforcement areas, the SEC brought 14 enforcement actions under the Foreign Corrupt Practices Act in calendar year 2009, roughly in line with the 13 actions brought in 2008. An Associated Press analysis of Ponzi schemes found that such frauds now account for 21 percent of the SEC's enforcement workload, compared to 17 percent in 2008, and 9 percent in 2005.

The SEC has certainly brought a number of significant cases in the last year, Schonfeld acknowledged. The agency also has shown “a willingness to shake up the bureaucracy internally and try to streamline the process to be more efficient.” At the end of the day, he predicted, the commission's ability to move more quickly will probably be the single most important factor in its ability to improve its post-Madoff reputation.

“Not all cases are equally strong.”

*Stephen Crimmins
K&L Gates LLP*

Former SEC enforcement lawyer Stephen Crimmins, now a member of K&L Gates LLP in its New York and Washington offices, also praised the enforcement division's reform initiatives--in particular, the simplified approval process for issuing subpoenas. He also remarked that Khuzami “is right on target when he says case selection is of critical importance.” On that point, Crimmins suggested that the experienced trial lawyers on staff be asked to take a

hard look at cases still in the investigation stage “to see if they're worth pursuing and how best to get needed evidence.”

“SEC trial lawyers should also have greater flexibility in resolving matters after they move into litigation without being bound to rigid formulas on how cases of a certain type can be settled. Not all cases are equally strong,” Crimmins stated.

Commitment to Reform.

Denver attorney Michael MacPhail, Holme Roberts & Owen LLP, also a former SEC enforcement lawyer, agreed that the commission “is in the process of redeeming itself,” and “is showing a commitment to reform itself to some extent internally. ... Certainly from the statistical standpoint they're bringing more cases and some of those cases are significant, especially the cases it brought at the end of the year.”

However, citing the “due process implications of greatly expanded” temporary restraining orders and asset freezes, MacPhail said he is concerned about whether the commission has “gone too far in some cases.” He also cited concerns about the impact Khuzami's initiatives are having on morale at the agency.

Because the reorganization eliminated “branch chiefs” as a category, MacPhail explained, the attorneys in those positions were demoted from supervisors to “nonsupervisory 'uber staff-attorneys,' and I know that it is creating a lot of hand-wringing. It could well be that these internal reforms are necessary and appropriate, but they are definitely having a negative short term impact.”

“People feel like they are in limbo right now. New jobs haven't been created, yet the SEC is replacing branch chiefs and people are concerned. There's a lot of anxiety about the unknown impact of the personnel moves underway.”

However, MacPhail acknowledged that in the longer term, the reorganization “has the promise of improving productivity because it's likely to create more on-the-street investigators,” an “appropriate response” to the commission's expanded workload.

“The SEC should be looking hard at the key players in the economic collapse, and I suspect that it is.”

*Michael MacPhail
Holme Roberts & Owen LLP*

More specifically, MacPhail suggested, “the SEC should be looking hard at the key players in the economic collapse and I suspect that it is. ... There are a lot of not-yet-public investigations of some of the Wall Street firms that were involved in the events of late 2008, so my suspicion is that they are focusing on the right things.” New York attorney Daniel Sommers, Cohen Milstein Hausfeld & Toll PLLC, too, said he expects that the newly restructured Enforcement Division “will begin to flex its muscles by taking on enforcement proceedings involving large institutions and complex financial instruments.”

However, MacPhail said he also sees cases involving very small companies and industry sectors that do not appear to have a broad public impact. “I think they should be focusing more resources on the components of the economic crisis than I see in my practice.”

Thomas O. Gorman, chair of Porter Wright Morris & Arthur LLP's securities litigation practice group, Washington, agreed that the SEC could do more in relation to the financial turmoil. “The SEC has touted its market crisis investigations for well over a year now, yet few cases have been brought,” he told BNA Jan. 14. “A key factor to watch this year is whether the SEC is able to bring more market crisis cases that focus on areas such as the mortgage-backed securities markets which were at the center of the crisis.”

Galleon and Insider Trading.

In litigation, one of the most closely watched proceedings in 2010 will be the SEC's lawsuit against registered investment adviser Galleon Management LP and billionaire fund manager Raj Rajaratnam--*SEC v. Galleon Management LP*. The case involves charges brought by the SEC and the Justice Department in October and November against Rajaratnam, Galleon, and other individuals and firms over what prosecutors described as the largest hedge fund insider trading case in history (41 SRLR 1937, 10/26/09; 41 SRLR 2023, 11/9/09).

Wayne State University law professor Peter Henning told BNA Jan. 12 that *Galleon* is the first significant SEC case involving hedge fund trading, an area that the commission has not been able to crack on a broad basis. "It has been an open secret on Wall Street that the funds trade information, and often come close to the line of swapping material nonpublic information," he said. "This is the first case that really focuses on how the information was obtained and used to reap profits, and it has had a chilling effect on a number of funds."

"It has been an open secret on Wall Street that [hedge funds] trade information, and often come close to the line of swapping material nonpublic information."

*Law Professor Peter Henning
Wayne State University*

Trial of the SEC's charges against Galleon and Rajaratnam is scheduled to begin Aug. 2. Attorneys also have suggested in prior interviews with BNA that the case could result in complex litigation (42 SRLR 23, 1/4/10). Among other interesting issues, the U.S. District Court for the Southern District of New York could determine that the SEC and DOJ should pursue parallel proceedings against the defendants, which could prove a challenge for prosecutors (41 SRLR 2213, 12/7/09; 42 SRLR 9, 1/4/10).

Two other important cases in the insider trading area are *SEC v. Cuban* and *SEC v. Dorozhko*. In *Cuban*, now on appeal to the U.S. Court of Appeals for the Fifth Circuit, the SEC alleged that billionaire entrepreneur Mark Cuban avoided losses of over \$750,000 by improperly selling his shares in Mamma.com ahead of a private investment in public equity (PIPE) announcement, which the agency alleged he orally agreed to keep confidential (41 SRLR 1854, 10/12/09).

The district court ruled in July 2009 that the SEC's complaint was deficient because it failed to plead that Cuban agreed not to trade on the nonpublic information about Mamma.com (41 SRLR 1395, 7/27/09). The court held that where insider trading under the misappropriation theory is based on an agreement, the defendant must agree both to keep the information confidential and not to trade on the information. The court also concluded that because Rule 10b5-2(b)(1) under the 1934 Securities Exchange Act does not require an agreement to refrain from trading on the nonpublic information, the SEC could not rely on the provision to impose the required duty.

"The *Cuban* case is important because it will test how far the SEC can stretch the concept of fiduciary duty to cover trading outside traditional areas involving insiders and their advisers," Henning said.

In *Dorozhko*, the U.S. Court of Appeals for the Second Circuit concluded in July 2009 that a computer hacker who trades on material nonpublic information can be held liable for insider trading even if the hacker did not violate any fiduciary duty in obtaining the information (41 SRLR 1410, 7/27/09). The case currently is before the district court on remand from the Second Circuit. Previously, observers told BNA that the appellate court's decision potentially opens new avenues of enforcement that the SEC could try to expand (41 SRLR 1583, 8/24/09).

Dorozhko will be significant for what constitutes "deception," Gorman said. The attorney noted that the SEC argued in the case that computer hacking equals deception because the hacker deceived the processes of the computer being hacked. "This is a very creative theory that should be watched on remand," he said.

Bank of America.

Gorman added that the SEC's high-profile prosecution of Bank of America Corp. (BAC) also has important

ramifications for the enforcement division's revitalization efforts. In September 2009, the U.S. District Court for the Southern District of New York rejected the SEC's proposed \$33 million settlement with the bank over charges that it lied to shareholders in the proxy statement soliciting their approval of the acquisition of Merrill Lynch & Co. in late 2008 (41 SRLR 1718, 9/21/09). The case is set for trial in March.

***Dorozhko* will be significant for what constitutes “deception,” attorney Thomas O. Gorman said.**

Then, after losing a bid to amend its earlier charges, the SEC in January brought a second case against the bank alleging that it violated federal proxy rules by failing to disclose billion-dollar losses at Merrill before the shareholder vote to approve the companies' merger (42 SRLR 80, 1/18/10).

Gorman described *BoA* as a “big black eye” for the SEC. “A win in these cases would dig it out of a black hole,” the attorney stated. On the other hand, Gorman said that a loss could be “very detrimental” to the agency's current efforts to rejuvenate enforcement “because the ill-fated settlement was negotiated by the current enforcement division and approved by the current commission.”

Henning, for his part, said the *BoA* litigation should be watched because “the commission rarely brings this type of proxy disclosure case.” The cases will test how hard the SEC is willing to push in this area, he said.

Credit Default Swaps, Clawbacks.

Meanwhile, in *SEC v. Rorech*, the SEC is litigating its first insider trading action involving credit default swaps. In the case, before the U.S. District Court for the Southern District of New York, the agency alleged that a hedge fund portfolio manager and a salesman at Deutsche Bank Securities Inc. illegally traded on information about bonds issued by VNU N.V., (VNUVY) an international holding company that owns Nielsen Media and other media businesses (41 SRLR 851, 5/11/09).

Rorech is significant because the law regarding whether derivatives--including CDSs--are “securities” subject to SEC enforcement authority is not fully settled. Nevertheless, the SEC has announced that it intends to widen its insider trading scrutiny to include derivatives traded by hedge funds (41 SRLR 2258, 12/14/09). In December, the court declined to decide, at the pleading stage, whether the instruments fall outside the SEC's authority, which could have been a major setback for the agency (41 SRLR 2301, 12/21/09).

Also closely watched will be *SEC v. Jenkins* in the U.S. District Court for the District of Arizona, involving the SEC's first use of the 2002 Sarbanes-Oxley Act's “clawback” provision--Section 304--against an individual who was not alleged to have violated securities laws. In July 2009, the SEC sued Maynard Jenkins, the former chief executive officer of CSK Auto Corp., (CAO) asking the court to order Jenkins to reimburse the company and its shareholders more than \$4 million he received in bonuses and stock sales profits while the concern allegedly was committing accounting fraud (41 SRLR 1394, 7/27/09).

Jenkins has mounted a spirited defense, arguing that the SEC's enforcement action is a “new post-Madoff interpretation” and a “vicarious strict liability” interpretation that departs sharply from previous interpretations and applications of the statute (41 SRLR 2158, 11/23/09). Jenkins filed a motion to dismiss in September which the court is expected to rule on soon. Meanwhile, the SEC has indicated that it will continue to use the clawback provision.

High Court.

Finally, two cases pending before the U.S. Supreme Court could impact the SEC's enforcement authority: *Morrison v. National Australia Bank Ltd.*, and *Textron Inc. v. United States*.

In November, the high court agreed--over the objections of the SEC and the Solicitor General--to review *Morrison*, a

Second Circuit decision dismissing a “foreign-cubed” case that raises critical questions about the reach of U.S. federal courts and the U.S. securities fraud laws with respect to foreign securities transactions (41 SRLR 2188, 12/7/09).

In *Morrison*, foreign plaintiffs sued a foreign issuer, Melbourne, Australia-based National Australia Bank Ltd., in U.S. court for violations of U.S. securities laws based on transactions in a foreign country. The case is viewed by lawyers as being an especially important test of the extent to which federal securities laws should be given extraterritorial effect. In October 2008, the Second Circuit dismissed the case, writing that the “particular mix of factors”—including that the fraudulent statements were passed through NAB's corporate headquarters in Australia, the lack of impact on Americans, and the lengthy chain of causation—required a finding that the court lacked subject matter jurisdiction (40 SRLR 1745, 10/27/08). The SEC originally urged the Second Circuit to assert jurisdiction, then reversed its stance by asking the Supreme Court not to hear the case (41 SRLR 1994, 11/2/09).

In *Textron*, Textron Inc. Dec. 24 filed a certiorari petition asking the Supreme Court to review the U.S. Court of Appeals for the First Circuit's conclusion that tax accrual work papers are not entitled to work product protection. In August 2009, the First Circuit ruled 3-2 that tax accrual work papers are not protected because the work product privilege is aimed at protecting work done for use in litigation, not in preparing financial statements.

Although the case involves the Internal Revenue Service, securities attorneys warned that the First Circuit had articulated a “new standard” for work product protection that could extend beyond the tax context (41 SRLR 1968, 10/26/09; 41 SRLR 2050, 11/9/09). Khuzami himself cited *Textron* during a speech at an accounting conference in December (41 SRLR 2258, 12/14/09). The enforcement director noted that a number of audit firms are withholding subpoenaed documents and asserting the work product privilege on behalf of clients. The SEC, Khuzami said, is “skeptical of such claims” in light of *Textron*. “And the First Circuit's common sense analysis is how we evaluate these types of assertions of privilege,” Khuzami said.

The high court has not yet determined whether it will accept certiorari in *Textron*.

By [Yin Wilczek](#) and [Phyllis Diamond](#)

Copyright 2010, The Bureau of National Affairs, Inc.