



Reproduced with permission from The United States Law Week, 78 USLW 2076, 8/11/2009. Copyright © 2009 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Securities—Investigations

Khuzami Unveils Broad Reorganization Of Enforcement Unit, New Subpoena Powers

NEW YORK—In a move he foreshadowed earlier this year, Securities and Exchange Commission Enforcement Director Robert Khuzami Aug. 5 announced his plans for a broad reorganization of the Enforcement Division into five specialized units, in an effort to muster staff expertise in a more systematic way.

In an evening address to the Association of the Bar of the City of New York, Khuzami also revealed that the commission has delegated to the division director the authority to issue formal orders of investigation, with accompanying subpoena power.

Khuzami added that he, in turn, intends to delegate that authority to senior officers throughout the division. “Staff will no longer have to obtain advance commission approval in most cases to issue subpoenas,” he said. “Instead, they will simply need approval from their senior supervisor.

“This means that if defense counsel resist 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.”

“This is huge,” Washington, D.C., attorney Stephen Crimmins, of Mayer Brown LLP, commented regarding the initiative. “This is a tour de force that covers the waterfront of what needs to be done to make SEC enforcement what all of its staff want it to be.”

Saying the particular areas of expertise outlined by Khuzami focus on current market problems, Crimmins posited that overall, Khuzami’s goal is to bring cases more quickly and to “free up resources to focus on what’s really important today.” The SEC staff—and the people who deal with the staff—“will appreciate that,” Crimmins stated.

In more targeted comments, John Olson, of Gibson Dunn & Crutcher LLP, Washington, D.C., questioned the decision to delegate to enforcement the authority to issue formal orders. “I understand the impulse behind that, but I think it’s a mistake.”

“By law,” Olson said, “the commission is responsible for overseeing the enforcement program and shouldn’t delegate that kind of responsibility to the staff. I’m all for expedited consideration of formal orders, but I think it makes sense for the commission to keep an eye on the progress of the enforcement program” by retaining such authority.

Specialized Units. In detailing his reorganization plans, unveiled in May to a Senate panel, Khuzami said the division will have five specialized units, devoted to:

- **Asset Management**—focusing on investment advisers, investment companies, hedge funds, and private equity funds. A comprehensive approach is needed, as “the lines between these various vehicles blur and overlap.” Issues for the unit include disclosure, valuation, portfolio performance, due diligence and diversification, transactions with affiliates, misappropriation, and conflicts of interest.

- **Market Abuse**—focusing on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals, and others. Technological tools and screening programs are planned “to ferret out suspicious trading activity,” looking for patterns, connections, and relationships across markets, including equities, debt securities, and derivatives, and across different corporate announcements and other market events.

- **Structured and New Products**—focusing on complex derivatives and financial products, including credit default swaps, collateralized debt obligations, and securitized products. Lack of transparency in these “huge” but “opaque” markets “has become a fertile ground for abuse and misconduct,” requiring specialized knowledge and commitment for enforcement.

- **Foreign Corrupt Practices Act**—focusing on “new and proactive approaches to identifying violations,” by working more closely with foreign counterparts and taking a more global approach.

- **Municipal Securities and Public Pensions**—focusing on areas that appear “ripe for scrutiny,” including offering and disclosure issues, tax and arbitrage-driven activity, unfunded or underfunded liabilities, and pay-to-play schemes.

Khuzami said that the introduction of national specialized units resulted from the division’s self-

assessment exercise, as an alternative to organizational structures that leave too much expertise “stranded and isolated.” The specialized units, he said, “will provide the structure and resources for staff to ‘get smart’ about certain products, markets, regulatory regimes, practices, and transactions,” making it less likely for investigators “to be misled by those who use complexity to conceal their misconduct.”

Specialization will also foster proactive decisionmaking and “help to enable us to attack problems systematically, swiftly and thoroughly, and on an industry-wide basis where appropriate,” he said.

Each specialized unit will be headed by a unit chief, Khuzami continued, and staff will be gathered nationally and given advanced training. The division will also hire people for the units with “practical market experience and other expertise, whether from private industry, other SEC divisions, or elsewhere.”

Redeploying Branch Chiefs. In a streamlining and flattening of the division’s management and internal processes, branch chiefs will be redeployed to conducting investigations, thus bringing some of the division’s “best and brightest performers” to the “heart-and-soul function of the SEC,” Khuzami said. The move should serve as a check on “the extra process, duplication, unnecessary internal review, and the inevitable drag on decision-making that happens in any overly-managed organization,” while encouraging autonomy and accountability, he said.

“The branch chiefs’ demonstrated excellence and talents can better serve U.S. investors if focused full-time on investigations,” according to Khuzami.

“We are also streamlining our internal process to make us more nimble and quick,” he continued. In addition to granting subpoena authority to the division director, the streamlining of decisionmaking will include “delegating the power to approve all routine case decisions from the deputy director at a national level to the division’s senior officers located throughout the country.”

Tolling Agreements Policy Shift. Meanwhile, in another policy shift, Khuzami announced, the division director’s approval will be needed for all tolling agreements—agreements to extend a particular limitations period.

“There are valid reasons to seek and grant tolling agreements, but tolling agreements have become far too common,” he said. “In some instances, they impose a significant cost of delay and may undermine our message of prompt accountability for wrongdoing. And I have it on good authority that the director will grant tolling agreements as an exception, not the rule.” Khuzami also pledged that 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.”

Another initiative will be the creation of an SEC Office of Market Intelligence, responsible for “the collection, analysis, risk-weighting, triage, referral, and monitoring of the hundreds of thousands of tips, complaints, and referrals that the agency receives each year.”

“This means that if defense counsel resist 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.”

Cooperation. In addition, four initiatives are being taken to foster cooperation by individuals, Khuzami said.

The division is seeking to create a public policy statement, like the commission’s “*Seaboard*” standards for corporations, to evaluate cooperation by individuals in enforcement actions, he reported. Second, the division is seeking an expedited process for delegating to the division director the authority to submit immunity requests to the Justice Department, Khuzami said. Third, the division is also “exploring ways to provide witnesses in the appropriate cases with oral assurance early on in a case that we do not intend to file charges against them.”

In the *Seaboard report*, issued in 2001, the SEC detailed factors it would consider in deciding whether to grant credit for cooperation by targets of investigations.

Finally, the division will be prepared to recommend deferred prosecution agreements, “in which we agree in the appropriate case to forego an enforcement action against an individual or entity subject to certain terms, including full cooperation, a waiver of statutes of limitations, and compliance with certain undertakings.”

However, Khuzami warned against “being lenient for the sake of leniency,” or “rewarding persons for simply complying with routine or expected requests.” He added: “If your client has broken the law, and has not provided the requisite level of cooperation, don’t expect leniency. Arguments such as ‘our competitors do it’ or ‘we’ve always done it this way,’ will not be credited.”

Khuzami also reported that the division is seeking greater resources from Congress, which has already provided some “targeted relief,” to address an 11 percent dip in staffing since 2005. The division has already added to its trial unit and plans to hire a chief operating officer to “manage information technology, oversee project management, and build efficient workflow processes, including in the critical area of our collection of funds and the distribution of those funds to harmed investors.”

Reaction to Madoff Scandal. In looking back on his first 100 days on the job, Khuzami said that the division’s reaction in the wake of the Madoff scandal was “one of the most impressive organizational responses to criticism I have ever witnessed.”

As signs that “the attorneys and investigators within the division remained focused on investor protection and pursuing wrongdoers, and were not distracted from their mission,” Khuzami pointed to a 10 percent increase in opening of investigations in the first months of the new administration, compared with the same period in 2008; a 118 percent increase in formal orders; a 147 percent increase in temporary restraining orders; and a nearly 30 percent increase in filing of actions.

“These results underscore the fact that the criticism of the SEC that resulted from Madoff—however justified—should not be permitted to obscure the 75-year tradition of vigorous enforcement resulting from the dedicated efforts of thousands of public servants who work tirelessly and with impressive results to protect the investing public,” Khuzami said.

“We listened to the criticism and used it as a learning opportunity,” he added. “We did what a responsible public agency must do—we used the episode as a catalyst to undertake a rigorous self-assessment of how we do our job.”

Better Decisions. According to Crimmins, Khuzami's move will require the staff "to be as smart as possible in allocating their limited resources. . . . [H]e has called on the staff to make better determinations as to whether to continue investigations in cases and if so what to charge."

"It's all about case selection," Crimmins stated: Khuzami's "primary theme . . . is the importance of case selection and not wasting resources on cases that are weak or that will not have a significant impact to benefit investors. . . . [I]f it's done right, . . . better case selection. . . can achieve tremendous benefits. But it's a terrific challenge."

Moreover, Crimmins predicted, the new staff powers will be "well received" by the defense bar, "because it will mean that matters won't languish for years without action . . . with the lives of those affected in limbo." While some delays are inevitable, "people need to know where they stand. People need to know whether they will be the subject of enforcement action or not, and if they have to resolve matters, they need to know that it can be done quickly and directly," Crimmins concluded.

Inefficiencies. Offering a different perspective, Denver attorney Michael MacPhail, of Holme, Roberts & Owen LLP, said he generally agrees with the concept of empowering the staff attorneys to have more decision-making responsibility. "The division historically has been very hierarchical, and relatively top heavy and inefficient. I think all these things justify what Khuzami is trying to do."

However, MacPhail continued, "at the same time, the SEC is trying to deal with the economic crisis and to revitalize its operations post-Madoff." Khuzami's expansive reorganization, he suggested, "could be disruptive" to the agency's mission, "distracting the staff at the very time the agency its trying to respond in a responsible way to [the] serious fraud that's been exposed by the economic crisis."

MacPhail also told BNA that under the reorganization, a number of upper management positions in the division will be eliminated. "They're going to pay these people the same, but they're going to make them so they're not going to supervise people any more." He said that "[w]hen you're taking somebody's supervisory responsibility from them, it's got to be bad for morale. . . . Accomplishing the same goals through attrition might be a better and more gradual way to do things."

MacPhail also cited the "perception" that Khuzami, a former federal prosecutor, "wants to bring in other people with his kind of background into management. That sends a bit of a message that could be disturbing to existing management." On the other hand, MacPhail offered, "[i]t could be that putting more people in the trenches will result in enhanced efficiency over time."

Hard-Boiled Approach. For his part, Columbia Law School Professor John C. Coffee Jr. said Khuzami's choice of enforcement techniques marks a "new, hard-boiled approach" taken from "the world of the U.S. Attorney's office"—an approach that "will likely get results in some cases," he said. "The older, gentler days of SEC prosecution are ending."

Following "the classic model of white-collar prosecution," the SEC can be expected to put more pressure on mid-level officers to "flip and testify against senior executives," or face a "ton of bricks" of prosecution brought down upon themselves, Coffee said.

"It may be hard-boiled, but it's what the country wants," he continued. "Even without Madoff, there would have been a lynch mob out there over executive compensation, in this climate."

BY JOHN HERZFELD
AND PHYLLIS DIAMOND (WASHINGTON, D.C.)

The text of Khuzami's speech is available at <http://www.sec.gov/news/speech/2009/spch080509rk.htm> on the SEC website.