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## New Enforcement Initiatives at the U.S. Securities and Exchange Commission

The U.S. Securities and Exchange Commission (SEC) hosted its annual *SEC Speaks* program on February 6-7, 2009, in Washington, D.C. During the program, the Commissioners and Staff outlined particular steps the SEC was taking to reinvigorate the agency's enforcement program in the wake of the economic crises that have shaken the financial markets. The Enforcement Staff also highlighted particular areas of focus for the near future, from subprime markets, municipal securities, and hedge funds, to a continued emphasis on Ponzi schemes, insider trading, market manipulation, and the Foreign Corrupt Practices Act (FCPA).

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**New Enforcement Procedures.** Chairman Mary Schapiro, who had been sworn in only days earlier on January 27, 2009, echoed much of her Senate confirmation testimony in stating that “[a] strong and reinvigorated SEC will be on the beat like never before to catch wrongdoers,” and that to effectively respond to market events the Commission “must be willing to change the way we do business.”<sup>1</sup> Chairman Schapiro described two immediate changes the Commission was putting in place that likely will affect civil monetary penalties levied against public companies and the Staff's ability to obtain subpoena power in investigations.

*An end to the penalty pilot program.* Chairman Schapiro announced an end to a pilot program that had been instituted in 2007, which required Enforcement Staff to obtain Commission approval prior to engaging in settlement discussions with public companies that involved a potential civil monetary penalty.<sup>2</sup> In practice, this pilot program reportedly frustrated the Enforcement Staff and left many practitioners concerned about whether it provided a meaningful opportunity to present defense arguments to the Commission before the Staff made its penalty recommendation and sought settlement authority.

In her speech at the *SEC Speaks* program, Chairman Schapiro announced that she was ending the penalty pilot program:



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“I am this week taking action to end the Commission’s two-year penalty pilot experiment, which had required the Enforcement staff to obtain a special set of approvals from the Commission in cases involving civil monetary penalties for public companies as punishment for securities fraud.

In speaking to our Enforcement staff, I’ve been told that these special procedures have introduced significant delays into the process of bringing a corporate penalty case; discouraged staff from arguing for a penalty in a case that might deserve a penalty; and sometimes resulted in reductions in the size of penalties imposed.

At a time when the SEC needs to be deterring corporate wrongdoing, the penalty pilot sends the wrong message. The action I am taking to end the penalty pilot is designed to expedite the Commission’s enforcement efforts to ensure that justice is swiftly served to those public companies who commit serious acts of securities fraud.<sup>3</sup>”

Both Chairman Schapiro and Commissioner Luis Aguilar had recently cited a decline in the number and amounts of civil penalties against corporate issuers as reasons to end the program.<sup>4</sup> If they are correct, removing the penalty program as an obstacle for the Staff to overcome could have the effect of causing the Staff to seek civil monetary penalties more often in settlements with public companies under investigation, and to demand larger penalties than it has in recent years. Also relevant is that the SEC’s most outspoken opponent of imposing penalties against public companies, former Commissioner Paul Atkins, left the Commission last summer at the conclusion of his second term.

*Approval of formal orders of investigation without full review by all five Commissioners.* Chairman Schapiro also announced a new procedure—actually another return to historical practice—whereby the Staff can obtain a formal order of investigation by seriatim approval or by a single Commissioner acting as a duty officer, rather than being required to submit each formal order request to a full review by all five Commissioners. The Staff lacks subpoena power—and thus depends entirely on “voluntary” compliance with its requests for documents and testimony—unless and until it obtains such a formal order from the Commission in a particular investigation.<sup>5</sup> Chairman Schapiro noted that in the past, “many formal orders of investigation [were] made subject to full review at a meeting of all five Commissioners, necessitating that they be placed on the calendar sometimes weeks in advance.”<sup>6</sup> The Chairman announced the new procedure to provide the Staff with the ability to obtain a formal order more quickly.

This new procedure may result in the Staff obtaining formal orders more quickly and more frequently in its investigations. Generally, programmatic announcements such as this one from the Chairman correspond with directives to the Staff to utilize the new procedures that have been described. Thus, companies and individuals should not be surprised if their first contact with the Staff is a formal subpoena demanding documents or testimony, rather than an informal written or oral request for voluntary compliance, as has been common in the past.

*More streamlined investigations.* In one of the more pregnant statements made during the conference, Deputy Enforcement Director George Curtis said that investigations would move more quickly in general and that the Staff would not necessarily seek to “turn over every stone” in each case. Curtis’s statement, on which he did



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not elaborate, may signal a new trend in which the Commission moves more quickly against certain entities and individuals while declining to commit additional resources to prolonged investigation of more marginal defendants and potential additional charges. We hasten to note, however, that this concept is not entirely new either.

**Enforcement Priorities.** The Enforcement Staff described its focus for the near future as being targeted on emerging areas like subprime markets, municipal securities, and hedge funds, as well as more familiar territory like Ponzi schemes, insider trading, market manipulation and FCPA cases.

*Subprime markets.* Los Angeles Regional Office Director Rosalind Tyson said the Staff currently has approximately 25 active investigations in the subprime area covering the spectrum of mortgage originators, mortgage securitizers, credit rating agencies and mortgage-backed security sellers. Tyson cited the Commission's September 2008 action alleging that two brokerage representatives misled customers into believing that auction rate securities being purchased in their accounts were backed by federally guaranteed student loans when, in fact, they were backed by subprime mortgages and by collateralized debt obligations based on subprime mortgages. The scheme allegedly included email confirmations to customers that disguised the nature of purchased securities by inserting terms such as "St[udent] Loan" and "Education" in the names of the securities.<sup>7</sup>

Tyson also cited the Commission's October 2008 case against five registered representatives of World Group Securities. The Commission alleged that the representatives convinced brokerage customers to refinance their fixed-rate mortgages into subprime adjustable-rate mortgages and diverted the proceeds of the refinancings to unsuitable variable universal life policies. According to the Commission, most of the customers had little formal education and many did not speak English fluently, if at all.<sup>8</sup>

Taken together, these cases illustrate that in what is likely to be a growing number of subprime cases pursued by the Commission, the Staff will focus on the same issues it has traditionally pursued in other cases, such as whether potential defendants either affirmatively misled or omitted to disclose material information to investors. Tyson confirmed that the Staff would be seeking to distinguish cases that reflect merely poor business judgment from those that involve fraud. However, as in the case of World Group Securities, it is clear that the Staff will apply a broad interpretation of what constitutes fraud, and will pursue defendants for unsuitable recommendations as well as for outright deception, especially in cases against regulated entities and persons.

*Municipal securities.* Deputy Director Curtis discussed the Commission's increasing focus on state and local entities involved in the securities markets, and emphasized that despite enjoying certain exemptions, these entities remain subject to Commission oversight for disclosure, manipulation, and insider trading issues. Curtis cited in particular the Commission's April 2008 case against five former officials of the City of San Diego. The officials allegedly knew that the city would face severe difficulty funding its future pension and retiree healthcare obligations, and that its unfunded pension liability was projected to increase dramatically, but failed to disclose that information to rating agencies and investors in city bond offering documents.<sup>9</sup>

Curtis also discussed the Commission's most recent Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934 (Exchange Act), which pertained to The Retirement Systems of Alabama



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(RSA), the retirement system for Alabama state and local employees. In its Report—the SEC’s only Section 21(a) Report since 2005—the Commission found that RSA had purchased securities while in possession of material nonpublic information, largely because the organization did not have adequate policies and procedures in place to assure compliance with the federal securities laws. The Commission declined to take action against RSA because it cooperated in the Staff’s investigation and took certain remedial actions. However, the Commission reported that although “[s]tate pension funds such as RSA are exempt from the requirements of the Investment Company Act of 1940 and the Investment Advisers Act . . . , public pension funds and their employees are subject to the anti-fraud provisions of the federal securities laws and Commission rules thereunder.”<sup>10</sup>

These cases exemplify the Commission’s increasingly clear signals to state and local authorities that although they may be exempt from certain aspects of the federal securities laws, they are not exempt from the antifraud provisions when they offer, purchase, or sell securities, and that the Commission will not hesitate to investigate and charge state and local entities in appropriate cases.

*Hedge funds.* The Commission has struggled in recent years with hedge fund regulation, largely due to federal court rulings that rejected the agency’s attempts to expand its regulatory reach in the area.<sup>11</sup> The Commission has responded, much as in the area of municipal securities, by sending the message that even if hedge funds and hedge fund managers are not registered with the Commission, they remain subject to the antifraud provisions when they offer, purchase, or sell securities. Deputy Director Curtis said that a good example of the Commission’s efforts in this area was its 2008 case against the managers of two now-defunct hedge funds associated with Bear Stearns & Co. In that case, the Commission accused the defendants of misleading hedge fund investors about the funds’ exposure to subprime mortgage-backed securities, and thus of violating the antifraud provisions of the Securities Act of 1933 and the Exchange Act.

The case against these hedge fund managers exemplifies the Commission’s willingness in this arena to use the historical tools at its disposal—particularly, the antifraud provisions—even as the agency struggles with bringing hedge funds under the umbrella of direct regulation. Although Curtis was not specific about the number of hedge fund investigations in the pipeline, he predicted that more hedge fund cases would be brought in the near future.

*Ponzi schemes.* On December 11, 2008, the Commission sued Bernard Madoff and his investment firm in what may be the largest Ponzi scheme case in history. The SEC alleged in its complaint that Madoff committed a \$50 billion fraud and later admitted to insiders that his business was “all just one big lie” and “basically, a giant Ponzi scheme.”<sup>12</sup>

Denver Regional Office Director Donald Hoerl said that the Commission has always focused and will continue to focus on Ponzi schemes that victimize investors through fraud, citing the fact that in recent years the Commission has brought an average of three Ponzi scheme cases per month. Hoerl also stated that the Staff will continue to look for the same kinds of recurring red flags that typically appear in such cases, such as a charismatic leader who is not registered with the Commission, a secret trading strategy that is not fully disclosed to investors, and marketing to affinity groups such as those sharing a common nationality or religion.



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*Insider trading.* Associate Enforcement Director Antonia Chion discussed the Commission's insider trading cases and said that nine percent of the Commission's enforcement actions in fiscal year 2008, or 61 actions brought against 103 defendants, included allegations of insider trading. Chion mentioned the Commission's well-publicized actions against Lou Pai, a former Enron Corp. executive who agreed to pay \$31.5 million in disgorgement and civil penalties for allegedly selling Enron shares while in possession of material nonpublic information, and Mark Cuban, the owner of the NBA's Dallas Mavericks franchise whom the Commission also alleged sold securities while in possession of insider information.<sup>13</sup>

Chion emphasized that no matter how big or small the alleged gain, individuals who trade while in possession of material nonpublic information are at risk of Commission action. Among other things, she said that defendants' attempts to evade detection through, for example, utilizing brokerage accounts associated with other entities or individuals were increasingly unsuccessful because of the Staff's ability to mine the extensive trading data available from exchanges, self-regulatory organizations and market participants.

*Market manipulation.* Deputy Enforcement Director Scott Friestad said the Staff was continuing to focus on market manipulation issues, including the dissemination of false rumors through media outlets. Friestad discussed the Commission's April 2008 case against Paul Berliner, a former registered representative of Schottenfeld Group, LLC. The SEC alleged that in the wake of The Blackstone Group's agreement to acquire Alliance Data Systems Corp., Berliner disseminated a false rumor that Alliance's board of directors was meeting to consider a revised proposal from Blackstone with a significantly lower acquisition price. The rumor, which Berliner disseminated through instant messages to traders at brokerage firms and hedge funds, caused Alliance's stock price to plummet by approximately 17 percent. While disseminating the false rumor, Berliner allegedly sold short Alliance shares and pocketed approximately \$25,000.<sup>14</sup>

While market manipulation issues are not new to the Commission's Enforcement Staff, Friestad emphasized that the Staff is examining the evolving means by which defendants now disseminate false information and otherwise manipulate the price of securities. He also said that in market manipulation cases, the Staff will typically be looking at whether hedge funds played any substantial role.

*Foreign Corrupt Practices Act.* Associate Enforcement Director Christopher Conte told the audience that FCPA cases remain a "focus area" for the Commission. He noted that the Commission has filed more than 35 FCPA cases since January 2006—more than the total it filed in all prior years combined since enactment of the FCPA in 1977—and that more are expected in the future. Conte cited the Commission's case brought in December 2008 against Siemens Aktiengesellschaft for alleged violations of the anti-bribery, books and records, and internal accounting controls provisions of the FCPA. In that case, Siemens agreed to pay \$350 million in disgorgement to the SEC, \$450 million in criminal fines to the U.S. Department of Justice, and \$569 million to the Office of the Prosecutor General in Munich, Germany in parallel criminal proceedings. The SEC alleged that Siemens made thousands of payments to third parties in a widespread and systemic practice of paying bribes to foreign government officials to obtain business.<sup>15</sup>

On February 11, 2009, just days after the *SEC Speaks* conference, the Commission announced settlements with Halliburton Co. and KBR, Inc. to resolve charges involving bribery of Nigerian government officials over a 10 year period. Halliburton and KBR agreed to pay \$177 million in disgorgement and a KBR subsidiary agreed



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to pay a \$402 million fine to settle parallel criminal charges brought by DOJ, sanctions which the Commission said “represent the largest combined settlement ever paid by U.S. companies since the FCPA’s inception.”<sup>16</sup>

Conte said the SEC will increasingly focus on executives and other individuals in FCPA cases, and will continue its current trend toward looking at industry-wide practices involving gifts, travel, entertainment and consulting fees. As both the Siemens and Halliburton cases illustrate, the ever-increasing magnitude of settlement numbers in FCPA cases ensures that FCPA enforcement will continue to be a high priority for the Staff.

**Conclusion.** The SEC recently has undergone significant changes in its ranks, most notably the appointment of its new Chairman in January 2009. The other Commissioners, however, are also relatively new to their jobs. Four have been sworn in since July 2008, and the longest tenured—Commissioner Kathleen Casey—has been at the agency since only July 2006. On the first day of the *SEC Speaks* conference, the agency announced the appointment of a new General Counsel, David Becker, who previously served in that role from 2000 to 2002.<sup>17</sup> More recently, on February 19, Chairman Shapiro named Robert Khuzami—best known for his credentials as a former criminal prosecutor of securities fraud—as the SEC’s new Director of Enforcement.<sup>18</sup>

With new leadership and a renewed sense of activism in the wake of the financial meltdown that has caused turmoil on both Wall Street and Main Street, it is likely that the SEC Enforcement Staff will act more quickly, more aggressively, and with an eye toward exacting greater penalties from enforcement action targets. The Staff would also be aided by the increased resources afforded the Commission in President Obama’s recently proposed budget, increasing the SEC’s financing by 13 percent.<sup>19</sup> The elimination of the penalty pilot program and the institution of streamlined formal order procedures could also embolden the Staff to pursue investigations and enforcement actions more vigorously. Likewise, the historic breakdown in the financial markets with which the Commission must now contend points toward an SEC that likely will take an even more activist stance in pursuing the agency’s mission of being the investor’s advocate.

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*This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.*

<sup>1</sup> Chairman Mary Schapiro, *Address to the Practising Law Institute’s “SEC Speaks in 2009” Program* (Feb. 6, 2009), available at <http://www.sec.gov/news/speech/2009/spch020609mls.htm>. See also *Statement of Securities and Exchange Commission Chairman-Designate Mary Schapiro* (Jan. 15, 2009), available at [http://banking.senate.gov/public/\\_files/SchapiroFINALtestimony11509.pdf](http://banking.senate.gov/public/_files/SchapiroFINALtestimony11509.pdf).

<sup>2</sup> See Chairman Christopher Cox, *Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference* (April 13, 2007), available at <http://www.sec.gov/news/speech/2007/spch041207cc.htm> (announcing the penalty pilot program).

<sup>3</sup> Chairman Mary Schapiro, *Address to the Practising Law Institute’s “SEC Speaks in 2009” Program* (Feb. 6, 2009), available at <http://www.sec.gov/news/speech/2009/spch020609mls.htm>.

<sup>4</sup> See Commissioner Luis Aguilar, *Empowering the Markets Watchdog to Effect Real Results* (Jan. 10, 2009), available at <http://www.sec.gov/news/speech/2009/spch011009laa.htm>.



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<sup>5</sup> See Securities Act of 1933 Section 19(c); Securities Exchange Act of 1934 Section 21(b).

<sup>6</sup> Chairman Mary Schapiro, *Address to the Practising Law Institute's "SEC Speaks in 2009" Program* (Feb. 6, 2009), available at <http://www.sec.gov/news/speech/2009/spch020609mls.htm>.

<sup>7</sup> *SEC Charges Two Wall Street Brokers in \$1 Billion Subprime-Related Auction Rate Securities Fraud*, Litigation Release No. 20698 (Sept. 3, 2008).

<sup>8</sup> *Commission Charges Five Registered Representatives with Fraudulent Sales of Unsuitable Securities Funded Through Subprime Mortgage Refinancings*, Litigation Release No. 20768 (Oct. 3, 2008).

<sup>9</sup> *SEC Charges Five Former San Diego City Officials with Fraud in Connection with City Municipal Securities Offerings*, Litigation Release No. 20522 (April 7, 2008).

<sup>10</sup> *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama*, Exchange Act Release No. 57446 (March 6, 2008).

<sup>11</sup> See *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (vacating rules adopted by the SEC that would have required many hedge fund managers to register with the Commission as investment advisers).

<sup>12</sup> *SEC Obtains Preliminary Injunction, Asset Freeze, and Other Relief Against Defendants*, Litigation Release No. 20834 (Dec. 19, 2008).

<sup>13</sup> *SEC Charges Former Chairman and Chief Executive Officer of Enron Energy Services with Insider Trading*, Litigation Release No. 20658 (July 29, 2008); *SEC Files Insider Trading Charges Against Mark Cuban*, Litigation Release No. 20810 (Nov. 17, 2008).

<sup>14</sup> *SEC Charges Wall Street Trader With Fraud For Spreading False Rumor*, Litigation Release No. 20537 (April 24, 2008).

<sup>15</sup> *SEC Files Settled Foreign Corrupt Practices Act Charges Against Siemens AG for Engaging in Worldwide Bribery With Total Disgorgement and Criminal Fines of Over \$1.6 Billion*, Litigation Release No. 20829 (Dec. 15, 2008). See King & Spalding Client Alert, *Siemens Settling Multi-National Anti-Bribery Probe for \$1.6 Billion* (Dec. 22, 2008), available at <http://www.kslaw.com/Library/publication/ca122208b.pdf>.

<sup>16</sup> *SEC Charges KBR, Inc. with Foreign Bribery; Charges Halliburton Co. and KBR, Inc. with Related Accounting Violations – Companies to Pay Disgorgement of \$177 Million; KBR Subsidiary to Pay Criminal Fines of \$402 Million; Total Payments to be \$579 Million*, Litigation Release No. 20897 (Feb. 11, 2009).

<sup>17</sup> *David M Becker Named SEC General Counsel and Senior Policy Director*, Release No. 2009-20 (Feb. 6, 2009).

<sup>18</sup> *Robert Khuzami Named SEC Director of Enforcement*, Release No. 2009-31 (Feb. 19, 2009).

<sup>19</sup> *Statement From Chairman Schapiro on Proposed Budget for SEC*, Release No. 2009-37 (Feb. 26, 2009).