ALERTS

SEC Update: Enforcement Program Taking Shape Under New Leadership

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U.S. Securities and Exchange Commission Chairman Mary Jo White last week announced an important change to the SEC's policy of permitting parties to settle SEC securities claims without admitting wrongdoing. Chairman White's announcement follows other remarks that further illuminate how Co-Directors George S. Canellos and Andrew J. Ceresney will oversee the SEC's Enforcement Division under White's leadership. These developments demonstrate the impact that White, Canellos and Ceresney — who worked together during White's tenure as the U.S. Attorney for the Southern District of New York — are having on SEC Enforcement, including adopting familiar approaches based on their experience as prosecutors.

Revision of "No Admit, No Deny" Policy

According to White's public remarks, in certain cases, the SEC will require that settling parties admit wrongdoing as a condition of resolving securities-related charges. Like other civil regulatory agencies, the SEC historically has allowed parties to settle claims without admitting or denying the factual allegations in the charging documents. Departing from that practice for some cases will make the SEC's settlement policy more consistent with the approach of U.S. Attorneys' offices ("USAO") in criminal plea and similar agreements.

Most SEC settlements will not be impacted by the new policy of seeking factual admissions of wrongdoing, according to White. The SEC intends to seek admissions only in select cases — those involving significant

investor harm or egregious intentional conduct — where the SEC concludes that a public acknowledgement of wrongdoing is appropriate. Whether to seek such an admission will be decided by the SEC on a case-by-case basis. Moreover, the new policy will not apply to pending matters where settlement talks had begun before the policy change was announced.

The impact of this change will depend on how frequently the SEC seeks factual admissions and the extent to which defendants resist such demands. Defendants typically are reluctant to make admissions due to potential collateral consequences. For instance, admissions may undercut the ability to defend companion private securities litigation, including shareholder class action suits. They also could serve as the basis for criminal prosecutions. White stated that when parties refuse SEC demands for admissions, the SEC is prepared to litigate when it concludes that admissions of wrongdoing are required to serve the public interest. In such cases, defendants face two unattractive options — accepting the harsh collateral consequences of admitted wrongdoing or confronting the financial and reputational risk of protracted litigation with the SEC.

Particularly following the financial crisis, the SEC's "no admit, no deny" settlement policy has been questioned. Among the critics are a handful of federal court judges who have hesitated before approving or have rejected high-profile SEC settlements. The most notable critic may be Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York, who initially rejected, then approved one settlement and later refused to approve another in a decision that is currently under review by the Court of Appeals for the Second Circuit. In the aftermath of such criticism, the SEC modified its settlement approach in early 2012 by announcing that it would no longer allow defendants who admit wrongdoing in connection with criminal proceedings to resolve civil SEC charges for the same conduct without similar admissions.[1]

White emphasized that the SEC's policy change was not a criticism of the traditional "no admit, no deny" approach. Indeed, she noted that the ability to seek such settlements will remain an important aspect of the SEC's Enforcement program. The SEC has argued that allowing it the flexibility of settling certain enforcement actions under circumstances where the defendant does not have to admit liability enables the SEC to resolve cases more quickly, preserves resources and avoids litigation risk.

Only time will tell how frequently the SEC will insist on admissions to resolve its claims. How often it does so, and whether potential defendants refuse, could have far-reaching consequences for both the SEC and those it regulates and investigates.

SEC Enforcement Trends

The change in SEC settlement policy may prove to be the first of many modifications the new leadership has in store for the Enforcement Division. Earlier last week, SEC Enforcement Co-Director Canellos provided valuable insights regarding other key aspects of the SEC's enforcement program under the new chairman, many of which are summarized below.[2]

Structural Issues

One of the most noticeable changes so far was White's appointment of co-directors for the first time in the Enforcement Division's history. Canellos explained that there has been no formal division of responsibilities or areas of focus between the co-directors — nor is such a division expected. While the most "significant" investigations might justify involvement from both co-directors, in other matters one or the other will take the lead. Canellos and Ceresney expect to work together closely and to be in constant communication with regard to enforcement matters.

Canellos indicated his view that having a former prosecutor as SEC chairman is a "good thing" for both the Division and those the SEC regulates. In an obvious understatement, Canellos noted that White "gets" enforcement issues. According to Canellos, White is more likely than other commissioners to focus on litigation risks and nuances such as whether evidence on which an enforcement recommendation is based would be admissible in litigation.

Enforcement Priorities

- *Asset Management*. Canellos expects the Asset Management Unit, one of five specialized units created within the Enforcement Division following the financial crisis, to remain active. He predicted it will continue to spawn more than its share of Enforcement matters. He

believes the unit is sized appropriately given the ascent of investment advisers and growth in assets under management.

- *Accounting Fraud*. Canellos expects Enforcement to increase its focus on suspected accounting and financial fraud. He does not, however, believe that a specialized "accounting fraud" unit is necessary. Instead, he favors having accountants from Enforcement and the SEC's Office of Chief Accountant help identify matters worthy of further investigation by Enforcement attorneys. These efforts will be aided by the (still aspirational) "accounting quality model" being developed by the SEC's Division of Economic and Risk Analysis. That model will use computer software to help the SEC discern whether financial statements signal potential accounting fraud. Until the model is operational, staff will continue to look for traditional indicia of potential accounting issues, such as restatements, auditor turnover and earnings management.

- *Insider Trading*. Canellos believes the "wave" of insider trading cases is not over, though he expects the number of future cases to be flat, in part because recent efforts resulted in so many enforcement actions. He mentioned investigations concerning so-called "political intelligence" firms as examples of such cases, though he noted that certain aspects of those inquiries present unique challenges to pursuing enforcement actions.

SEC/USAO Cooperation

Perhaps not surprisingly given that White, Canellos and Ceresney are former prosecutors, Canellos advocates continuing the SEC/USAO collaboration that has developed in recent years. He predicts the number of criminal referrals by the SEC will remain stable.

U.S. Attorneys' offices will, according to Canellos, continue to use wiretaps in appropriate cases. However, the evidence needed to obtain a wiretap authorization and the vast resources needed to sift through the resulting evidence necessarily limits the circumstances in which wiretaps will be used, he said.

Canellos identified two trends he expects to continue in the criminal arena. First, U.S. Attorneys' offices will pursue what formerly might have been considered only "marginal" criminal securities-related cases. Second, criminal prosecutors will become involved in SEC investigations

at early stages (often to pre-empt later requests from other U.S. Attorneys' offices).

Specialized Units

Canellos indicated that the Enforcement Division continually assesses the effectiveness and composition of its specialized units. While he does not perceive a need to create any additional units, he believes specialized units will remain an Enforcement fixture for at least two reasons. First, the complexity of certain products and industry practices requires expertise best developed through specialized units. Second, the units allow Enforcement to direct necessary attention to important programmatic areas and priorities.

Canellos explained that he believes specialized units have resulted in numerous cases that otherwise would not have been pursued, though he acknowledges the risk that specialized units could pursue increasingly marginal cases. He said avoiding that result requires both robust supervision and empowering junior staff with the discretion to make charging decisions, again drawing on the model of U.S. Attorneys' offices.

Wells Process/Charging Decisions[3]

Canellos favors more and earlier pre-Wells dialogue between Enforcement staff and defense counsel. He recognizes "obstacles" to that approach, however, including staff fears that doing so could delay investigations unnecessarily or subject staff to claims of unfairly "shifting" theories during the course of an investigation.

Enforcement has adopted a "scoring" technique that senior management use in quarterly reviews of open investigations. Staff score investigations from 1 – 3 based on how likely they are to result in an Enforcement recommendation. As investigations age, supervisors press staff to close or conclude those that are less likely to result in Enforcement actions. Canellos cited this review process as another reason defense counsel should engage in early dialogue with Enforcement staff about the merits of investigations.

Canellos generally supports providing defense counsel with access to the investigative record during the Wells and pre-Wells process, but he does not believe doing so should be mandatory. Instead, whether to do so

should be decided case by case, consistent with the goal of ensuring that the staff understands defense counsel's position and the SEC makes informed decisions. He encourages defense counsel to make surgical requests and to press the staff for additional information if necessary.

Canellos emphasized that whether to recommend enforcement action should not vary depending on whether the case will be settled or litigated. In either case, the relevant question is whether the SEC "should win" based on the evidence.

Other Predictions

Canellos indicated his view that Enforcement and the SEC's Office of Compliance Investigations and Examinations should increase their cooperation. While the result could be more Enforcement referrals, Canellos believes the SEC's response to issues uncovered during exams must be "calibrated" depending on the facts — ranging from counseling, to deficiency letters, to Enforcement investigations and, finally, to criminal referrals.

Regarding "whistleblower" awards, Canellos confirmed that a number of substantial awards are in the pipeline. Although Canellos indicated he was aware of one potential award that could approach $10 million, he believes whistleblower awards will fall short of the "avalanche" some have predicted.

Financial-crisis-era investigations are wrapping up, according to Canellos. He noted that senior Enforcement officials are focusing attention "aggressively" on concluding pending inquiries. At this point, Canellos thinks that to justify commencing a "new" investigation of financial-crisis-era conduct would require very compelling and unique facts.

Conclusion

These developments confirm that the newly installed team of White, Canellos and Ceresney will not hesitate to modify approaches — including adopting policies familiar to them from their work as prosecutors — and will put their own imprimatur on the SEC's Enforcement Division.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Jan. 7, 2012 statement by Enforcement Director Robert Khuzami, available at: http://www.sec.gov/news/speech/2012/spch010712rsk.htm.

[2] Canellos responded to questions during a June 17, 2013 forum of the Federal Bar Association's Securities Law Section in Washington, D.C.

[3] During the Wells process, named after John A. Wells, the lawyer who chaired the advisory committee that made recommendations to improve the SEC's Enforcement process, Enforcement staff provide counsel with a non-public "Wells notice" that they are considering recommending that the Commission authorize enforcement proceedings. The notice outlines the general nature of the potential violations, including the relevant statutes or regulations at issue and the contemplated relief. Prospective defendants are afforded the opportunity to provide a "Wells submission" designed to dissuade the staff from making the contemplated recommendation. If the staff pursue the enforcement recommendation, the Wells submission is provided to the Commission along with the staff's recommendation, known as an "action memorandum."

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