Client Alert

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Inside Baseball – SEC Enforcement Co-Chief Calls 'Em Like He Sees 'Em

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Led by a new team of co-directors, the Enforcement Division of the Securities and Exchange Commission (SEC) is poised to create new initiatives dedicated to efficiency, greater staff discretion and specialized areas of focus. This was co-director George Canellos' message as he addressed a panel of SEC alumni and other practitioners sponsored by the Federal Bar Association's Securities Law Section on June 17, 2013. While Canellos laid out some ambitious plans for the SEC, he stressed the limits of those plans and the challenges that the agency may face in implementing them. And he also tried to satisfy the attendees' desires to hear some Division "inside baseball."

1. THE NEW LINEUP

Canellos first discussed how the recent internal changes have affected the Division. Canellos and Andrew Ceresney were appointed as co-directors of the Enforcement Division by new SEC Chair Mary Jo White on April 22, 2013, marking the first time the Division has had dual leadership. Canellos reported that their new dynamic is working "seamlessly." Notably, the co-directors eschew strict divisions of labor and instead jointly handle policy and procedure issues and litigation matters.

Canellos did not expect significant changes to follow the appointment of Chairman Mary Jo White. White, an experienced trial attorney, is well equipped to make informed enforcement decisions, he said; in particular, she is able to identify nuances of a case that might affect the likelihood of success in litigation initiated by the Commission or other agencies, such as the Department of Justice (DOJ).

2. RISK ANALYSIS: CHOOSING WHEN TO SWING AWAY

Canellos plainly articulated his preferred standard for determining whether to bring a case: "should the Division win?" He believes the Division must have more than a colorable or non-frivolous claim or one that will survive a motion to dismiss; it requires a case backed by evidence sufficient to carry the day. Canellos also emphasized the need for a uniform standard to ensure that the decision to bring charges is not influenced by a party's willingness to settle.

This approach is reflected in the Division's measured response to new credit crisis actions. Canellos made clear that, during the crisis, the Division was not afraid to take action; even while partnering with the DOJ, the Division would often proceed on cases that the DOJ considered outside the "zone of criminal activity."

Today, however, given the recent Supreme Court decision in the *Gabelli* case (see the related Mofo Client Alert) rejecting a "discovery" rule on the SEC's five-year statute of limitations for obtaining a penalty, it appears less likely that the Division will initiate many new actions growing out of the credit crisis from five years ago. Canellos stated that a new investigation would be warranted only upon a strong lead alleging possible violations beyond the five-year statute of limitations and only when the alleged acts cry out for a prophylactic response by the SEC.

3. ENGAGEMENT WITH COUNSEL: CONFERENCE AT THE MOUND

The defense bar questioned the reluctance of SEC staff to engage with defense counsel prior to the issuance of a Wells notice. While Canellos acknowledged the unspoken policy among staff attorneys not to confer with defense counsel until all the evidence is gathered, he encouraged early dialogue, and suggested that when counsel believes that the case lacks merit, they should request an early meeting to discuss the theories of the case. He bemoaned the "top down" culture of the Division, and expressed support for broadening the discretion of Division staff. An increased sense of ownership and clear guidelines could facilitate communication while maintaining a consistent voice throughout the Division in interactions with defense counsel. He supports a deeper exchange of information before the Wells process where the circumstances so warrant.

4. EYE ON THE BALL: "RENEWED FOCUS" ON ACCOUNTING FRAUD AND FINANCIAL DISCLOSURE CASES

Although, as recently reported, the Division is intensifying its focus on accounting fraud and financial disclosure cases, Canellos does not see any need for a specialized unit. He believes that by shuffling resources, the Division can utilize accountants in regional offices without repurposing attorneys within the SEC.

According to Canellos, attorneys within the Division should remain "litigation-oriented," and rely on the Divisions' broader group of accounting specialists to focus on the red-flag issues in accounting and financial disclosures. In an effort to be proactive, the Division also plans to partner with other groups such as the Division of Corporation Finance and the Office of the Chief Accountant to find the "obscure" red flags that would bear fruit in an investigation. The Division is also developing an Audit Quality Model (AQM) that would identify particular risk factors that suggest accounting misstatements or insufficient disclosures. Examples include: a change in auditors twice in five years; a write-down in good will; or results that consistently do not differ by more than a certain percentage from earnings estimates Canellos did not commit to a date when the AQM would become operational.

5. FOUL TIP: DEFERRED PROSECUTION AGREEMENTS

Canellos indicated that the SEC is committed to using deferred prosecution agreements (DPA) in cases where a corporation has shown significant cooperation in accordance with the *Seaboard* factors. DPAs are used when the SEC is seeking forward-looking prophylactic relief to ensure corporate compliance. In contrast, a non-prosecution agreement is used to reward cooperation when no such relief is sought.

6. IN THE STRIKE ZONE: RISK BASED INITIATIVES AND OTHER EFFICIENCIES

Canellos spoke of improving efficiency of SEC investigations through risk-based initiatives. For example, by proactively surveying the accounting industry, the Commission can decrease the number of investigations that fail to develop into enforcement actions, thereby lowering costs on issuers and accounting firms, provided that it does not miss possible cases.

To improve efficiency, Canellos also advocated combining the Office of Compliance Inspections and Examinations (OCIE) with the Enforcement Division. According to Canellos, the Enforcement Division is capable of counseling issuers and accounting firms for minor or ambiguous violations. While the agency as a whole is split on this issue, certain regional offices already have the two groups under common management.

7. STEALING SIGNS: DEVELOPMENTS IN INSIDER TRADING

Canellos expects that the number of insider trading cases will likely remain constant for the foreseeable future. In response to a question regarding wiretaps, Canellos explained that, while those programs have been "hugely successful," they have limited use in most insider trading investigations. Wiretaps are incredibly resource-intensive, and work only where there are wired communications in cases involving organized groups of conspirators.

Canellos argued that the STOCK Act's usefulness is also limited because it does not adequately define a member of Congress's duty to keep confidential information private. He also feels that the Act is ambiguous as to whether a member may freely discuss legislation with industry officials and constituents, which is part of a member's job. Canellos stated that therefore ultimately the question might be whether the official directed information for a good or a bad purpose.

8. ASSET MANAGEMENT: THE SEC HITS A HOME RUN

Canellos addressed the recent explosion of '40 Act cases, noting the massive increase in broker dealers and assets under management. He recognized the Asset Management Unit as a prime example of successful specialization in the Division. This unusually complex and arcane area of financial regulation requires that specialists weed out potential violations that might otherwise go unnoticed. Though any specialized group may find itself pursuing increasingly marginal cases in times of calm, the danger is mitigated by the breadth of the asset management industry. When the limited focus of the group leads to diminishing returns, the resources may be shifted to a broader spectrum of issues that may uncover unanticipated cases.

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