

## WHAT'S NEXT FOR THE SEC?

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To Our Clients and Friends:

Recently confirmed as the chairman of the Securities and Exchange Commission, Mary Schapiro is poised to lead the SEC amid great uncertainty about the agency's effectiveness, scope of authority and potential regulatory restructuring. Although it is far too early to know exactly where Chairman Schapiro will take the agency or what initiatives or reforms she intends to pursue, her recent public remarks provide a small but significant window into what shifts we might expect to see in the SEC's regulatory and enforcement initiatives.

### AGGRESSIVE ENFORCEMENT: INCREASED RESOURCES, NEW TOOLS

Chairman Schapiro has left little doubt that one of her primary initiatives will be to reinvigorate the SEC's enforcement program. In her Senate confirmation testimony, Chairman Schapiro vowed to be "as aggressive an enforcer as anybody has ever been at the head of the SEC." She has punctuated this pledge by appointing a new Director of Enforcement, Robert Khuzami, an experienced federal prosecutor with significant experience in pursuing securities fraud and other white-collar crimes. He has pledged to "relentlessly pursue and bring to justice those whose misconduct infects our markets, corrodes investor confidence and has caused so much financial suffering." In view of these commitments by Chairman Schapiro and Enforcement Director Khuzami, participants in securities markets should anticipate significantly stepped-up enforcement and much closer scrutiny of their activities by a vigorous SEC.

Despite its criticism of the SEC at recent hearings, Congress seems prepared to support these intensified enforcement efforts. Pending legislation sponsored by Senator Charles Schumer and Senator Richard Shelby would provide \$110 million to hire 100 new SEC Enforcement Division employees, 500 new FBI agents and 50 new federal prosecutors dedicated to detecting, investigating and prosecuting financial fraud and white-collar crime.

High-profile financial scandals and economic turmoil have also fueled calls for more immediate and, from some fronts, drastic change at the SEC. In her first week, responding to some of these calls, Chairman Schapiro announced two policy changes intended to remove procedural hurdles that were widely blamed for delaying and reducing enforcement activity. One of those policy changes will make it easier for the staff to negotiate penalties against issuers. Therefore, expect more penalty cases and increased fines against issuers in the future.

In speeches and testimony, Chairman Schapiro also has indicated her support for the following modifications:

- Swifter and more forceful action on whistleblower complaints;
- An improved system for tracking and analyzing tips received by the SEC, with centralized control and review by high-level staff;
- Aggressive pursuit of temporary restraining orders and preliminary injunctions, to “stop fraud in its tracks;”
- A renewed focus within the SEC on risk assessment, including a fully reconstituted Office of Risk Assessment devoted to the task;
- Widespread sharing of intelligence among state, federal and self-regulatory organizations;
- Proactive analysis of new financial products, balancing the advantages of innovation against possible risks to the system;
- Strengthening the rights of shareholders, by allowing proxy access for “significant, long-time shareholders” and a rule that gives shareholders an advisory vote on executive compensation.

Chairman Schapiro is also said to be planning to look into whether the boards of banks and other financial firms conducted effective oversight leading up to the financial crisis, as well as considering asking boards to disclose more about directors’ backgrounds and skills, specifically how much they know about managing risk.

But there are some, even at the SEC, who believe that more dramatic change is warranted. At least one SEC Commissioner has expressed his view that the SEC should be granted an even broader expansion of enforcement powers. In a recent speech, Commissioner Luis A. Aguilar proposed that Congress should combat fraud by authorizing the SEC to prosecute criminal violations of the federal securities laws in cases where the Department of Justice has declined to bring an action. Commissioner Aguilar also believes that the SEC should have greater investigatory powers, including the authority to bring civil and administrative proceedings for violations of 18 U.S.C. § 1001 (the statute that is violated when someone lies to a government official), as well as the authority to seek civil money penalties when the SEC is lied to during the course of an investigation.

While Commissioner Aguilar’s statements reflect a widespread desire for change, Chairman Schapiro has not yet expressed a view on the more dramatic measures he has proposed. Furthermore, it is unlikely that the Department of Justice, which is primarily charged with overseeing criminal prosecutions, will easily cede its responsibility, nor is Congress likely to

enact new legislation granting enforcement authority to the SEC beyond its current civil jurisdiction over the federal securities laws.

#### OVERSIGHT RESPONSIBILITIES: FILLING THE GAPS

The current financial environment also has sparked many discussions about the government's oversight of securities and other financial products. At her confirmation hearings, Chairman Schapiro characterized the current approach to regulation as "stovepiped," with the lamentable result that certain categories of financial activity do not fall under any government oversight. To close these gaps, Chairman Schapiro has expressed her desire for federal regulation of all systemically important financial products and participants, as well as all products that can function as securities or economically substitute for securities, such as derivatives and municipal securities. This gap-closing measure includes her call for immediate federal legislation to require registration and disclosure of hedge funds. Chairman Schapiro has also stated her intention to strengthen risk-based oversight of broker-dealers and investment advisers, improving the quality of audits for non-public broker-dealers and promoting the safe and sound custody of customer assets by any broker-dealer or investment adviser. We can expect modifications in the SEC's inspection program and additional rules to address these issues.

Speaking more broadly, Chairman Schapiro announced her intention to pursue a transformation away from the current regulatory and enforcement model, in which agencies divvy up their oversight responsibility according to type of financial product. Instead, she would prefer a regime where regulators assess risks in the system from an investor or business-conduct perspective. As for the widely discussed possible merger of the SEC with the Commodities Future Trading Commission, Chairman Schapiro has stated her view that such a merger makes sense, but only if the new entity maintains the SEC model of focus on investors and markets, broad regulatory authority and vigorous enforcement, coupled with flexible exemptive power to permit dynamic regulation where needed.

#### OUTLOOK

While it is not yet clear which of the many proposals under consideration will come to fruition, the momentum for change seems certain to result in increased SEC activity, particularly in the enforcement arena. We will continue to update you as significant developments occur.

In the meantime, issuers and other participants in the securities markets would be well advised to assess their own mechanisms for compliance and internal controls, including their procedures for risk assessment and for responding to internal allegations of fraud or other misconduct. Corporate boards may want to consider establishing a risk committee if they have not done so already. Given the strong desire of Congress and Chairman Schapiro to

demonstrate more vigorous efforts to protect investors and prevent the recurrence of 2008's financial scandals, 2009 appears likely to be a year of heightened scrutiny and enforcement.

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