A NEW APPROACH FOR THE SEC—CRIMINAL ENFORCEMENT AND MANDATORY DISCLOSURE OF VIOLATIONS BY PUBLIC COMPANIES

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The United States Securities and Exchange Commission ("SEC") is hard at work remaking and re-energizing both its image and law enforcement role. It is also trying to ensure its survival as the premier agency overseeing the financial markets. It has assembled a new team at the helm, including a former federal prosecutor as head of the Enforcement Division and a new SEC Chairman, Mary Schapiro, who has committed herself to revitalizing the agency and has the Washington regulatory background to succeed.

The SEC had long taken its role as the "top cop" of the markets somewhat for granted. It's rather grand motto is "To Protect The Investor," and since its birth in the 1930's there had been no competitor to it in that role. But as this decade has unfolded, that mission has been both challenged and eroded. In the early part of the decade came the collapse of Enron and other assorted corporate fraud scandals that cost investors billions in equity. While it was never demonstrated that the SEC had negligently "missed" these debacles, there was always a concern why the industry regulator did not pick up early on the warnings buried in various financial filings, especially Enron's.

Then came the challenge of the state attorney generals who began chipping away at the SEC's turf. Foremost among them was Elliott Spitzer of New York, who used New York (not federal) law, including its criminal enforcement provisions, to outflank and

outgun the SEC in the policing of Wall Street. Spitzer famously self-destructed, but his successor, Andrew Cuomo, has taken up the mantle and continues to make headlines bringing cases that, in an earlier, simpler time, would have been handled by the SEC, if they were handled at all. Other aggressive state AG's, who are generally younger politicians looking for the brass ring to higher office, have followed suit. There has emerged a ragged patchwork of enforcement, including recurring but uneven criminal law forays into the securities law field by the United States Department of Justice ("DOJ"), which (unlike the SEC, which can bring only civil cases) carries the power to indict individuals or corporations, destroying careers and organizations if its so chooses to wield its enormous power.

More recently, the SEC was hit with the Bernie Madoff scandal, in which it appears that the enforcement staff for whatever reason may have missed or ignored various red flags of the kind that experienced investigators do not normally overlook. Most recently came the staff insider-trading allegations, emanating from the agency's own Inspector General, which generated world-wide headlines strongly suggesting that SEC employees were using their positions of trust to make illicit profits on the stock market. Likewise, the SEC seems frequently to find itself the target of certain politicians in Congress who regularly take shots at the agency.

The SEC will survive, and emerge stronger, from these challenges. It has solid leadership and a highly professional staff. It needs to consider the various internal management reforms that have been suggested by various astute outside observers, including streamlining the enforcement process, reorganizing the top-heavy staff structure of the Enforcement Division, prioritizing its cases, and making sure the

Commissioners themselves avoid any colossal mistakes or regulatory blunders which can open the doors to the next big financial debacle that no one today sees coming.

This observer, a former enforcement division trial lawyer who makes no claim to be an expert in the securities laws but perhaps has the detachment afforded one who saw the agency from the inside for awhile but was not there so long as to become a "career" SEC insider, here offers several "outside the box" suggestions which might help the SEC regain its footing as the top regulator of the financial markets.

FIRST, the agency needs to clean up the toxic implications left by the investigation undertaken by SEC Inspector General H. David Kotz into what he chose to call "suspicions of insider trading" by SEC enforcement attorneys. While it is understandable that no one at the SEC wants to tangle with its Inspector General, it is evident upon reading Kotz's March 2009 Report, even in heavily redacted form, that he failed to uncover any real evidence of insider trading by the two employees in question. In my opinion, there was actually very little evidence even to *suspect* them of such trading. Both employees reported or otherwise cleared the vast majority of their trades with the proper SEC officials, including, it appears, the very trades Kotz found so suspicious. Inside traders, and I have known, prosecuted and defended a few, do not go out of their way to report their trades, especially to the SEC itself. This "case" would never have made the first cut had it been reviewed by someone who knows anything about how you go about putting together a viable insider trading case. Unless IG Kotz is sitting on some smoking gun he chose to leave out of his report, which I doubt, his accusations and suspicions are little more than just that, and should never have been allowed to be portrayed by the media or Congress as evidence of actual insider trading.

The two SEC employees in question were careless in some respects, including their personal emailing on SEC time (of course none of us has ever done that, right?). It appears that on several occasions they traded in companies that later came under investigation. Likewise, the SEC's loose "honor system" compliance procedures needed a makeover to be sure, and the agency is taking steps to tighten them. But this falls far short of the allegations in the IG report of "suspicious activity, appearances of improprieties, and evidence of possible trading on nonpublic information, and/or insider trading." IG Kotz should never have referred the matter to the U.S. Attorney's Office, as he announced. He should have followed through on the investigation and, presumably, gathered the necessary evidence to either close it himself or present a real criminal case to the DOJ. Instead, the entire country, indeed the world, was treated to several news cycles of screaming headlines about corruption at the SEC which could seriously undermine the credibility of the agency and its staff, to say nothing of the permanent damage it did to the staffers themselves.

The Kotz Report was issued in early March. By now, some action should have been taken against these employees if there was anything to this matter. I suspect there is not, but the uncertainty lingers on. The SEC has recently announced reforms to the way it handles employee stock trading, including beefing up what was clearly an antiquated compliance effort. I would go even further than the agency has, and ban all trading of individual stocks by SEC officials and employees, other than mutual funds or exchange traded funds, so that there is no need to worry about trading in individual stocks. Most SEC staffers are, usually by financial necessity, small players in stocks, and there are just too many risks to them and the agency if they are free to trade in any individual stocks,

even those not under scrutiny by the agency. While at it, I think the entire federal workforce should be under similar restrictions, at least as to stocks that can be impacted by decisions made by their agencies, such as defense contractor stocks and DOD employees. The SEC should also review the allegations itself, or appoint a special counsel to do so, and move quickly to either sanction these employees, or clear them.

SECOND, the SEC, which will soon be receiving additional millions for enforcement staff under a new federal fraud fighting law, should invest some of that money in creating a criminal unit. This group could, with consultation from the enforcement staff, select cases which are serious enough to justify criminal prosecution, and seek speedy authority from the DOJ to investigate, indict, and prosecute such cases, assuming the DOJ itself declines to undertake the case. At least one SEC commissioner is on record favoring criminal authority, assuming the DOJ has chosen not to prosecute the matter itself (presumably, the DOJ will be loathe to allow the SEC first-line authority to bring criminal cases initially, which in my view would be the ideal situation). The SEC "criminal unit" would quickly become a central focus for criminal securities cases, establishing a benchmark of consistent standards as to what constitutes (in the government's view, at least) criminal conduct in regard to securities law violations. Today, there is too much randomness about who gets indicted and who does not, and many cases end up being settled as civil matters which could and should have been prosecuted criminally, while outlier criminal cases are brought randomly with draconian results for the handful of unlucky executives who happen to be involved. Likewise, giving the SEC criminal power would be just the deterrent "stick" it needs to put itself on equal footing with state attorney generals eyeing the SEC's historic turf.

THIRD, the SEC should consider adopting, by rule or statute, a relatively new tactic in federal law enforcement, which is putting the burden on the regulated parties to come forward when they have evidence of violation of the applicable law, or face suitable penalties. This approach has recently been adopted in the federal government contracting regulations, requiring that government contractors whose principal executives or mangers have "credible evidence" (but not necessarily hard proof) of violations of certain federal fraud and false claim laws must "timely disclose" such evidence to the government or face suspension or disbarment from federal contract eligibility. Similar rules for prompt (not more than 60 days) disclosure of any "misconduct [that] may violate criminal, civil or administrative law" has since 2003 applied as well to pharmaceutical manufacturers.

The SEC could require publicly traded companies under its jurisdiction to likewise disclose "credible evidence" of violations of the securities laws as an affirmative matter, not simply encourage them to make disclosure to get favorable treatment on penalties and fines, as is now the case. The voluntary approach has resulted in many companies confessing to violations of the Foreign Corrupt Practices Act, involving bribery of foreign officials. Likewise, many companies are quick to report uncovering financial or accounting fraud to the SEC, for fear of adverse treatment if they hold back. Thus, it can be expected that a mandatory disclosure requirement would enhance this trend and uncover a multitude of potential and actual violations. Failure to disclose could result in a range of penalties, including fines and penalties. Perhaps the most potent deterrent would be to require a company that does not disclose such violations, and is later found to have actually committed violations and hid them, to disclose that fact in its

filings and admit to it (not simply "neither admit nor deny" as the language usually reads now). This could expose violators to the scourge of private plaintiffs' litigation, in which an admission of withholding prior knowledge of wrongdoing could prove fatal to the company in a class action case, for example). I am not particularly a fan of such forced confessions, but given the trend has already arrived for drug makers and federal contractors, the SEC would be well advised to jump on the bandwagon. Such a rule would clearly put the onus on stock issuers, and their managements, lawyers and accountants, to install effective compliance programs to discover and report fraud promptly.

In short, the SEC has the personnel, the expertise and the resources to quickly regain its footing and momentum in the battle against corporate fraud. It should clean up the insider trading matter quickly, then consider these and other more aggressive steps to overcome detractors and re-take the initiative in the enforcement business. The investing public expects no less.