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CLIENT MEMORANDUM

New SEC Chairman Schapiro Announces Changes Aimed at Reinvigorating Enforcement Program

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In her first speech since becoming Chairman of the Securities and Exchange Commission, Mary Schapiro announced last Friday two steps designed to "reinvigorate" the SEC's enforcement program and "empower" the staff of the Enforcement Division. First, Chairman Schapiro announced that she would end a "pilot program" begun by her predecessor, Christopher Cox, which required the SEC staff to obtain Commission approval before beginning settlement negotiations in cases involving civil penalties against corporate issuers. Second, Chairman Schapiro stated that she would implement steps to ensure more rapid approval of formal orders of investigation, without which the SEC staff cannot issue subpoenas for documents or testimony.

Although these two changes could be viewed narrowly as affecting only SEC internal procedures, they are more properly viewed as intended to be part of a broader message to industry, investors and Congress that, under Chairman Schapiro's leadership, enforcement at the SEC will be swift and vigorous. In addition, these changes serve as a signal to the SEC staff, which of late has been subject to harsh criticism, that the Chairman supports their efforts and is willing to delegate increased authority to them. It remains to be seen how the end of the pilot program will impact the imposition of civil penalties in future cases before the Commission. It is likely, however, that as the Commission tries to reassert its status the nation's preeminent securities regulator and to preserve its future role in any legislative restructuring of the nation's financial regulatory system, the size of civil penalties against public issuers sought by the Commission will increase.

CIVIL PENALTIES

On April 13, 2007, then Chairman Christopher Cox announced the implementation of the pilot program for all cases in which the staff sought civil monetary penalties against public issuers. In all such cases, before the staff could begin negotiations with defense counsel, it was required to obtain the Commission's approval that a civil penalty was appropriate and obtain authorization to negotiate for a penalty within a specified range. Under previous practice, the staff had been free to negotiate all aspects of a settlement, including whether there should be a civil penalty and in what amount, before presenting its recommendation to the Commission. The pilot program was inapplicable to matters involving regulated entities.

Chairman Cox stated that the pilot program would increase the staff's leverage in negotiating settlements, would not cause delay, and would provide for increased consistency across cases. Since its introduction, the pilot program has been criticized on many fronts. Some viewed it as a cause of delay. Some believed it undermined the Wells submission process and required the Commission to make penalty determinations on a less than complete record. Others believed that the pilot program caused issuers to incur additional expense associated with preparing submissions to the Commission on penalty issues that could have been avoided if they had been allowed to negotiate a resolution with the staff. Some on the SEC staff believed the pilot program's diminution of their authority reflected a Commission that was distrustful of their judgment. In a speech on January 10, 2009, Commissioner Luis Aguilar contended that the pilot program had made the process "onerous," had led to delays, unneeded "layers of review", and "micro-managing." He also emphasized that the pilot program coincided with dramatically lower penalties. He urged Chairman Schapiro to end the pilot program as her first official act. She has now done so.

While the cause may not be entirely clear, the SEC has indeed imposed significantly lower civil penalties against issuers in recent years. The SEC issued guidance regarding civil penalties in January 2006 which set forth the nine factors it would consider in making penalty determinations with respect to corporate issuers. (See SEC Press Release 2006-4). In the pre-guidance period from 2003 to 2005, the average amount of the penalties imposed was approximately $80 million. Since the penalty guidance, the number of cases in which a penalty was imposed increased, but the size of the penalties imposed decreased. In 2006 and 2007, the average penalty imposed was approximately $38 million. The trend was even more evident in 2007, when the average penalty was approximately $18 million. In 2008, the average penalty fell below $15 million, and the highest penalty imposed against an issuer in any case was $25 million.

The decrease in the size of civil penalties is at least in part attributable to a change in the types of cases that have come before the Commission in recent years, as the Commission completed its dispositions in financial fraud cases involving conduct from the pre-Sarbanes-Oxley era. But other factors contributing to the decrease in civil penalties in recent years are the arguments that civil penalties unnecessarily inflict a second injury on innocent shareholders already harmed by corporate misconduct and that aggressive enforcement can decrease the competitiveness of U.S. companies in the global economy.

It would be wrong to think that the abandonment of the pilot program will itself lead to increased civil penalties. However, the fact that Chairman Schapiro chose to address civil penalties in her first speech suggests that, under her leadership, civil penalties are likely to receive renewed emphasis. As the Commission tries to reinvigorate its enforcement program amid uncertainty as to the future structure of the nation's financial regulatory system, it is likely that public issuers will face the prospect of increased civil penalties in SEC cases. The Commission will face the difficult challenge of how to balance properly the perceived need for deterrence with the strains civil penalties could have on companies already impacted by the economic downturn.

As a result, we believe that going forward, it will be more important than ever for issuers facing regulatory scrutiny to assess quickly the facts and law relevant to any governmental inquiry. Moreover, to minimize monetary sanctions, it may be increasingly important to be able to demonstrate to the SEC staff, in appropriate cases, that issuers are willing to cooperate with the staff's investigations, to remediate the effects of their conduct, and to improve any compliance procedures that may failed to detect the alleged misconduct.

OTHER INITIATIVES

In addition to Enforcement-related items, Chairman Schapiro announced the following initiatives:

- the formation of an Investor Advisory Committee to ensure that the Commission will be attuned to issues of concern to investors;
- improving the quality of credit ratings by addressing conflicts faced by credit rating agencies;
- promoting and regulating centralized clearinghouses for credit default swaps;
- strengthening risk-based oversight of broker-dealers and investment advisers; and
- improving audits of nonpublic broker-dealers and promoting the safe custody of customer assets.

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