

SHOULD THE SEC SPIN OFF THE ENFORCEMENT DIVISION?

PETER J. HENNING*

"It's only when the tide goes out that you learn who's been swimming naked." Warren Buffett.

The federal government's blueprint for financial reform in the wake of the market meltdown of 2008 involves strengthening the oversight powers of the Securities & Exchange Commission ("SEC" or "Commission"). Among President Obama's proposals is greater regulation of credit-default swaps, a multi-trillion dollar market that remains completely unregulated by any administrative body. In addition to new rules for the market, the financial reform plan will seek to "[e]mpower[] market regulators to take vigorous enforcement action against fraud, market manipulation, and other market abuses."¹

The government may be misguided in its decision to rely on the SEC as the primary civil law enforcement agency for the financial markets, however. Over the past few years, the SEC's record for policing fraud in the securities markets has not been stellar. The SEC's mishaps range from failing to uncover a Ponzi scheme² to a completely mismanaged insider trading investigation.³ There is even the possibility

* Professor of Law, Wayne State University Law School © 2009. The author may be contacted at peter.henning@wayne.edu.

¹ U.S. Dept. of the Treasury, *Strengthening Regulation of Core Markets and Market Infrastructure*, June 17, 2009, available at http://www.financialstability.gov/docs/regulatoryreform/strengthening_reg_core-markets_infrastructure.pdf.

² Former investment adviser Bernard Madoff received a 150-year prison sentence after confessing to an enormous Ponzi scheme. The government estimated that Madoff's scheme lasted decades and cost investors billions of dollars, yet the SEC still missed the warning signs regarding Madoff's conduct. See *Testimony of Linda Chatman Thomsen, Director, Division of Enforcement, United States Securities and Exchange Commission, Investigations and Examinations by the Sec. and Exch. Comm'n and Issues Raised by the Bernard L. Madoff Investment Securities Matter Before the United States Sen. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 5-6 (2009). The Commission's Inspector General issued a highly critical review of the SEC's various failed investigations of Madoff's investment advisory operation in which his Ponzi scheme flourished. See SEC, Office of Investigations, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme – Public Version*, Aug. 31, 2009, available at <http://www.sec.gov/news/studies/2009/oig-509.pdf>.

³ An investigation of possible insider trading at Pequot Capital Management was suddenly shut down and the lead investigator fired shortly thereafter. See Report of SEC Investigation, 153 CONG. REC. S10889-90 (daily ed. Aug. 3, 2007). At one point, the head of the SEC's Division of Enforcement showed particular deference to counsel for a witness with powerful Wall Street connections by providing reassurances about his role, even though he had not testified in the matter. *Id.*

that SEC staff engaged in insider trading.⁴ Yet, under President Obama's proposals, the SEC "appears a winner in the opening phase of financial services regulatory reorganization."⁵ Rewarding the agency that seemingly failed in its core enforcement function with additional regulatory powers is like asking General Motors to operate the entire American automobile industry. One wonders why the SEC's failures have resulted in a reward rather than a reconsideration of how the laws are enforced.

Despite its problems, the SEC could still get its "mojo" back as Wall Street's top cop. However, it is worth asking whether the enforcement function should be shifted away from the SEC and moved to an agency that can coordinate civil and criminal investigations without fear of outside influences. The problems the SEC experienced over the past few years in fulfilling its obligation to police the financial markets are traceable at least in part to pressure from Congress, the White House, and Wall Street to cut back on vigorous enforcement of the securities laws, especially the antifraud provisions. Furthermore, the agency has to police the very people it seeks out for advice and counsel in crafting its rules. Taking a hard look at whether the Commission can continue to serve as Wall Street's "top cop" is thus in order.

The current environment that is so supportive of increased regulation and enforcement will, at some point, pass from the scene as the pendulum swings back toward a less intrusive approach to oversight. Whether the Commission can resist renewed entreaties to go easier on enforcing the law in order to free the capital markets from strict regulation is an open question. To allow the SEC to regulate Wall Street, splitting off at least a portion of the enforcement function to an agency with expertise in prosecution, specifically the United States Department of Justice, is worthy of consideration.

Any decent financial planner would advise you to at least consider selling an investment when the market values it highly, especially when there is a possibility that the value will decline in the future. I worked in both the SEC Enforcement Division and the Criminal Division of the Department of Justice, so I am not pushing a particular institutional bias in favor of one over the other. My point is that this may be the time for the Commission to spin off the Enforcement Division to the Department of Justice to limit the possibility that enforcement of the major antifraud provisions of the federal securities laws will be hampered the way it has been in the recent past.

⁴ See United States SEC, Office of Inspector General, *2009 Semiannual Report to Congress*, at 40-42, available at <http://www.sec-oig.gov/Reports/Semiannual/2009/semiapr09.pdf>.

⁵ Stephen J. Crimmins, *Securities Regulation Under the Obama Plan*, 41 SEC. REG. & L. REP. (BNA) 1209, 1209 (June 29, 2009). The author notes that "[j]ust months after some were placing much of the blame for the financial crisis on the SEC's shoulders and questioning whether it was up to the task of fixing things, the Treasury Proposal now praises the SEC as 'an experienced federal supervisor'" *Id.*

I. THE SEC'S ENFORCEMENT FOCUS

The SEC states that its mission is “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”⁶ Among its primary functions is the oversight of the capital markets by, *inter alia*, regulating brokers, investment advisors, mutual funds, and market operators to ensure that capital is available and that securities are traded efficiently. The SEC adopts a wide range of rules, from net capital requirements for broker-dealers to disclosure regulations for publicly-traded companies, and its ongoing responsibilities include oversight of the operating procedures for the major stock exchanges.⁷ Under the Foreign Corrupt Practices Act, the SEC is responsible not only for overseas bribery cases involving public companies, but also for ensuring that companies whose shares are traded on stock exchanges maintain adequate accounting systems and internal controls.⁸ On top of all this responsibility, the Commission is seeking to expand its supervisory role by pursuing congressional authority to be put in charge of the securities-related over-the-counter derivatives market, which has an estimated market value of approximately \$6.8 trillion.⁹

All the standard regulatory work of inspecting broker-dealers and reviewing corporate and mutual fund filings comes before the SEC staff as part of its responsibility for oversight of the complex federal securities laws, such as the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Advisers Act of 1940, and the Investment Company Act of 1940.¹⁰ In addition to a number of technical provisions in these statutes, the Commission is also responsible for policing the markets under broad antifraud provisions, including § 78j(b) of the Securities Exchange Act, which prohibits use of “any manipulative or deceptive device or contrivance” in connection with the

⁶ See SEC, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation* (Sept. 22, 2009), available at <http://www.sec.gov/about/whatwedo.shtml>.

⁷ 15 U.S.C. § 78s(b)(1) (2009) (“Each self-regulatory organization shall file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such self-regulatory organization (hereinafter in this subsection collectively referred to as a “proposed rule change”) accompanied by a concise general statement of the basis and purpose of such proposed rule change.”).

⁸ See 15 U.S.C. §§ 78dd-3 (2009).

⁹ See *Testimony Concerning Regulation of Over-The-Counter Derivatives by Chairman Mary L. Schapiro, Before the Subcomm. on Securities, Insurance, and Investment of the Sen. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2009).

¹⁰ See 15 U.S.C. § 77a (2009); 15 U.S.C. § 77aaa (2009); 15 U.S.C. § 78a (2009); 15 U.S.C. § 80a-1 (2009); 15 U.S.C. § 80b-1 (2009).

purchase or sale of any security.¹¹ At the end of the 2008 fiscal year, the SEC had over 4,000 open investigations of securities law violations – more than one for each employee at the agency.¹²

In addition to its civil regulatory role, SEC Commissioner Luis A. Aguilar has even proposed that the authority to pursue criminal prosecutions for securities law violations be transferred to the Commission, because “[p]roviding the SEC with this authority would be an effective way to enhance the federal law enforcement of all securities law violations by expanding the amount of cases that may be brought.”¹³ By law, the Attorney General has the exclusive responsibility for criminal prosecutions by the federal government, an authority that is rather jealously guarded.¹⁴ It would be quite a change if one particular subject matter were carved out of the Department of Justice and moved to the agency responsible for drafting the regulations and overseeing the laws to be enforced. Such a shift in authority could even engender an impermissible conflict of interest.¹⁵

¹¹ 15 U.S.C. § 78j(b) (2009).

¹² See Select SEC and Market Data, Fiscal 2008, Table 4, available at <http://www.sec.gov/about/secstats2008.pdf>; SEC, The Investor’s Advocate *supra* note 6 (“The Commission’s approximately 3,500 staff are located in Washington D.C. and in 11 Regional Offices throughout the country.”).

¹³ Luis A. Aguilar, SEC Comm’r, Empowering the Markets [sic] Watchdog to Effect Real Results, Speech before the North American Securities Administrators Association’s Winter Enforcement Conference (Jan. 10, 2009), available at <http://www.sec.gov/news/speech/2009/spch011009laa.htm>. Commissioner Aguilar further suggested that:

[T]he SEC could use greater ability to bring cases against people who lie during the course of an investigation. Accordingly, Congress should grant the Commission the power to bring civil and administrative proceedings for violations of 18 U.S.C. 1001 and to seek civil money penalties. 18 USC 1001 is the criminal statute that is violated when someone lies to a government official.

Id.

¹⁴ 28 U.S.C. § 516 (2009) (“Except as otherwise authorized by law, the conduct of litigation in which the United States, an agency, or officer thereof is a party, or is interested, and securing evidence therefor, is reserved to officers of the Department of Justice, under the direction of the Attorney General”). See *United States v. Cox*, 342 F.2d 167, 190 (5th Cir. 1965) (Wisdom, J., concurring) (“The prosecution of offenses against the United States is an executive function within the exclusive prerogative of the Attorney General.”).

¹⁵ In *Young v. United States ex rel. Vuitton et Fils S.A.*, 481 U.S. 787, 805 (1987), the Supreme Court rejected the appointment of a party’s attorney to pursue a criminal contempt prosecution based on the violation of a court order. The Court stated that:

The Government’s interest is in dispassionate assessment of the propriety of criminal charges for affronts to the Judiciary. The private party’s interest is in obtaining the benefits of the court’s order. While these concerns sometimes may be congruent, sometimes they may not. A prosecutor may be tempted to bring a

In response to the recent perceived breakdowns in the enforcement process, Robert Khuzami was appointed as the new Director of the Enforcement Division.¹⁶ Mr. Khuzami's credentials were touted in an SEC press release: "Throughout his career, Rob has demonstrated an unwavering commitment to prosecuting wrongdoers and protecting citizens. As a former federal prosecutor, Rob is well-suited to lead the SEC's Division of Enforcement as we continue to crack down on those who would betray the trust of investors."¹⁷ Mr. Khuzami's outstanding record as a prosecutor includes working on a significant terrorism case, as well as securities fraud prosecutions.¹⁸ After leaving government service, he worked as general counsel for the Americas at Deutsche Bank, a multinational financial institution.¹⁹ What he is missing, however, is direct experience with the civil side of the SEC, including more arcane areas such as disclosure cases and delinquent filings. A good litigator can practice in a wide variety of areas, but the mindset of a prosecutor or in-house counsel is quite different from that of the civil regulator who must take into account the burdens of regulation and the need to allow some flexibility in the enforcement of voluminous regulations.

A recent initiative by Mr. Khuzami, with the Commission's support, gave the Enforcement Division the authority to issue formal orders of investigation without prior approval. Such orders would allow the staff to issue subpoenas for records and to require individuals to appear for testimony.²⁰ In *SEC v. Jerry T. O'Brien, Inc.*, the

tenuously supported prosecution if such a course promises financial or legal rewards for the private client. Conversely, a prosecutor may be tempted to abandon a meritorious prosecution if a settlement providing benefits to the private client is conditioned on a recommendation against criminal charges.

Id.

While not exactly the same, a similar issue could arise if the SEC were to have the authority to pursue both a civil and criminal action for an alleged violation of the federal securities laws. In such a case, might the Enforcement Division use the threat of criminal charges as a bludgeon to obtain a civil settlement, or to pursue a defendant who had won a victory in a case?

¹⁶ Press Release, SEC, Robert Khuzami Named SEC Director of Enforcement (Feb. 19, 2009), available at <http://www.sec.gov/news/press/2009/2009-31.htm>.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ See 17 C.F.R. § 200.30-4(a)(1) (2009); Robert Khuzami, Director, SEC, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009), available at <http://www.sec.gov/news/speech/2009/spch080509rk.htm>. In this speech, Mr. Khuzami explained the rationale for the change as prompted by a need for speed, and perhaps even a move to send a message to defense counsel not to mess with the SEC. He stated:

We are also streamlining our internal process to make us more nimble and quick. I am announcing tonight that the Commission has approved, subject to certain

Supreme Court noted that “[t]he purposes of such an order seem to be to define the scope of the ensuing investigation and to establish limits within which the staff may resort to compulsory process.”²¹ The former process required the Enforcement Division staff to get approval from the full Commission before it could issue subpoenas, a slow and bureaucratic process. Now, management in the Enforcement Division can authorize the formal order without further review, creating a much more streamlined process that is akin to the way the Department of Justice conducts grand jury investigations, which do not require any prior approval before subpoenas are sent to obtain records and testimony.²² The criminal investigatory model appears to be the dominant approach these days.

The apparent push to turn the Enforcement Division into a quasi-prosecutorial office²³ is interesting because the premium focus seems to be on pursuing enforcement cases that involve dishonest practices broadly affecting the

exceptions, an order that delegates to the Division Director the authority to issue formal orders of investigation, with their accompanying subpoena power. I in turn intend to delegate that authority to senior officers throughout the Division. Thus, staff will no longer have to obtain advance Commission approval in most cases to issue subpoenas; instead, they will simply need approval from their senior supervisor. This means that if defense counsel resist the voluntary production of documents or witnesses, or fail to be complete and timely in responses or engage in dilatory tactics, there will very likely to be a subpoena on your desk the next morning.

Id.

²¹ SEC. v. Jerry T. O'Brien, Inc., 467 U.S. 735, 738 n.1 (1984).

²² See SARA SUN BEALE ET AL., GRAND JURY LAW & PRACTICE § 6:2 (2d ed. 1993) (“In a majority of states and in the federal system the prosecutor plays a more significant role in using the subpoena power to marshal evidence for presentation to the grand jury. Although the statutes in these states do not explicitly address the question of whether the prosecutor must seek the grand jury’s authorization before exercising subpoena power, the general thrust of the provisions seems to be to give the prosecutor independent authority to issue subpoenas.”).

²³ On July 2, 2009, the SEC issued a press release touting the hiring of Lorin L. Reisner as Deputy Director of the Enforcement Division. Press Release, SEC, Lorin L. Reisner to Join SEC Enforcement Division (July 2, 2009), available at <http://www.sec.gov/news/press/2009/2009-150.htm>. Mr. Reisner will serve directly under Mr. Khuzami. *Id.* This press release described part of Reisner’s background as serving “as an Assistant United States Attorney for the Southern District of New York from 1990-94, where he investigated and prosecuted financial crimes, public corruption, organized crime, narcotics and firearms offenses.” *Id.* A month earlier, the SEC had appointed George S. Canellos Regional Director of its New York Regional Office, the most important office outside of the headquarters in Washington, D.C. Press Release, SEC, George S. Canellos Named Regional Director of SEC New York Regional Office (June 2, 2009), <http://www.sec.gov/news/press/2009/2009-125.htm>. Mr. Canellos was also a colleague of Mr. Khuzami in the U.S. Attorney’s Office in Manhattan, where he was a Senior Trial Counsel on the Securities and Commodities Fraud Task Force. *Id.* Serving in this previous position means he has substantial experience in the securities field, albeit on the criminal side, much like the primary focus of Mr. Reisner and Mr. Khuzami. *Id.*

markets, and not as much on the more mundane, although important, aspects of securities law enforcement. The majority of the SEC's enforcement cases are administrative proceedings, not federal court filings.²⁴ Thus, while insider trading and Ponzi scheme cases may garner the greatest media attention, it is the day-to-day administration of the federal securities laws that ensures the capital markets are operating properly. While the prosecutorial model may appease members of Congress and the public who want heads on platters after the Madoff debacle, that is not necessarily the SEC's role as the primary regulator of the capital markets.

Criminal prosecution is usually reserved only for the most serious cases, and is not a tool to be used unreflectively or in response to public outcries. Unlike a civil enforcement action, a criminal prosecution triggers a wide range of constitutional rights, most prominently the due process requirement that the charge be proven beyond a reasonable doubt. If there is a conviction, then the court is empowered to inflict significant punishment on the defendant, including a term of imprisonment. An SEC civil enforcement action is usually not designed to punish a person, but instead is a remedial proceeding to protect the public and seek disgorgement of ill-gotten gains to return to those who suffered losses. Criminal and civil proceedings are not interchangeable, and involve significantly different considerations. There is a good reason why they are handled separately, even if there is significant overlap in the underlying facts and legal theories.

II. THE SEC AND THE NATURE OF CIVIL ENFORCEMENT

Making the SEC more like the Department of Justice by turning the Enforcement Division into a new type of United States Attorney's Office may not be the best way to advance the SEC's role as the overseer of the capital markets. The enforcement function may be among the SEC's better known operations, but it is certainly not its only purpose. The SEC's regulatory role in adopting rules for the markets and companies has far greater impact on the markets, because it shapes the way Wall Street operates on a day-to-day basis.

When it engages in rulemaking, it is important for the SEC to listen to its constituencies, which include not only small investors, but also investment banks, brokerage firms, mutual funds, stock exchanges, and even the oft-reviled hedge funds and private equity firms. Lobbying the SEC is not necessarily improper because the Commission has to balance the needs of different constituencies, not all of whom have the same goals. The SEC routinely turns to leaders on Wall Street and broader investment communities for advice, which is important in fulfilling its investor protection and market integrity mandates. For example, Bernie Madoff was

²⁴ See Select SEC and Market Data, Fiscal 2008, Table 2, available at <http://www.sec.gov/about/secstats2008.pdf>.

a member of the SEC Advisory Committee on Market Information along with other leaders of investment banking firms, broker-dealers, and academics.²⁵

While the SEC solicits the views of the firms it regulates, it also must enforce its rules in cases involving proceedings against firms led by the same people it looked to for counsel. Separating these two functions cannot be easy, and in the case of Madoff, his standing at the SEC undoubtedly gave him a veneer of propriety that easily could have discouraged staff members from asking the kind of hard questions that would have led to the unraveling of his massive Ponzi scheme.²⁶ Separating out at least some of the enforcement function from the regulatory process would lessen the likelihood that a person could turn access to the SEC into a type of “free pass” from close scrutiny of violations of the federal securities laws.

When firms are accustomed to advocating to the SEC their position on how to craft a rule, they will not shy away from using the same pressure tactics to resist an enforcement action. Moreover, they will happily recruit allies on Capitol Hill who have shown a proclivity for getting involved in the SEC’s operations. When enforcement is but one among the many functions of an agency, it can be hard for its constituents to distinguish between the different roles and to understand that what is appropriate in one area might not be appropriate in another. The enforcement operation should operate largely free from the public eye, but such privacy is hard to achieve when so much of the SEC’s activity is open to the public and subject to outside persuasion.

²⁵ See SEC, *Report of the Advisory Committee on Market Information: A Blueprint for Responsible Change* at n.221 (Sept. 14, 2001), available at <http://www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm>.

²⁶ The SEC Inspector General’s Report reviewing the SEC’s failed inquiries into Madoff’s operation showed that the staff did not perform such basic functions as reviewing account and bank records to ascertain the scope of the investment advisory business. OIG Madoff Report, *supra* note 2, at 456. Such simple steps would have almost immediately revealed the fraud. The Report concluded that:

The OIG investigation found that the SEC received numerous substantive complaints since 1992 that raised significant red flags concerning Madoff’s hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading and should have led to a thorough examination and/or investigation of the possibility that Madoff was operating a Ponzi scheme. However, the OIG found that although the SEC conducted five examinations and investigations of Madoff based upon these substantive complaints, they never took the necessary and basic steps to determine if Madoff was misrepresenting his trading. We also found that had these efforts been made with appropriate follow-up, the SEC could have uncovered the Ponzi scheme well before Madoff confessed.

Id.

This raises a more fundamental question: is the Enforcement Division a law enforcement agency or a vehicle to enforce the SEC's rules and vindicate its interests as an advocate? The distinction is important because we expect a prosecutor to be neutral and detached, described in the ABA Model Rules of Professional Conduct as a "minister of justice."²⁷ If the enforcement function is a means to advocate on behalf of the SEC, then its lawyers are like any other attorney representing a client and seeking the best outcome possible within the bounds of the law. On the other hand, if the Enforcement Division is more of a prosecutor than an advocate, then its oversight should differ from that of other divisions in the SEC. Such differentiation, however, does not appear to exist.

Not only is the SEC subject to interest group lobbying, but even within the agency the decisions of the Enforcement Division must be approved by the same five Commissioners who adopt the rules being enforced.²⁸ Unlike the Department of Justice, which is not responsible for enacting the criminal laws it enforces, the SEC both makes the rules and enforces them. Indeed, the SEC also has the authority to police the attorneys who appear before it in an investigation or in litigation, which raises the question whether the SEC might use its disciplinary authority improperly.²⁹

While the SEC is the primary civil regulatory agency responsible for enforcement of the federal securities laws, a violation of those provisions can also result in a criminal prosecution if the defendant's violation is "willful."³⁰ The SEC

²⁷ MODEL RULES OF PROF'L CONDUCT R. 3.8 cmt. [1] (2007) ("A prosecutor has the responsibility of a minister of justice and not simply that of an advocate.").

²⁸ 17 C.F.R. § 202.5(b) (2009) ("After investigation or otherwise the Commission may in its discretion take one or more of the following actions: [i]nstitution of administrative proceedings looking to the imposition of remedial sanctions, initiation of injunctive proceedings in the courts, and, in the case of a willful violation, reference of the matter to the Department of Justice for criminal prosecution.").

²⁹ See Julie Andersen Hill, *Divide and Conquer: SEC Discipline of Litigation Attorneys*, 22 GEO. J. LEGAL ETHICS 373 (2009).

³⁰ 15 U.S.C. § 78ff(a) (2009), the codified version of Section 32 of the Securities Exchange Act of 1934, provides:

Any person who willfully violates any provision of this chapter (other than section 78dd-1 of this title), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than \$5,000,000, or imprisoned not more

and the Department of Justice frequently bring parallel civil and criminal cases, often filing them on the same day.³¹ Parallel proceedings have become a staple in corporate criminal cases, but it is fair to question the purpose being served by bringing both types of actions, especially if the SEC is acting as a prosecutor rather than a civil regulator.

If the Enforcement Division should be operating like a United States Attorney's Office, which seems to be the thrust of recent changes in its operations, then why should the civil portion be separated from the criminal? Perhaps it would be better to put the civil and criminal functions in a single office, which could then decide whether to pursue one remedy or the other. The creation of such a single office might diminish the need for a "land grab" by two competing bureaucracies, each seeking to vindicate its own interests or to garner its share of the spotlight. Such unification might also allow the SEC to avoid engaging in meaningless exercises of its regulatory authority, such as issuing an order barring Bernie Madoff from ever associating with a broker-dealer firm and disclosing the order on the same day he was sentenced to a 150-year prison term.³² Given Madoff's prison sentence, is his future association with a broker-dealer firm a real concern?

III. SHOULD THE SEC SPIN OFF THE ENFORCEMENT DIVISION?

Making the Enforcement Division more of a prosecutorial office raises the question whether prosecutorial activity is appropriate for a civil regulatory agency. Criminal prosecution involves considerations that are not necessarily relevant in civil cases, including the presumption of innocence, the need for imposing punishment, and the allocation of scarce prosecutorial resources. If the goal is to bring more securities fraud cases, whether they involve insider trading, accounting fraud, or Ponzi schemes, then simply reorienting the Enforcement Division to be more aggressive will not ensure that result. Instead, why not transfer the enforcement function for larger securities fraud cases to the Department of Justice and allow the

than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding \$25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

³¹ For example, on October 16, 2009, the SEC filed a civil action against a group of defendants for trading on inside information, the same day the Department of Justice filed a criminal complaint against the same defendants charging them with securities fraud based on the same trading. *See* SEC v. Galleon Mgmt., L.P., No. 09-CV-08811 (S.D.N.Y.), *complaint available at* <http://www.sec.gov/litigation/complaints/2009/comp21255.pdf>; United States v. Rajaratnam, No. 09-MAG-2306 (S.D.N.Y.), *available at* <http://www.justice.gov/usao/nys/hedgefund/rajaratnamrajetalcomplaint.pdf>.

³² *See* In the Matter of Bernard L. Madoff, Admin. Proc. No. 3-13520 (SEC June 16, 2009), *available at* <http://www.sec.gov/litigation/admin/2009/34-60118.pdf>.

SEC to focus more on regulation of the capital markets and enforcement of the rules that pertain to those areas?

Such a transfer of civil enforcement authority would not be the first time that an administrative agency has shared this function with the Department of Justice. Antitrust regulation is divided between the Federal Trade Commission and the Antitrust Division, and there is a division of authority regarding different types of transactions subject to review by one or the other.³³ In the health care fraud area, the Department of Justice conducts investigations and litigation regarding Medicare and Medicaid fraud along with the Department of Health and Human Services.³⁴

One obvious benefit of transferring at least some of the SEC's civil enforcement function to the Department of Justice would be lessening the ability of Wall Street to lobby for a weaker enforcement regime. While the SEC is in close touch with the constituencies it regulates, these constituencies do not have similar clout with the Attorney General. Moreover, funding for the Enforcement Division is only one part of the larger SEC budget, which has been subject to cutbacks when the SEC's regulatory efforts come under fire. Since it is politically less palatable to cut the Department of Justice's budget, funding for securities law enforcement would be more secure. However, the Department of Justice is not immune to lobbying or political interference with its operations, a fact demonstrated by the regime of Attorney General Alberto Gonzales.

If the civil and criminal enforcement operations were housed in one agency, there could be a greater coordination of cases. For more serious securities law investigations, the grand jury could be used for its broad powers to compel the

³³ The Federal Trade Commission explains the division of authority in this way:

Both the FTC and the U.S. Department of Justice (DOJ) Antitrust Division enforce the federal antitrust laws. In some respects their authorities overlap, but in practice the two agencies complement each other. Over the years, the agencies have developed expertise in particular industries or markets. For example, the FTC devotes most of its resources to certain segments of the economy, including those where consumer spending is high: health care, pharmaceuticals, professional services, food, energy, and certain high-tech industries like computer technology and Internet services. Before opening an investigation, the agencies consult with one another to avoid duplicating efforts.

FTC, *An FTC Guide to The Enforcers* (July 8, 2008), available at http://www.ftc.gov/bc/antitrust/factsheets/FactSheet_FedEnforcers.pdf.

³⁴ See 18 U.S.C. § 3486(a) (authorizing the Attorney General to issue a civil subpoena for the production of documents and testimony in an investigation of any health care offense); *Sliding Down the Slippery Slope? The Future Use of Administrative Subpoenas in Criminal Investigations*, 73 *FORDHAM L. REV.* 2251, 2265 (2005) ("In 1996, as part of HIPAA, Congress further entangled civil and criminal investigatory processes by granting the Attorney General the power to issue administrative subpoenas for use by the FBI in federal health care fraud investigations.").

production of evidence and appearance of witnesses. For more narrowly confined cases, civil subpoenas could be used to obtain information, particularly in cases involving corporations and investment firms that can be expected to be cooperative, at least initially. Rather than having both criminal and civil investigators piling into a case, the Department of Justice could take a more measured approach and determine which avenue, if any, to pursue in its case.³⁵

Any transfer of the civil enforcement function would require congressional authorization to permit the Department of Justice to issue civil subpoenas and pursue the remedies that only the SEC is currently authorized to seek. In addition, Federal Rule of Criminal Procedure 6(e) on grand jury secrecy would need to be modified to take into account the sharing of information gathered in a criminal investigation for possible use in a civil enforcement act.³⁶ It would be useful to keep the authority to pursue administrative proceedings in the SEC and to limit the Department of Justice's authority to only federal court actions. The Department of Justice would focus on violations of the antifraud provisions of the federal securities laws, while the SEC would continue its role in crafting regulations and using the administrative process to enforce them.

Shifting the enforcement authority over fraud cases away from the SEC would involve costs. The impact on the staff morale would be significant, especially for those in the Enforcement Division, which would have to shrink. Fewer opportunities for synergies between different divisions would exist if a significant portion of the enforcement function were no longer lodged in the agency, especially those types of contacts that occur on an informal basis among staff members who see one another on a regular basis. On the other hand, removing a portion of the enforcement authority from the SEC could have a beneficial effect if the Commission were able to devote greater resources to its core regulatory function, while relying on another agency to carry forward the prosecutorial role.

³⁵ Perhaps the model used for tax investigations could be adapted to the securities field. In tax cases, a revenue agent conducts a civil investigation until there are "firm indications of fraud," at which point the criminal division takes over the case and the civil investigation must shut down. *See Internal Revenue Manual* § 25.1.3.1.1 (2009); *see also* *United States v. Peters*, 153 F.3d 445, 454 (7th Cir. 1998) ("Continuation of audit activities after the revenue agent begins preparation of the fraud referral also may be indicative of an agency attempt to gather information for a criminal prosecution while keeping the taxpayer in the dark as to the true nature of its investigation. (citation omitted) Indeed, the Manual clearly directs a revenue agent to suspend her activities at the earliest opportunity after developing firm indications of fraud."). It may be that such a division of authority could work in the securities area so that those being investigated have a better idea of where the government believes the case is headed in order to respond accordingly, rather than assuming that every case could go criminal and therefore being much more circumspect in any contacts with the government.

³⁶ Current Federal Rule of Criminal Procedure Rule 6(e) only provides that certain limited persons must not disclose a matter occurring before the grand jury. FED. R. CRIM. P. 6(e)(2)(B) (2009).

IV. CONCLUSION

I am not so naïve as to think that the SEC is out there shopping its Enforcement Division, and am aware that any proposal to share the enforcement authority for securities fraud would likely draw bitter opposition from the Commission and its supporters, particularly those on Capitol Hill who might lose some of their oversight authority. Who wants to give up authority, especially when it can be used to generate nice headlines in the *Wall Street Journal* and *New York Times*? Getting a decent appraisal for the Enforcement Division or a fairness letter from an investment banker to support a spin-off may be more difficult.

President Obama's push to enhance regulation of the financial markets calls for rethinking not only what should be subject to greater government oversight, but who should be enforcing the rules. When an agency does not fulfill its mission, as Chairman Mary Schapiro has candidly admitted, then it may be time to ask whether a more radical approach should be taken to enforce the federal securities laws. In five years, will there be a push to cut back on the regulatory structure and resultant enforcement regime? Moving enforcement of the antifraud provisions to the Department of Justice would not necessarily ensure better policing of the markets, but it might diminish the likelihood that there would be the oversight failures like the ones we have seen over the past few years.