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Robert Khuzami Engages in a Question and Answer Session at SIFMA June Luncheon

On June 28, 2011, Robert Khuzami, Director of the Division of Enforcement at the U.S. Securities and Exchange Commission (SEC or the Commission), engaged in a question and answer session moderated by Richard Walker, Managing Director and General Counsel of Deutsche Bank, at the SIFMA Compliance and Legal Society June Monthly Luncheon (SIFMA Luncheon). The following provides an overview of the questions posed and Mr. Khuzami's remarks at the SIFMA Luncheon.

Mr. Walker opened the discussion by asking Mr. Khuzami how much more inventory of cases the SEC has from the financial crisis and questioned when the SEC can close this chapter. Mr. Khuzami noted that the credit crisis cases are a high priority for the SEC. The Commission has used many resources, especially with respect to challenging cases like those concerning structured products. Although Mr. Khuzami could not answer how large the inventory is, he did note that some cases might run up against statute of limitations issues.

The next question addressed the press' criticism of the Commission for not holding senior executives accountable in some cases. Mr. Walker noted that the SEC has charged about 50 individuals, but asked what accounts for the gap between charging low- and high-level individuals. Mr. Khuzami offered that the SEC has had a pretty impressive record of charging mortgage originators, including IndyMac, Countrywide, Schwab, State Street and Evergreen, to name a few. Although the Commission has not yet charged heads of investment banks, which Mr. Khuzami noted is a barometer for success by some critics' measure, he commented that criminal authorities have also not brought cases against these high level executives, even after taking long, hard looks at these potential cases. Additionally, in Mr. Khuzami's view, the fraudulent activity is not necessarily happening at the highest levels of an organization, especially in the structured products sector; rather, the activity is happening two and three levels down, where products are manufactured and sold. Accordingly, it is difficult to reach into the highest levels of organizations unless there is tangible evidence of fraud there.

Mr. Walker then asked on what basis the SEC could hold a corporation responsible for the acts of lower level employees. Mr. Khuzami replied that respondeat superior, a broad principle, could provide the basis and is not a significant hurdle to the Commission holding a corporation liable.

When Mr. Khuzami was next asked whether the nine-figure penalties in two recent cases that were based on single transactions set a new benchmark for the Commission, Mr. Khuzami responded in the negative. He remarked that the transactions ranged from low million dollar transactions to $2 billion transactions and, consistent with penalty guidance, the penalties can get big. Moreover, Mr. Khuzami noted that if investors are defrauded, the exposure to these companies can be even greater. In these two cases, for example, the starting figures for the penalties were high because the Commission provided fair funds to the harmed investors.

Mr. Walker followed up by providing the example of Satyam Computer Services, and questioned the $10 million penalty as low considering that, in his view, the fraud was so obvious. Mr. Khuzami noted the practical considerations of dealing with a foreign company located in India, and then distinguished the Satyam case as one where the Indian government intervened and imprisoned the senior management involved in the fraud. Mr.

Walker then asked whether there was cooperation in that case that dropped the penalty from nine figures to eight. Mr. Khuzami commented only that, among many factors that went into the Commission's decision, the response by the Indian government was swift and certain in this specific case.

Mr. Khuzami's comments led Mr. Walker to his next question regarding cooperation. Mr. Walker noted that the Commission has followed the practice of the Department of Justice with its recent use of deferred prosecution and non-prosecution agreements, and asked what the Commission's view is on these tools. Mr. Khuzami remarked that these tools have worked well for the SEC. The Commission used a deferred prosecution agreement first in the case against Ternaris, S.A., and then a non-prosecution agreement in the case against Carter's, Inc. Despite the success of these tools, Mr. Khuzami noted that defense attorneys might be reluctant to enter into such an agreement based on the lack of track record the Commission has using them. Moreover, most defense counsel would question how entering into one of these agreements could affect a criminal proceeding, and the Commission has said that it will interface with the Department of Justice about these cases.

Mr. Walker followed up and asked how these various tools—cooperation agreements, non-prosecution agreements, and deferred prosecution agreements—differed from each other. Mr. Khuzami admitted that the Commission has not provided a lot of information on these tools and that there has not been enough transparency around their use. All told, the Commission wants people to know that by using these tools, they are getting the benefits of cooperating. Moreover, the SEC is now standardizing agreements with certain terms so that people can expect uniformity and less disparity in similar situations. When asked who in the Commission ensures fairness in the use of these agreements, Mr. Khuzami responded that the SEC and the parties are required to lay out the reasons for the cooperation agreements, which are then vetted by a Cooperation Committee of six officers, each which has a Department of Justice background. After the Cooperation Committee makes a determination, the agreement is then vetted through other committees before the Commission renders its final determination. Mr. Khuzami also clarified that these agreements are being used at the individual and corporate levels, the benefit of which is to ensure that the charge against a party is eliminated.

Next Mr. Walker asked Mr. Khuzami about what products and activities worry him today. Mr. Khuzami remarked on the various categories that concern him. First, the usual insider trading, accounting fraud and broker-dealer violations will always concern him. Second, deal valuations are an issue, especially with the LinkedIn IPO that had a spike in the market with low yields for investors. Third, Mr. Khuzami noted that there is limited transparency in the markets with respect to high frequency trading, algorithmic trading, and manipulations through momentum-driven strategies. Fourth, he noted that although the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) will help provide transparency about structured products, like reverse convertible notes, ETFs and derivatives, these products remain of interest and concern. In the asset management world, valuation, conflicts of interest and preferential redemption issues can be concerning. Finally, within the retail space, he is mindful of mutual fund issues, microcap fraud, and, with respect to gatekeepers, lawyers and broker-dealers not fulfilling their duties.

The conversation then turned to how the Commission is implementing the new whistleblower statute. Mr. Khuzami remarked that the Commission has an Office of Market Intelligence (OMI), made up of four individuals, that handles the front-end work flow. Whistleblowers submit complaints on a form, which are input into a database so that the OMI can locate information, see trends and triage the complaints. Mr. Khuzami noted that before the Dodd-Frank whistleblower statute went into effect, the SEC got 30,000 tips per year. In the last 12 months, the OMI has not seen a great increase in this number, and has even seen a higher quality of tips and complaints, which Mr. Khuzami believes reflects, at least in part, that people are understanding which complaints will be most viable after Dodd-Frank. Mr. Khuzami also discussed the strict anonymity provisions of the statute, which restrict the Commission from wholesale referring complaints to the subject companies to handle internally. Rather, the SEC handles some of the complaints on its own and communicates with the subject companies about others. Nevertheless, Mr. Khuzami noted that many whistleblowers still choose to handle their complaints

internally within their companies. Whistleblowers who handle a complaint internally actually are benefitted by doing so; because they are given 120 days to file with the SEC and their complaint is related back to the time it is filed internally, they get the benefit of seeing all documents that the company provides the SEC, and may also get an increased award. Mr. Walker closed this portion of the program by questioning what disincentives are in place to stave off frivolous whistleblowing. Mr. Khuzami noted that, among other things, (1) whistleblowers have to submit their complaints under penalty of perjury or, if they proceed anonymously, they must have a lawyer who attests to the truth and accuracy of the complaint, and (2) interfering frivolously or not acting cooperatively can have the effect of reducing a whistleblower award.

Audience Questions and Answers

Mr. Khuzami concluded his remarks by addressing a handful of audience questions. The first question circled back to Mr. Khuzami's comment about respondeat superior, and questioned what provides the basis for a case on respondeat superior liability. Mr. Khuzami responded that the Commission evaluates a company's processes, policies and procedures to determine whether they were designed to prevent the problem at issue. Mr. Khuzami provided an example of cases where firms have allowed low-level employees to re-use pitch books and deal term templates without taking certain nuances of the deals into consideration. Although Mr. Khuzami called this a "poor model," he noted that the firms involved in these cases have gone back to strengthen their processes.

Another audience member asked Mr. Khuzami about the pressures of operating under the watchful eye of Congress and questioned the Commission's ability to close cases in this environment. Mr. Khuzami noted that the same concerns currently exist in all federal agencies. With respect to closing cases, the SEC has set up processes to ensure they have gathered all the necessary information and have done a thorough review of the evidence so that if the Commission is ever challenged, the Commission Staff (Staff) can say "we took all the right steps." Additionally, Mr. Khuzami noted that the Staff is professional and dedicated, and that its recommendations are subject to a great amount of input to make sure Commission decisions are well-founded.

Mr. Khuzami was then asked to comment on the Commission's thought process about whether to bring administrative proceedings or injunctions in federal court. Mr. Khuzami remarked that under Dodd-Frank, the SEC has plenary authority in administrative proceedings and can get complete relief. He noted that there are additional remedies that the SEC can seek in a federal court, such as the appointment of a receiver and equitable relief, but the Commission does not have a list of criteria for bringing one or the other at this point.

The final question asked of Mr. Khuzami was regarding his comment at a speech a few weeks ago where he spoke about defense bar practices that concerned the Commission. Mr. Khuzami noted that certain practices worry the Commission, such as multiple representation of clients within the same corporation that have been coached to give remarkably consistent stories and views of events during their testimony. He commented that the Staff is aware of these issues and is sensitive to them, and the Commission is willing to raise concerns to defense counsel and internally to have a dialogue about them. Mr. Khuzami did remark that the SEC has not found this occurring with all defense counsel, but did find it worth noting.

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