

Commentary: The Long Arm of the SEC

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With the Great Recession slowly grinding to a halt and Bernie Madoff safely locked away for several lifetimes, the national spotlight has momentarily shifted away from the SEC and its quest to bring all fraudsters to justice. More than six months after Mary Schapiro's appointment to the SEC's top post, focusing on the SEC's recent enforcement efforts can shed some light on whether future violators will be deterred by the Commission's new regime.

Philosophers and legal theorists have argued for centuries over the purpose of enforcement and punishment. The arguments arise over how much of the benefit of punishment is deterrence of future crimes, and how much is "eye for an eye" retribution. Those who believe that the primary goal of punishment should be deterrence argue that people will break the law as long as the reward is greater than the risk. If only one in five thousand car thieves went to jail, then more people might consider taking a joy ride from time to time. By contrast, responding to unlawful behavior with swift and harsh punishment increases the risk involved and thus deters potential violators. Those who argue for punishment mainly as a form of retribution generally just want to see the punishment fit the crime, with limited concern for the punishment's greater social impact.

Schapiro's goal from the start appeared to be deterrence of future violations through tougher enforcement today. Since taking over as SEC Chairman in late January, Schapiro has made enforcement a top priority. Summing up the Commission's enforcement philosophy shortly after taking office, Schapiro quoted former SEC Chairman and Supreme Court Justice William O. Douglas, saying the SEC must "have the 'shotgun behind the door ... loaded, well-oiled, cleaned, ready to use, but with the hope that it will never have to be used.'" To better arm the Commission for the battles to come, Schapiro appointed Robert Khuzami, a former federal prosecutor, as the new Director of the Division of Enforcement.

Schapiro has a history of being tough on crime. Any firm that has been the subject of NASD or FINRA examinations can attest that the heat was turned up significantly after Schapiro took over as head of NASD in 2006. Fortified by Schapiro's reputation and spurred on by some tough talk early on, what has the Division of Enforcement accomplished in 2009?

Enforcement's 2008 results serve as a useful benchmark. In the fiscal year ended September 30, 2008, the Commission brought 671 enforcement actions, the second-highest number in its history. The SEC also collected more than \$1 billion

for Fair Fund distributions to investors. In the last three months of 2008, the Commission continued to vigorously pursue fraud in the auction rate securities and subprime mortgage markets.

The results so far in 2009 indicate that Schapiro and Khuzami have followed through on their early promises. In June, Schapiro testified before the Senate Subcommittee on Financial Services and General Government regarding Enforcement's progress. For the period from February through May 2009, the Commission opened 66 more investigations and issued 114 more formal orders than during the same period in 2008. Emergency filings in the form of requests for temporary restraining orders, typically related to Ponzi scheme cases, rose 283% during the February through May time period, undoubtedly in response to the fear generated by the Madoff case. Enforcement also cast a wider net during the first half of 2009, charging 527 defendants from January through June, compared to just 317 during the first half of 2008.

The Division of Enforcement has continued its crusade in the second half of 2009, announcing a myriad of actions, including injunctions halting a \$45 million Ponzi-like scheme in California and a \$50 million offering fraud and Ponzi operation in Detroit. Charges brought against Bank of America relating to the executive bonus scandal resulted in a \$33 million settlement, pending court approval. The Division of Enforcement also recently took its fifth enforcement action related to the Madoff mess when it charged Frank DiPascali, the former Madoff Chief Financial Officer, for his role in the massive fraud. So, what should we make of the ramp-up in enforcement activity?

Analyzing the SEC's enforcement blitz can lead to two opposing conclusions. At first blush, an increase in enforcement activity appears to be a good sign – more criminals being caught and punished means fewer remain to commit future violations. On the other hand, the continuing increase in enforcement may reveal that potential violators are not being deterred. Although the SEC prosecuted at near record levels in 2008, the numbers show a significant increase in the number of securities violations being committed or continued in 2009.

For the moment, the Commission's focus on enforcement may seem like exacting retribution for the victims of the investment community's recent sins. The increase in SEC prosecutions in 2009 is likely a response to securities law violations set in motion long before Schapiro and Khuzami took their current jobs, therefore it may be too early to tell whether the SEC's actions will have the deterrent effect Chairman Schapiro intended. I believe that punishment's true value lies in its ability to deter, and I think we will see the deterrent value of the SEC's 2009 enforcement crackdown in 2010 and beyond.