



Working with the SEC

Introduction

On November 28, 2007, members of the European and North American Audit Committee Leadership Networks met for the second time. In conversation with Treasury Secretary Henry M. Paulson, Jr., and Securities and Exchange Commission (SEC) leadership alumni, members discussed the competitiveness of global capital markets, regulatory balance, and the governance of sustainability.¹ Members also set out their audit committees' priorities for 2008, which include reviewing enterprise risk management, the evolution of the internal audit function, and the increasing importance of information technology (IT) risk. For further information on the networks, see "About this document," on page 8.

The first session at the summit focused on how to work more constructively with the SEC, and members were joined by:

- **Mr. Roel Campos**, Partner in charge of the Washington office of Cooley Godward Kronish and SEC Commissioner from 2002 to 2007
- **Mr. Steve Cutler**, Executive Vice President and General Counsel of JPMorgan Chase and Director of the SEC's Division of Enforcement from 2001 to 2005
- **Mr. Bill McLucas**, Partner and Co-chair of the Securities Department of WilmerHale and Director of the SEC's Division of Enforcement from 1990 to 1998.²

Network members participating in the meeting, who sit on the boards of more than 40 large-, mid-, and small-cap public companies between them, included:

- Mr. Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Mr. Per-Olof Eriksson, Audit Committee Chair, Volvo
- Mr. Gene Fife, Audit Committee Chair, Caterpillar
- Mr. Jan Hommen, Audit Committee Chair, ING
- Mrs. Judy Richards Hope, Audit Committee Chair, Union Pacific
- Mr. Laban Jackson, Audit Committee Chair, JPMorgan Chase
- Dr. DeAnne Julius, Audit Committee Chair, Roche Holding
- Mr. Oscar Munoz, Audit Committee Chair, Continental Airlines
- Mr. Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Ms. Pam Patsley, Audit Committee Chair, Texas Instruments
- Sir Ian Prosser, Audit Committee Chair, BP
- Ms. Guylaine Saucier, Audit Committee Chair, Areva
- Dr. Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr. Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services

¹ See also Audit Committee Leadership Summit, "Discussion with Treasury Secretary Hank Paulson," *ViewPoints*, January 23, 2008, available at http://www.Tapestry_EY_Summit_View4_Jan08.PDF, and "Commentary on the governance of sustainability," *ViewPoints*, January 23, 2008, available at http://www.Tapestry_EY_Summit_View5_Jan08.PDF.

² For short biographies of the three guests, please see the appendix on page 9.

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Members from Ernst & Young participating in the discussion included:

- Mr. Tom Flannery, Americas Director, Audit Committee Communication
- Mr. Steve Howe, Americas Managing Partner
- Mr. Tom McGrath, Managing Partner, Northern Europe, Middle East, India and Africa Client Service
- Mr. Christian Mouillon, Managing Partner, Continental and Western Europe Client Service

ViewPoints reflects the networks' use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations. However, Msrs. Campos, Cutler, and McLucas have given permission for their comments to be attributed. Their comments represent their personal opinions and do not reflect those of their current organizations.

Executive summary

The second Audit Committee Leadership Summit brought together the European and North American Audit Committee Leadership Networks to continue a discussion on the theme of regulatory balance begun at the February 2007 summit and continued in a subsequent North American network meeting in September 2007. In the February meeting, SEC chief accountant Conrad Hewitt joined members for a discussion on the future of financial reporting. Members raised concerns over issues such as review work (comment letters), enforcement, and extraterritoriality.³ In the September meeting with John White, the director of the SEC's Division of Corporation Finance, "Many members ... commented on the growing distance they sense between public companies and the SEC."⁴

Members also proposed that discussions with the SEC should include the Division of Enforcement. As one member explained before the meeting, *"I think the issue that we all face is that Enforcement colors all aspects of our relationships with the SEC."*

The discussion on November 28 covered the key questions outlined below, with further detail on subsequent pages:

- **Has the SEC become more aggressive in its approach, or less?** (*Page 3*)

All three guests said the increased aggressiveness of the SEC could be traced back to the high-profile accounting scandals of the early 2000s. They also pointed to the structure of the SEC, which puts a lot of power in the hands of the permanent staff. A number of audit chairs have commented that the increase in SEC staff after the accounting scandals has inevitably led to more, but not necessarily better, enforcement activity. The guests differed on whether the SEC had softened its approach in the last year or so, with Mr. Campos and Mr. Cutler citing the decline in penalties in fiscal 2007 and Mr. McLucas cautioning that although the agency might be in the process of changing, it was slow work.

³ Ernst & Young and Tapestry Networks, "Enhancing trust and competition in global capital markets," *ViewPoints*, April 6, 2007. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Summit_View1_Apr07.PDF.

⁴ Audit Committee Leadership Network, "Regulatory balance: a dialogue with John White," *ViewPoints*, October 19, 2007, 5. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Oct07_View17.pdf.



- **What is the global impact of the SEC’s approach?** (Page 5)

Members were particularly concerned that the SEC’s approach to enforcement is making the U.S. public equity market less attractive to foreign companies, with record numbers of European companies delisting from U.S. exchanges. Mr. McLucas agreed that the perceived inflexibility of U.S. regulators was a problem. Mr. Campos pointed out that it was perfectly reasonable for companies to delist if they are not active in the U.S. markets and spoke positively of the increasing influence of European regulators on their U.S. counterparts. Mr. Campos also suggested that a move to adopt International Financial Reporting Standards (IFRS) in place of U.S. Generally Accepted Accounting Principles (U.S. GAAP) for U.S. companies might help create an impetus for culture change at the SEC, since IFRS – which is principles based – would require SEC staff to accept the use of professional judgment by companies and their auditors. However, European members believe that the SEC will become the de facto regulator and interpreter of the IFRS, and are concerned that the SEC will not respect the degree of professional judgment required by IFRS.

- **How can companies and their boards improve their relationship with the SEC?** (Page 7)

All the members participating in the discussion agreed that they want to build better relationships with the SEC. The three guests suggested that audit committee chairs could encourage their companies to meet with the commissioners, heads of division, and individual staff “*on the ground floor*” to show the SEC the company’s human face and develop a good working relationship in advance of any problems being identified. Audit chairs themselves could also meet with SEC commissioners and staff and should not be put off if their initial approach is not accepted.

Has the SEC become more aggressive in its approach, or less?

According to the SEC, “The Division of Enforcement assists the Commission in executing its law enforcement function by recommending the commencement of investigations of securities law violations, by recommending that the Commission bring civil actions in federal court or before an administrative law judge, and by prosecuting these cases on behalf of the Commission.”⁵ In terms of resources, the Government Accountability Office (GAO) recently conducted a review of the Division of Enforcement and reported, “The Sarbanes-Oxley Act of 2002 substantially increased SEC’s appropriations, and Enforcement subsequently increased its staffing levels.”⁶ Audit chairs have commented that the increase in SEC staff has inevitably led to more, but not necessarily better, enforcement activity.

Accounting scandals led to an increase in aggressiveness

All three guests believe that the increased aggressiveness of the SEC could be traced back to the accounting scandals of the early 2000s. Mr. Campos said, “*The SEC reacted to the public outrage. It’s easy to forget how bad things were with retail investors. Congress was very concerned that retail investors would stay home. The U.S. is very retail investor based, and our liquidity depends on this. Even very developed*

⁵ Securities and Exchange Commission, “The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation.” Available at <http://www.sec.gov/about/whatwedo.shtml>.

⁶ Government Accountability Office, *Additional Actions Needed to Ensure Planned Improvements Address Limitations in Enforcement Division Operations* (Washington, DC: Securities and Exchange Commission, 2007), 10. Available at <http://www.gao.gov/new.items/d07830.pdf>.

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economies like the U.K. are not as retail based. We wanted to keep money out of socks and mattresses.” Mr. McLucas agreed: “[The] companies that failed had world-class management, accountants, lawyers, and boards. The SEC staff asked, ‘Who can we trust? The auditors? The lawyers? Because it couldn’t be the board or management.’ The reality is that ... if the SEC had not ramped up aggressiveness, they would have been found wanting.”

However, there were differences of opinion regarding whether that increase in aggressiveness had now subsided. Mr. Campos stated, *“That mission has mostly been done. The SEC has become less aggressive. ... The [fiscal 2007] penalties assessed were less than in any previous year.”*⁷ The types of sanctions that Enforcement can seek on behalf of the SEC include monetary penalties or fines and disgorgements of the profits that individuals or companies may derive from having committed securities violations. An increasing number of cases appear never to reach the penalty stage. A report on SEC enforcement by the law firm Foley & Lardner stated, *“In the current fiscal year (beginning October 1, 2006), 74% of cases were settled at the time of filing; compared to 64% in 2006, 48% in 2005 and 67% in 2004. Criminal indictments have declined since 2004.”*⁸ Mr. Campos added, *“The SEC issues large parking tickets, but it doesn’t put companies out of business.”*

Mr. Cutler agreed that *“the storm has abated”* and told members, *“I think the SEC has shifted a lot. In the absence of the backdating issue, you would have seen a big diminishment of enforcement. The world at the SEC today is not as bad as you think it is.”* Mr. McLucas commented, *“Steve [Cutler] has said the SEC’s tenor has changed. I would say it’s changing.”* He added, *“It will be a long march back out of the past.”*

SEC structure and culture play a part

The three guests agreed that the structure of the SEC puts a lot of power in the hands of the permanent staff, who are often more skeptical than the appointed Commission. Mr. Cutler said, *“There is a divide between the staff and the Commission that is different [from the situation at] other regulatory agencies. The staff at the SEC has more power than [staff at] any other agency. Some of it is Sunshine Act related. As the commissioners can’t meet together, the staff becomes the conduit and repository for information within the organization.”* Mr. McLucas felt that the divide between the Commission and the staff also contributed to the lag in the staff’s response to the public debate about the competitiveness of capital markets: *“Messages sent on U.S. competitiveness have been lost at certain levels within the SEC.”*

Members noted a seeming reluctance on the part of SEC staff to engage in dialogue with companies and their boards. One member reported, *“As audit committee chair, I offered to meet with regulators ... They*

⁷ More details on the decline in penalties assessed can be found in David Scheer and Jesse Westbrook, “SEC Penalties Fall Amid ‘New Ethos’ on Company Fines,” *Bloomberg.com*, November 19, 2007. According to the report, “U.S. Securities and Exchange Commission sanctions fell to the lowest level since 2002 after Republican commissioners complained that heavy penalties hurt investors and the agency brought fewer billion-dollar accounting fraud cases. The SEC ... extracted about \$1.6 billion in fines and illicit profits in the year ending Sept. 30, compared with more than \$3 billion in each of the previous three years, according to a report the regulator released Nov. 15. In 2002, when Congress passed the Sarbanes-Oxley corporate governance law, the total was about \$1.4 billion.” However, the article also reports that “the SEC brought 656 cases in fiscal 2007, 14 percent more than the previous year, according to its Nov. 15 report.” Available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJKCRZoXEz7l>.

⁸ Foley & Lardner, “SEC Enforcement Trends.” Report presented to the sixth annual National Directors Institute in Chicago, March 8, 2007. Available at http://www.foley.com/files/tbl_s31Publications/FileUpload137/3990/SECEnforcementTrends.pdf.

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said, *‘We don’t see any point in meeting with the audit committee chair.’ That was an interesting response. There is no conflict, but also no communication. I was kindly disinvented.*”

The SEC’s culture, particularly as compared with the cultures of other U.S. and European regulators, was a theme of both summit meetings. One U.S. audit chair said, *“People appreciate that [the SEC is] tougher when things go badly. But they’re [also] tougher when we’re not doing things wrong ... The reputations of human beings and companies are at stake. When the issues are gray, why can’t we talk about them?”*

The lack of dialogue may also impact the number of cases that remain open. The GAO reported that “about two-thirds of Enforcement’s nearly 3,700 open investigations as of the end of 2006 were started two or more years before, one-third of investigations at least five years before, and 13 percent at least 10 years before ... Other data suggest that the number of aged investigations that did not result in an enforcement action may be substantial.”⁹ Russell Ryan, a former assistant director in the enforcement division and now a partner at King & Spalding, described the dilemma in *Compliance Week*: “[Issuers] think an investigation is over, but don’t dare to call the staff for fear of prompting renewed interest in the case ... It’s a particular concern for public companies who have already disclosed that they are under investigation and would like to inform the market that the investigation is no longer a potential issue.”¹⁰

Mr. Campos provided some insight into the SEC’s culture, saying *“The SEC does not have the view that they’re out to get corporate America. They have diligent employees, but no one is trying to find cases. There is always a ‘scandal du jour’ – backdating and now, perhaps, subprime.”* However, Mr. McLucas responded, *“Can the SEC move the ball and have a dialogue like you’d get from a European regulator?”*

What is the global impact of the SEC’s approach?

Members were particularly concerned that the SEC’s approach to enforcement is making the U.S. public equity market less attractive to foreign companies. One European member said, *“If I’m a Russian or Chinese company, the last place I’d look to list would be the U.S.”* Another European audit chair warned, *“The world doesn’t need U.S. money; the U.S. needs the world’s money.”* A U.S. audit chair agreed: *“The perception worldwide is ‘don’t go to the U.S.’”*

Delistings continue to grow

Just days after the summit, the Committee on Capital Markets Regulation issued its second report on the competitiveness of the U.S. public equity market and stated, *“Foreign delistings rose to 30 in 2006 – 6.6% of all listed foreign companies. Through October 2007, a record 56 foreign companies (including major European companies) – or 12.4% of listed foreign companies – have delisted.”*¹¹ Mr. Campos addressed the question of delisting directly. *“A lot of companies listed on the NYSE were in the U.S., but not active in*

⁹ Government Accountability Office, *Additional Actions Needed to Ensure Planned Improvements Address Limitations in Enforcement Division Operations*, 21.

¹⁰ Melissa Klein Aguilar, “Report: SEC Must Improve Enforcement Operations,” *Compliance Week*, September 25, 2007. Available to subscribers at http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=3675.

¹¹ Committee On Capital Markets Regulation, “The Competitive Position of the U.S. Public Equity Market,” December 4, 2007, 3. Available at http://www.capmktreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf.

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the U.S. market or developing a U.S. investment base. I have always supported the ability to delist if there is no shareholder base here, so we made it easier to do, and many companies have taken that way.”¹²

A study by Columbia professor Jack Coffee compared the proportion of total SEC resources spent on enforcement with a similar spend by the Financial Services Authority (FSA) in London. He found that whereas the FSA typically spends about 12–13% of its total budget on enforcement, the SEC spends 38–41% of its budget. Prof. Coffee concludes, “The United States pursues securities law violations with a regulatory intensity unmatched elsewhere in the world. This intensity probably contributes to the U.S.’s lower cost of equity capital and probably explains (at least in part) the valuation premium that cross-listing foreign firms experience ... [It] also explains the unwillingness of many foreign firms to enter the U.S. market.”¹³

Mr. Campos said that because of the large number of retail investors in the United States, “*the U.S. regulatory structure has always been more of an enforcement approach.*” He continued, “*Chinese companies are coming to the U.S. because the NYSE or NASDAQ brand gives them a worldwide push. They take advantage of our lower cost of capital ... There is up to a 35% premium for stocks [listed in the United States] due to our protections. If you want to grow [by acquisition], you can do deals more nimbly.*”

European influence on U.S. regulators

Mr. Campos also spoke of the increasing influence of European regulators on their U.S. counterparts. “*The SEC is now a prudential regulator for investment banks. Safety and soundness is the mission, not enforcement ... This approach came about from the influence of Europe, the U.K., and the European Union. They wanted us to oversee investment banks through a consolidated approach.*”

Mr. Campos also suggested that adoption of IFRS in place of U.S. GAAP for U.S. companies, a move that the SEC is currently considering,¹⁴ might stimulate culture change at the SEC since IFRS would require SEC staff to be more accepting of the use of professional judgment by companies and their auditors. Mr. Campos commented, “*Having IFRS adopted, with a principles-based approach, will force the SEC to be in dialogue, or they won’t be able to deal with IFRS at all.*”

European members believe that the SEC will emerge as the de facto regulator and interpreter of IFRS, at least until Europe gets an equivalent regulator. They are wary about the SEC’s respect for the degree of professional judgment required by IFRS. One European audit chair commented, “*[We need] to understand how the SEC will train its own staff to handle IFRS as a principles-based approach that [their] enforcement [approach] does not fit.*”

¹² According to the SEC’s 2007 Annual Report, “In March 2007, the Commission approved changes to rules for foreign private issuer deregistration eliminating conditions that had been considered a barrier to entry. The rules provide foreign private issuers with greater flexibility in accessing and exiting U.S. capital markets, encouraging participation in U.S. markets and providing increased investor choice.” Available at <http://www.sec.gov/about/secpar/secpar2007.pdf#sec1>.

¹³ John C. Coffee, Jr., “Law and the Market: The Impact of Enforcement,” May 7, 2007, 70. Available at <http://www.law.upenn.edu/academics/institutes/ile/SeminarPapers/Coffee,%20Law%20and%20the%20Market.pdf>.

¹⁴ On August 7, 2007, the SEC published a “concept release” – a document seeking input regarding public companies’ interest in being able to prepare financial statements either in accordance with IFRS or U.S. GAAP. The comment period closed on November 13, 2007. The concept release is available at <http://www.sec.gov/rules/concept/2007/33-8831.pdf>.

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The theme of respecting professional judgment is also emerging from the SEC's Committee on Improvements to Financial Reporting (CIFI_R), which is looking at drivers of accounting complexity. The Standard Setting Subcommittee of CIFI_R wants "to defuse the fear of second-guessing by replacing it with a willingness to respect reasonable, good faith judgments made following an agreed-upon professional judgment framework."¹⁵

How can companies and their boards improve their relationship with the SEC?

All the members participating in the discussion agreed that they want to build better relationships with the SEC. One U.S. member remarked, "*We have met the enemy and he is us. We need to be the solution. If we build quality into our systems to avoid more Enrons, there will be nothing for the SEC to do. Even with best efforts to build quality into the system, the SEC doesn't listen. We need to try to improve things systematically for all public companies.*" Msrs. Campos, Cutler, and McLucas proposed several ways in which companies could build a better relationship with the SEC:

- **Meet with the commissioners.** Mr. Campos said, "*It is useful to pass on your perceptions ... The current softening is Commission driven.*" Mr. McLucas concurred: "*Work from the Commission down to senior staff. [Make the point that] companies, boards, and management are doing this for all the right reasons ... That should overlay communication to senior staff people and the Commission: that the people in the dialogue are putting their own reputation and economic self-worth on the line.*"
- **Meet with senior management.** Mr. Cutler said, "*I always think of [one particular individual from a leading investment bank]. He came to the SEC once a quarter and roamed the halls. He met with the heads of Market Regulation and Enforcement. Did he have an agenda? Of course he had one. But he was helping us by telling us what was going on out there. He turned it into something that was useful for us ... No one could think about [the investment bank] without thinking about [him]. He was seen as a good guy with integrity.*"
- **Meet with staff.** Mr. Cutler said, "*I advise senior management to meet with regulators whenever they can. It is critical to establish a relationship, a human face, in the absence of a problem. You don't want the regulators to see you as a faceless institution.*" He also suggested, "*These people are human beings. Start with the positive. If you go in with 43 things they're doing wrong, they'll tune out. Start by telling them they're doing some good things.*" Mr. McLucas added, "*If you can do it with the oversight divisions, it helps, as people can have a view of the character of people and the enterprise.*" However, one European member cautioned, "*In the U.S., it quickly becomes a legal issue, and ... the lawyers wouldn't want management to talk to the SEC.*" To the audit chair whose invitation to meet staff had not been accepted, Mr. Cutler said, "*I encourage you to keep pushing for the meetings and do them.*"
- **Consider escalating specific problems to the Commission or senior management.** Mr. Campos said, "*As a group, I urge you to write thoughtful letters to the Commission about staff unfairness, or where there are irritations. You can influence that.*" However, Mr. McLucas recommended caution: "*You have to weigh the benefits versus the consequences. It gets to the issue of*

¹⁵ Standard Setting Subcommittee, "Report for Discussion at November 2, 2007, Full Committee Meeting," 3. Available at <http://www.sec.gov/about/offices/oca/acifr/acifr-sc2-report.pdf>.

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disconnect between the staff and the Commission. It's a slow process of shifting the mind-set at the staff level. You have to win the heart and mind of the person on the ground floor first.”

Conclusion

The need for regulatory balance has been a major theme of the North American and European Audit Committee Leadership Networks for several years. Most recently, the focus has been on the SEC and the possibility of creating internal culture change that moves the regulatory agency to a more prudential, risk-based relationship with the issuing community. The SEC appears to be moving beyond the fallout of the immediate post-Enron era. If, as Mr. Campos has suggested, adoption of IFRS in the United States results in the SEC staff having greater respect for the professional judgments of boards and their auditors, then such a move may represent a real opportunity for companies and their boards to engage in the deeper, more relationship-driven dialogue with SEC staff that they desire.

About this document

The Audit Committee Leadership Networks in Europe and North America are groups of audit committee chairs drawn from leading global companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives this document may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European and North American Audit Committee Leadership Networks. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.

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Appendix: Short biographies of guests

Mr. Roel Campos was sworn in as an SEC commissioner in August 2002 and only returned to the private sector in 2007. During his service at the SEC, Commissioner Campos presided over hundreds of complex enforcement cases and also participated extensively in the crafting and adoption of all of the SEC's major regulatory initiatives. He also served for four years as the Commission's liaison to the international regulatory community. He is now partner in charge of the Washington office of Cooley Godward Kronish.

Mr. Steve Cutler was head of the Enforcement Division at the SEC from 2001 to 2005. During this period, Mr. Cutler oversaw the agency's investigations of some of the largest financial reporting failures in the nation's history, including those at Enron, WorldCom, Adelphia, Qwest, and Tyco. Before joining the SEC as deputy director of Enforcement in 1999, Mr. Cutler was a partner at Wilmer, Cutler & Pickering, and he returned there in 2005. In 2007, he took the position of executive vice president and general counsel at JPMorgan Chase.

Mr. Bill McLucas joined the SEC's Division of Enforcement in 1977 and rose through ranks, eventually serving as director of Enforcement for eight years, from 1990 to 1998. He remains the longest-serving Enforcement director in Commission history. Mr. McLucas led the Division's staff in numerous high-profile investigations and landmark enforcement actions. He currently serves as partner and co-chair in the securities department at WilmerHale, where he represented the special committees of UnitedHealth Group, Nortel Networks, Enron, and WorldCom.